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Financial Literacy 101: Five Key Components

Financial literacy is about understanding how the different areas related to money, work, and life function independently and together. Breaking the parts down and taking consistent action keeps you on top of the issues, helps you get ahead, and can lessen stress and worry when something unplanned inevitably happens.

The U.S. Treasury's Financial Literacy and Education Commission has come up with a useful framework for tackling finances and gaining literacy called MyMoney Five.

Using their framework as a guide, here are some quick tips to help newer students build their financial literacy. If you're experienced and consider yourself financially literate, then the framework can act as a checklist to make sure you've got all the basics covered.

Maximizing What You *Earn* – and What You Keep

Salaried or self-employed, growing income and earning more depends on hard work, luck and growing your skills routinely. That said, your compensation package includes more than your earned income. In addition to your paycheck, you may have healthcare benefits, the opportunity to contribute to a tax-advantaged retirement savings plan (with or without an employer-matching contribution), and even the opportunity to participate in an employee stock option plan (ESOP). All of these can be extremely valuable.

In the midst of the hustle to earn more, looking after yourself can get missed. But taking care of yourself physically and mentally by using your healthcare benefits is one of the best financial investments you can make. Don't put off checkups or treatment, and don't overlook alternative, non-invasive wellness treatments, like physical therapy or acupuncture, that may also be covered and can help keep you earning.

When you are earning money, there are ways to save on the taxes owed on those earnings -- qualified retirement plans, for example. Whether through a company-sponsored plan or a SEP IRA, a good target is 15% of your salary, but even smaller amounts contributed early in your career will have a big impact later on, due to the power of compounding. If your company offers an employer matching contribution, be sure to contribute enough to make yourself eligible for the matching funds.

Maximizing your benefits and minimizing your taxes are two sides of the same coin. Contributions to a 401(k) or other tax-advantaged retirement plan will lower your income – and your taxes – in the year in which you contribute. Other benefits paid for with pre-tax dollars will do the same. These could include a transit plan, a healthcare savings account (HSA), or a flexible spending account. Be sure to review and actively select or skip any benefit offered, and do so annually as your situation will change.

Spend Smart – and Avoid Lifestyle Creep

The first step in managing your spending is creating a budget. Budgets have two components – the non-discretionary costs you have to spend every month (think: mortgage, student debt payments, food, rent, utilities, insurance, etc.) and the discretionary items you have control over. Different kinds of software and apps are available for tracking, organizing and presenting expenses. If you're more of a spreadsheet person or even if you prefer writing on notecards, go with that. Any system that you will use consistently is valuable.

One useful strategy is to set up different bank accounts for discretionary spending, like travel, meals out or small luxuries, and limiting the amount of funds available for these. Or you may choose to use charge cards that need to be paid off every month, instead of allowing you to build a balance you'll have to pay interest on, as with a credit card.

As you get further along in your career, it's important to make sure that your success works for you. You'll have additional funds available, so avoiding the temptation to spend them will be more difficult. Instead, think about your long-term goals. Living well within your means, or even below your means, will allow you to put your money to work for you by saving and investing.

***Save and Invest* – Early and Often**

The first step to savings is to cover your bases. Set up an emergency fund with enough liquid cash to meet at least three months of your expenses. Keeping this current as your income and expenses increase is important. A cushion of funds can keep your long-term plans on track and can make short-term problems much easier to get through.

Contributing as much money as possible to a tax-advantaged retirement savings account lets you take advantage of the power of compounding and save on your taxes. But you shouldn't stop saving even if you've maxed out your retirement account annual contribution. Saving and investing in a taxable account will allow you to build wealth, and also add investment vehicles that may not be available in your retirement account. A taxable account can help you build a diversified portfolio that will be better able to weather the ups and downs of the markets.

There are an endless number of investment options available and setting up a solid investment plan with short-term and long-term goals, and then sticking to a funding schedule is the best way to keep your plan on track.

***Borrowing* + Credit Are Investments in Yourself**

You'll likely need to borrow money throughout your financial journey (education expenses and a home purchase are two typical examples).

You want to pay as little in interest costs as possible, and the key to that is to have an excellent credit rating. Keep credit card utilization low, pay off promptly, and automate as many payments as possible to ensure you always pay on time.

You'll also want to check your credit score frequently, and your credit report at least annually, to be sure everything is correct. When your borrowing is in place, then put a credit freeze on your accounts with each of the main credit bureaus to protect yourself from fraud.

The kind of borrowing you want to avoid as much as possible is high-interest credit card debt. Paying credit cards off in full every month will save you money and keep your credit score high.

***Protecting* Your Assets**

The old adage about insurance is that if you love someone, or you owe someone money, you should have insurance. Having adequate life insurance for each stage of life is important, particularly if you have a young family. A term life insurance policy can protect them and keep their lives, education plans, home, etc., intact if something happens to you. As your situation changes, some will find that insurance can also be the right tool to supplement investments or as an estate planning strategy.

Adequate homeowner's insurance and a solid motor vehicle policy with high coverage limits are also important. Early on in this journey, you may want to consider an umbrella policy that kicks in above the limits of standard coverage.

The Bottom Line

Having a solid understanding of the building blocks of your financial plan can help you in many ways on your financial journey. Taking the time to think through the various areas of finances ahead of time, before issues arise, and then making a plan and following through set the foundation of a successful money mindset.
