Try to avoid an investing experience for your child that consists of only winning or only losing, since the education comes as much from the one as from the other.

A Parent's Guide: How to Introduce Kids to the World of Investing

By Paula Hogan

You want to introduce your child to investment management concepts in the best possible way—no boring lectures, no imprudent risking of wealth, nothing that involves revealing anyone's actual finances.

Where do you start?

There are multiple low-cost and even no-cost ways to make the world of investments visible to a child. Here are some ideas.

No-Cost Introductions

At a very basic level, look for ways to bring up investment issues in ordinary conversation. Let your children see your interest in investments by commenting at the dinner table on the stock market in general and/or on some stock that you are watching. Even better, ask your children to make predictions about what stocks to follow together. If there is sufficient interest, suggest a contest between two stocks with the winner to be determined once a year, with prices checked each week during the year.

You could also draw up a paper portfolio in consultation with your child, and offer to pay one cent on the dollar for paper profits, perhaps via trips to the ice cream store; losses mean you eat at home, or with a mature child—the child pays you at the same one cent to the dollar rate. Or you could also consider letting your child know something about your own portfolio, especially if you happen to have a hobby account—that is, a relatively small part of your own portfolio reserved for fun trading and flyers. Propose that you will act on a child's buy recommendation—if the child will tell you when to sell. If you don't want to divulge actual dollar amounts, remember that you can always describe any portfolio in percentage terms: "OK, we've got 30% of the portfolio in Exxon stock. What do you think?"

Today's 401(k) and other retirement plans often provide good educational material and investment fund descriptions along with the private account value information. Consider sharing with your child the non-private information about your retirement account, including for example, the descriptive information about the various investment options and the performance of each option in different time periods. Simply looking at the retirement plan material together each quarter brings out the idea of what decisions investors need to make, how to go about making them, and what happens over time to various investments. It also lets the child see that you are acting now to prepare for a future retirement, without requiring that you divulge private account value information.

Paula Hogan, CFP, CFA, is a fee-only financial planner with Hogan Financial Management, Milwaukee, Wisconsin.

Modest Cost Introductions

As children show more interest in investments, you may want to consider more realistic experiments with investment education.

For very motivated older children, consider providing a realistic trial run by allowing them to manage a small portfolio. Helping a child start an actual portfolio with his or her money can be a daunting challenge because of the high initial minimum investment that is typically required to open a mutual fund account or to purchase a round lot of stock. Most mutual funds require a sum of as much as $3,000 to open an account. Sometimes a lower minimum is accepted if the investor is willing to commit to a plan of regular monthly payments. However, this regular commitment can be as much as $100/month, which can quickly add up to a lot of money.

Searching out funds with a low or no minimum initial investment, however, is not a good strategy. As a perusal of the Morningstar database reveals, funds with no or low minimum initial investments are usually the funds with the highest annual expense ratios. Using funds with a high expense ratio—that is, over the average 1.2% per year level—is a strategy with a potential to gut long-term performance.

An alternative solution to the problem of the high initial deposit requirements is a "signing bonus," that is, a gift from an adult of the difference between a child's own savings and the required minimum deposit. But, what if your family is not able or willing to invest such large amounts? Then, it's time to consider the various investment vehicles that allow lower initial investments, including IRA accounts, direct stock purchases, and when the child is still below the state-determined age of legal maturity, custodial accounts.

Dividend Reinvestment Plans: Companies that offer dividend reinvestment plans are an ideal route to consider for families seeking to introduce their children to stock investing. Many of these companies are large, well-known firms that will be familiar to children, and the reinvestment plans provide a cost-effective way to finesse the expenses of purchasing stock through a brokerage firm, so building diversified portfolios with low-dollar investments is possible. While the traditional dividend reinvestment plan requires that the first share be purchased through a broker, more and more companies are offering direct purchase plans, which allow investors to buy the initial shares directly from the company. Most of these direct purchase plans have minimum initial investments, but most are quite reasonable.

The companies listed in Table 1 all offer dividend reinvestment plans and are of particular interest to young investors. The list was compiled by Charles B. Carlson, author of "No-Load Stocks," (McGraw-Hill, Inc.; 1995). The table also highlights companies that offer direct purchase plans, including their minimum initial investments, based on information taken from AAII's 1997 "Individual Investor's Guide to Dividend Reinvestment Plans" (the *AAII Journal*'s special feature this issue).

While dividend reinvestment plans have many positive features, be aware that consolidated statements are not available for this investment vehicle. Therefore, each additional holding in a portfolio of dividend reinvestment plans will greatly multiply the paperwork delivered to your home each period for permanent safekeeping.

IRA Accounts: IRA accounts can be opened even for minor children, as soon as the child has earned income. At that point, the child can begin depositing the lower of earned income or $2,000 each year into an IRA account. Remember that "earned income" does not include investment earnings, just income reported on a W-2, a 1099, or an IRS Form Schedule C. You can help qualify your child for an IRA contribution by hiring the child in your business as long as the child actually performs a job, is compensated in some proportionate way to the job performed, and where applicable, is included in your employee benefit package. Remember that Social Security taxes do not apply to children under the age of 18 when employed by a parent. If a child is self-employed, for example, as a baby-sitter or snow shoveler, IRA contributions are not likely to go unchallenged unless accompanied by some supporting documentation, such as the payment of self-employment taxes.

You can help a child start an IRA account by supplying lots of encouragement and, to the extent consistent with your own values and budget, your own cash. Especially helpful is that most mutual fund companies have minimum initial deposit requirements for IRA accounts that are typically as low as $100 to $500. Some families make up the difference between what a child is willing to invest himself in an IRA and the total allowable amount, at least for the first year. Some parents and grandparents make a habit of fully funding the child's entire IRA account in each subsequent year. Other families provide only matching funds in order to instill the habit of savings.

Whichever route you take, carefully consider whether a deductible or a non-deductible IRA account makes the most sense. Since most children have low incomes and are not included in a qualified retirement plan, they are usually able to deduct IRA contributions against current income. However, designating the IRA to be non-deductible is permitted and may be a wiser decision since the child

Table 1.
Dividend Reinvestment Plans Targeted to Young Investors

Coca-Cola
Harley-Davidson
Hershey Foods
Intel
Limited—teen girls
PepsiCo
Rubbermaid—Little Tikes toys
VF Corp.—Lee jeans
Wrigley—20 packs of gum sent to registered shareholders each year

Direct Purchase Plans (min. purchase)*
Amoco ($450)
British Airways ($250)
Chevron ($250)
Grand Metropolitan—Burger King; Haagen Dazs ($250)
IBM ($500)
Mattel ($500)
McDonald's ($1,000)
Mobil ($250)
Penney, J.C. ($250)
Procter & Gamble ($250)
Sears ($500)
Sony ($250)
Texaco ($250)
Tribune—owner of the Chicago Cubs ($500)
Wal-Mart ($250)

**Allows investors to buy first as well as subsequent shares directly, without a broker.*

Sources: Charles B. Carlson, "No-Load Stocks," McGraw Hill 1995; AAII's "The Individual Investor's Guide to Dividend Reinvestment Plans," 1997.

will likely be in a higher tax bracket at the time funds are withdrawn. The choice between the deductible and non-deductible designation will depend on an estimate of the child's current and future tax brackets, and also, because of the kiddie income tax rules, the parent's tax bracket up until the child turns 14.

A disadvantage of IRA accounts for kids is the 10% penalty usually imposed for withdrawing IRA funds before the age of 59½, for example, even for the payment of college tuition. However, the inability to easily access IRA funds before the age of 59½ also implies that funds in an IRA account, under current tax rules, will also not inadvertently hurt a child's chance of receiving college tuition assistance. On the current federal college aid application form, a child's IRA account is not a reportable asset and so is not usually deemed by colleges to be available for tuition payments. Under current rules then, IRA accounts appear to be well-suited to helping a child to begin an early, regular, and long-term savings program.

Custodial Accounts: Custodial accounts, also known as UGMA accounts (Uniform Gift to Minors Account) or UTMA accounts (Uniform Trust for Minors Account), usually have a low—e.g., $500—required initial investment, and so can be attractive for young investors. Remember, however, that funds placed in a custodial account, just like an IRA account, are the property of the child. Once the child is an adult as determined by state law, the child can use the funds at his own discretion without family supervision. Financial advisers often remark that you can make a good guess about the age of a child when listening to a parent talk about a custodial account. Usually, parents of teenagers just don't express the same romantic view of custodial accounts as do the parents of newborn babies! Custodial accounts can also inadvertently hurt a child's chances of receiving college aid, since colleges tend to view money in a child's name as more available for tuition payments than, for example, investments held in the name of the child's parents.

Family income taxes can also be a concern when using custodial accounts. Custodial accounts are registered under the Social Security number of the child and so earnings are taxable to the child. Especially if you are a grandparent, be sensitive to the effect that this extra taxable income can have for the child's parents. Children under the age of 14 can earn up to $650 of investment income each year that is tax-free. The next $650 of income is taxed at the child's marginal tax rate, then any excess is taxed at the marginal rate of the child's parents. After the child turns age 14, income is taxed to the child at the child's rate. When planning custodial accounts, be sure that you don't unwittingly create an unwelcome tax liability or tax preparation chore for the child's parents.

Joint Accounts and Payable on Death Accounts

If you don't need a low initial minimum deposit, don't want to use a custodial account, but do want an account in which the child has some ownership interest, consider a joint account or a payable on death account. Both of these kinds of accounts are available at banks, brokerage houses, and mutual fund companies. Funds kept in joint accounts are the property of both owners and can be withdrawn by either party at any time without notice to the other. Taxable income is reported to the owner whose Social Security number is on the account. Taxes can be paid by this owner in full or, alternatively, can be shared between the owners, with the agreed upon tax liability reflected on each of the owners' individual tax return.

At the death of an owner, if a joint account is registered with a non-spouse as "joint with right of survivorship," the whole account is taxed in the deceased owner's estate except to the extent that the surviving owner can document personal contributions to the account. The account then passes outside of the deceased owner's will, directly to the surviving owner. If, however, a joint account is titled "as tenants in common," then half of the account is taxed in the deceased owner's estate and then passes under the deceased owner's will to whoever is named in the will.

Payable on death accounts belong entirely to the owner whose Social Security number is used to register the account. During the lifetime of the owner, payable on death accounts cannot be accessed by, and in fact can even be kept private from, the named beneficiary. At the owner's death, the whole account is taxed in the owner's estate and then passes outside of the owner's will, directly to the named beneficiary.

Targeted Products

The financial marketplace has responded to the rising demand for investments targeted to young investors with new products. Several products already on the marketplace, mentioned not as recommendations, but as indications of the potentially different kinds of products that are available are:

- The Stein Roe Young Investor, offered by the Stein Roe mutual fund company (800/338-2550). Morningstar describes the fund as a large-cap growth stock fund that emphasizes securities of "strong growth companies whose products appeal to and affect the lives of children or teenagers."
- The American Century family of funds, formerly known as the Twentieth Century family (800/634-4113), offers the American Century Giftrust, which is not just a mutual fund, but an irrevocable trust that matures at the later of 10 years from each deposit or when the child reaches the age of majority. The underlying investment fund, according to Morningstar, is a small-cap growth fund. Investors should be aware that deposits into this fund, in the eyes of the IRS, are "gifts of a future interest." Consequently, each contribution is deducted from the donor's lifetime $600,000 exemption equivalent and must be reported at

the time of the contribution on IRS Form 709. The tax benefits of irrevocable trusts vary, and thus most investors should consult with their financial advisers before investing in them.

- The Little Women's Fund, sponsored by the Milwaukee Foundation, offers a prototype charitable trust targeted toward young women to teach about investing and philanthropy.

These are highly specialized products and likely to be emulated by other organizations. As new products are offered, remember that regardless of the direct emotional appeal, the familiar standards of common sense, suitability, cost, and effectiveness are still appropriate to apply before making any investment.

What to Avoid

In light of the wide and growing array of suggested ways to develop investment expertise in young people, it is prudent to pause and consider what strategies should be avoided. Tax advisers will caution you against giving gifts of appreciated stock since the child would assume your old, low-tax cost basis for such gifts. In contrast, if the child receives the appreciated security after your death as an inheritance, the relevant tax cost basis is stepped-up to the market value at the time of your death, allowing the family to capture a valuable tax benefit.

EE savings bonds have long been a traditional gift for young children and, because of a recent increase in the credited interest rate, now once again offer a competitive tax-advantaged return. However, EE savings bonds are complicated to redeem and offer little investment education. If, despite these disadvantages, EE savings bonds meet your needs, then carefully consider whether to register the bonds in the name of the child or of the child's parents. EE bonds can be used tax-free for the payment of college tuition if, among other requirements, the bond is registered in the name of the parent, not the child. (See IRS Form 8815 and instructions for details.)

Financial advisers caution against giving gifts you cannot afford and gifts your family does not want since these gifts come burdened with family issues and can actually worsen family relations. Be clear with yourself and with the child about your intentions. Avoid saying a child is in charge when you really are not ready to cede control of investment decisions. Children often know before adults when the message is mixed and understandably usually have a strong and negative reaction. In contrast, if you are forthright about what you are willing and not willing to delegate, children get a live demonstration of a key investment skill, namely the ability to deal matter-of-factly with reality.

And finally, just as your child's sports coaches advise, avoid an investing experience that consists of only winning or only losing, since the education comes as much from one as from the other.

Above all, try to get in the frame of mind of the world's great teachers, who share their knowledge not only by teaching, but also by setting an example. The whole process provides a priceless opportunity to demonstrate the key traits of the successful investor: curiosity, a drive for achievement, self-knowledge and an ability to deal matter-of-factly with reality. It's hard to think of a better send-off for the next generation than to see these traits in the people who love them.