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Long-Term Planning for Young Investors

Even if you're new to the working world, it's not too soon to start a savings and investment plan. Following a few simple steps can get you on your way.

If you've just started your first job after college, congratulations — you've accomplished one of life's biggest milestones. But you're only getting started. As you grow older, you're likely to experience major life events such as getting married, having children, purchasing your first home, seeing your children off to college and — ultimately — retiring.

But when you approach these milestones, will you be financially prepared? Saving and investing for these life events may seem like a difficult undertaking — especially if you currently have pressing financial commitments like monthly expenses and student loans. But no matter how far you are from reaching these milestones, it's never too early to begin saving and investing for them. In fact, the sooner you get started, the better, because even a small investment can make a big difference over time. (Note, however, that there are inherent risks in investing in securities, such as stocks and bonds. Past performance is no guarantee of future results.)

So if you haven't given much thought to saving for your future, here are some steps to take to get you started.

Maximize Your Workplace's Benefits. Learn about the benefits available from your employer, including its retirement plan and life, medical and disability insurance coverage. If you have questions about these benefits, speak with someone in your benefits office or human resources department to learn about how to best take advantage of these options.

Create a Budget. No matter what savings and investing goals you have, budgeting is an important first step toward pursuing them. To develop a budget, conduct a *cash flow analysis* by comparing your monthly income with your monthly expenses. Once you set up your budget and live within your means, you will see how much disposable income you have to invest for your future.

Because your earnings and expenses can change from month to month, you should review your budget periodically. This will ensure that you have an accurate and up-to-date forecast of your saving, investing and spending habits.

Pay Down Debt. Develop a plan to pay off debts like school loans, car payments and credit card bills. If you have credit card debt, pay off the highest rate lender first and then work on eliminating other debts. Consider consolidating your debts with a credit card that offers a lower interest rate.

If you have student loans and you're writing checks each month to several different education lenders, you may have thought about consolidating the debt. When it comes to student loans, however, there may be a catch. Most consolidation plans do offer a longer term to repay the loans, but may charge you a higher interest rate. So only use a consolidation loan if the interest rate is lower than the one you're paying now. If you're a homeowner, consider consolidating your credit card and student loan debt into a home equity loan, where you'll probably be charged a lower rate and may get a tax deduction. (There are risks associated with consolidating debts with a home equity loan. Please seek the advice of a professional.)

Build an Emergency Fund. Begin developing an emergency fund you can tap into in case of a financial crisis such as a sudden job loss, extended illness or major car or home repairs. Try to save three months' worth of living expenses. In the event of a cash emergency, you'll need to get this money quickly, so invest your emergency fund in a liquid asset such as a savings account or a money market mutual fund.*

Protect Yourself with Insurance. Having sufficient insurance protection is an important part of your overall financial plan. Life insurance provides financial protection to your family if you die unexpectedly. If you have people who depend on you financially, whether it's a spouse or partner, children or other family members, you need some form of life insurance coverage. For most young people, *term life insurance* is the most cost-effective way to replace income for survivors.

If you're currently working, you may be eligible for group life insurance through your employer. Group policies typically provide a low-cost way to obtain life insurance coverage. To determine if the coverage available through your group policy is sufficient for your needs, speak with someone in your employer's benefits office or a financial consultant. If you decide that you need additional coverage through an individual policy, look for an insurance company with top financial ratings and good service. Also, make sure you have the appropriate amount of homeowner's (or renter's), auto and disability insurance. A financial consultant or insurance

company representative can help you determine what type — and how much — coverage you need.

Set Financial Goals. List your goals according to your priorities. Your goals will include retirement and, depending on your life circumstances, perhaps the down payment on a home, college savings for your children and other needs.

When listing your goals, make sure retirement is at the top of the list. To cover your living expenses in retirement, you're likely to need between 80% to 100% of your gross working income. To reach this goal, you'll probably need to invest a sizable amount of money throughout your working life, so begin investing as soon as you can. The sooner you start, the more time you'll have to potentially benefit from the compounding of earnings and/or interest of these investments.

Start Investing for Retirement. Enroll in your employer-sponsored retirement plan, whether it's a 401(k), 403(b) or 457(b) plan. Depending on your employer, you can either contribute to a pretax supplemental retirement plan or the new after-tax Roth 401(k)/403(b) plan.

With a pretax supplemental retirement plan, your contributions come directly from your paycheck before you pay taxes, which can help reduce your current taxable income. As with your employer's retirement plan, the funds in a supplemental plan can grow tax deferred, which means you don't owe taxes on the money until you withdraw it in retirement. (Withdrawals of earnings prior to age 59½ are subject to ordinary income tax and a federal 10% penalty may apply.)

In 2006, many employers began offering a new kind of supplemental retirement plan known as the Roth 401(k) or Roth 403(b). Unlike pretax supplemental retirement plans, contributions to a Roth 401(k)/403(b) plan are made on an after-tax basis, which means you don't get a payroll tax reduction on your contributions. However, Roth 401(k)/403(b) earnings become available completely tax free when you're age 59½ or older, and if you hold the account for five or more years, or if you satisfy other retirement criteria; with a pretax 403(b) or 401(k) plan, earnings are only tax deferred, so you'll have to pay income taxes on your contributions and earnings when you withdraw your money. Whether you invest in a pretax 401(k)/403(b) or the new Roth 401(k)/403(b) plan, for the 2007 tax year the maximum allowable contribution to an employer-sponsored retirement plan is \$15,500, or \$20,500 if you're age 50 or older.

Look into an IRA. If you're able to max out on your supplemental retirement plan, think about using an IRA to help you build additional assets for retirement. Through an IRA, you can set aside a portion of your earned income each year. As with 401(k)s and other retirement plans, all accumulated earnings grow tax deferred.

There are two primary types of IRAs — Traditional IRAs and Roth IRAs. With a Traditional IRA, contributions may be tax deductible, depending on the account holder's adjusted gross income, tax filing status and whether he or she is covered by an employer-sponsored retirement plan. With a Roth IRA, contributions are never deductible, but withdrawals are completely tax free if the account holder meets certain requirements. Whether you invest in a Traditional IRA or a Roth IRA, for the 2007 tax year you can contribute up to \$4,000, or \$5,000 if you're age 50 or older. (Withdrawals prior to age 59½ are generally subject to ordinary income tax and a federal 10% penalty tax.)

Plan for Financing Your First Home. When buying your first home, coming up with a down payment is no easy feat, but investment vehicles like stocks, bonds and mutual funds can help you accumulate the necessary amount. If you set aside 20% of the home's purchase price for the down payment, you will avoid the added burden of Private Mortgage Insurance (PMI), which lenders tack on as a monthly fee if you borrow using a smaller down payment. Keep in mind, too, that your house is likely to be the biggest investment you'll ever make, so shop around for the best deal on prices and interest rates.

A house is generally an appreciating asset, which means it's likely to increase in value over the years. There's nothing wrong with going into debt for an appreciating asset — provided you can afford the mortgage payments, of course. In the long run, when you sell a house, your goal is to get at least as much as or even more than what you paid for the house in inflation-adjusted dollars.

If You Marry, Combine Your Finances. If you plan to marry, note that marriage will likely have a significant effect on your finances. As a result, discuss with your spouse your respective savings and investment plans to identify any prospective challenges to your financial strategy. For example, although it's often less expensive for two married people to live together, other expenses you're likely to have in marriage — such as saving for a house or your children's education or purchasing additional life insurance — can strain your ability to save for retirement.

To balance these competing goals, create a unified financial plan before your marriage. Compare your savings and investment strategies to see if both you and your spouse are on the same page financially, or if you'll need to make changes to your plan. For example, if you have little or no debt, but your partner has significant debt, you'll need to develop a budget to pay down the balance.

Also, pay attention to how you both think about investment risk. If you and your spouse are both aggressive investors, you may be overexposed to risk. Conversely, if you're both too conservative — sticking to less risky fixed-income accounts — your investments run the danger of not keeping up with inflation. In either case, you'll probably want to create a diversified “master portfolio” that has the right balance of safety and growth opportunity. You can create this portfolio by adjusting the investment mix within your separate plans, or by consolidating your retirement assets. (Note that diversification does not guarantee against loss.)

Prepare for the Cost of Starting a Family. It costs a lot to start a family these days. However, with proper planning, you can raise a family without getting into a financial bind. Discuss with your spouse how you intend to finance the costs of raising a child. In your discussion, focus on every stage of your child's life, including private or secondary school education (if applicable), college expenses, a first car and any other savings goal.

Among these goals, college costs are likely to be the most expensive, so develop a college savings plan as soon as you can after your child's birth. Your earnings will then have the potential to compound over a long period of time. There are several products you can use to save for college costs, including Section 529 tuition savings programs, a Coverdell Education Savings account and UGMA and UTMA accounts.

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