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Vanguard's guide to financial wellness

Small steps can make a big difference in achieving your goals

Why financial wellness?

Managing multiple short- and long-term financial goals can feel overwhelming at times. Sixty-five percent of Americans surveyed say that money is a significant source of stress. This guide provides a three-step financial wellness framework for determining the next best actions people could take to bring them closer to their goals, no matter where they are in their financial journey.

- **Step 1: Take control of your finances.** This will enable households to create an effective budget and take advantage of high-reward opportunities, such as paying the minimum on all debts, taking full advantage of employer match opportunities, and paying down high-interest debt such as payday loans and credit cards.
- **Step 2: Prepare for the unexpected.** Households can benefit from setting aside emergency savings to cover modest, unexpected expenses; creating a contingency fund in case of job loss; and evaluating insurance and legal-document needs.
- **Step 3. Make progress toward your goals.** It is possible to invest more in tax-advantaged accounts (retirement, health, and education) and in taxable accounts for pre-retirement-age goals (home, car, and vacations, among others) while paying down lower-interest debt (student loans, mortgage, and car loans), and even to consider gifting strategies.

How to use this guide

This financial wellness guide aims to cover topics that most investors will face at some point, regardless of their financial status. The next best actions it provides are meant to be put into practice consistently and continuously, as some of them may take time to complete. This guide focuses primarily on households' accumulation phase, before retirement. For guidance on decision-making in retirement, see Jaconetti et al. (2021). For an overview of how Vanguard thinks about creating goals, see *Vanguard's Principles for Investing Success* (2020).

Contents

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Introduction

Vanguard's mission is *"to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success."* To achieve that success, investors need to be able to allocate their budgets to pay current bills, tackle debt, prepare for unexpected circumstances, and invest to achieve goals. According to a Federal Reserve Board survey, more than three-quarters of U.S. families report having debt, and 45% of families carry credit card debt, with an average debt of $6,300 (Bhutta et al., 2020). Among the families surveyed, 36% indicated they could not cover an emergency expense of $400. More than 40% had not been able to save money over the previous year.

Personal finances also affect people emotionally. Sixty-five percent of Americans surveyed say money is a significant source of stress (American Psychological Association, 2022). For people under age 43, that figure jumps to 82%. Americans say personal finance issues affect their mental health, physical health, sleep, self-esteem, relationships at home, and work productivity and attendance (PwC, 2022). For many of us, the prospect of saving for retirement can be overwhelming when considering current spending needs and outstanding debt payments. This can lead to inertia, which in turn can have adverse financial planning consequences later in life.

These factors likely deter people from having the best chance for investment success and from realizing the ultimate objective of achieving their financial goals. We created this financial wellness guide and accompanying framework because giving investors the best chance for investment success also entails helping people to allocate their budgets to concurrently pay bills, tackle debt, save money, and invest. Together, these lay out a path to financial independence, which results in the financial flexibility to meet both short- and long-term goals. By helping to improve households' financial situation, we can make an impact not only on people's well-being financially but also in life and at work. We define financial wellness as follows:

Financial wellness is the objective financial situation of a person, household, or family. It is the ability to meet current and near-term financial obligations and to be on track to meet future goals.

Understanding one's 'next best actions' is a critical part of financial planning

People naturally want to achieve their goals in the best way possible. When dealing with multiple goals, though, knowing what to do next may be a complex problem and may lead to confusion—or worse, to inaction. In addition, life is uncertain and goals may change over time. For these reasons, instead of trying to figure out a "perfect plan," we seek to answer the following question: Given your goals and objective financial situation, what are the *next best actions* to take in your financial life?

Our framework is designed to guide you toward these areas of focus in your financial life to improve your well-being. This guide aims to highlight common financial wellness focus areas and how to approach tackling them using suggested action steps. For some, this guide may not be detailed enough to address your specific needs. In those situations, it may be best to consult with a financial planning professional for more guidance.

How our work compares with the Consumer Financial Protection Bureau's

Our financial wellness definition and framework are based on the Consumer Financial Protection Bureau's work on financial well-being. The CFPB defines that term as "a state of being wherein a person can fully meet current and ongoing financial obligations, can feel secure in their financial future, and is able to make choices that allow enjoyment of life" (CFPB, 2015). The CFPB also says that "financial well-being can be defined as a state wherein you:

- have control over day-to-day, month-to-month finances;
- have the capacity to absorb a financial shock;
- are on track to meet your financial goals; and
- have the financial freedom to make the choices that allow you to enjoy life."

Our work differs from the CFPB's approach in two important ways. First, our three-step financial wellness framework provides explicit guidance on specific actions we recommend that people take to achieve their desired financial goals; these include budgeting, paying down debt, following investing principles, having insurance, and establishing legal documents. The CFPB (2015 and 2017), on the other hand, focuses on the definition of financial well-being, the creation of a score for it, and factors that could relate to that score. However, the CFPB does not provide specific actions or financial guidance on what to do to achieve financial well-being.

Second, our framework stops short of considering people's subjective perceptions about their finances as part of our guidance. Although we believe that financial wellness has downstream effects on subjective perception, we focus on people's objective financial situation. In fact, the CFPB (2018) shows that someone's objective financial situation is the strongest predictor of their financial well-being score. For this reason, we concentrate on objective actions that are within a person's control.

Financial wellness is grounded in three key desired outcomes

Although the specifics will vary by household, starting down the path to financial wellness by taking a few small steps at a time can help set you up for a more sustainable and successful financial future. By providing comprehensive financial wellness guidance, as presented in our framework shown in **Figure 1**, we expect outcomes for households to be:

1. To identify opportunities to get finances under control through effective budgeting;
2. To meet unexpected expenses and protect against unanticipated life events;
3. To increase investment capacity and the probability of meeting financial goals.

Some steps that you may be able to take today could be contributing more to your employer plan to maximize your match, making an additional payment on credit card debt, or setting aside money for unexpected future expenses. Each of these actions adds financial flexibility to balance your current and future goals or expenses, which in turn builds financial confidence and freedom.

FIGURE 1.
Small steps can make a big difference in achieving your goals

Financial wellness framework

Step 1
Take control of your finances

Create a budget that works for you
- Find a strategy that works for you and that you can stick with over time

Maximize your employer-matched savings
- Take advantage of the opportunities to get a head start on your finances

Pay the minimum on all your debt
- Pay at least the monthly minimum(s), as this will reduce costs over time and improve your credit score

Pay down high-interest debt
- Save on paying interest, which in turn will free up cash flow for your other goals

Step 2
Prepare for the unexpected

Set up emergency savings for unexpected expenses
- Maintain at least $2,000 in cash for common spending shocks

Build up a contingency reserve in case of job loss
- Have about 3–6 months of expenses in readily accessible investments

Evaluate your insurance needs, coverage, and costs
- Consider having at least health, life, disability, motor vehicle, and home insurance

Get your legal documents in order to ensure that your wishes are realized
- Establish your will(s)
- Name your beneficiaries
- Designate a power of attorney

Step 3
Make progress toward your goals

Increase your savings and make the most of tax-advantaged accounts
- Explore available health savings options
- Examine retirement savings options: IRAs; 401(k), 403(b), and 457 plans
- Consider education savings options

Flex with taxable accounts
- Put away additional retirement savings beyond allowable limits
- Use for goals other than health, retirement, and education

Consider paying off lower-interest debt
- Evaluate your debt comfort and liquidity needs

Set a strategy for your charitable giving
- Think through the benefits, timing, and amount of your gifts
- Explore available ways to have the most impact

Source: Vanguard.

Step 1

Take control of your finances

Knowing where your money is going is key for the path toward financial wellness. For this reason, we start with how to think about budgeting. While first mentioned here, budgeting is a key tool throughout the framework and is important for enabling goal success. Then we can start to put together a sequence of actions to help improve your financial situation. Although households may be at different points in their financial journeys, this section helps you identify common, high-value opportunities to improve your personal financial situation.

Create a budget that works for you

Recent research shows that over 60% of American households live paycheck to paycheck, indicating that households may have difficulty achieving their financial goals (PYMNTS and LendingClub, 2022).

A budget is a "tool for awareness," as Richards (2015) puts it. People need to know where their money is going and make sure it is in line with their goals. Some people like budgeting; some don't. No matter the sentiment toward it, the way people spend their money should align with their goals in order to achieve successful outcomes.

An effective budget is one your household sticks to while being able to save toward your goals. Start by focusing on meeting current needs and using the remaining amount across the topics in our framework. Some people may have the capacity to save today, while others may need to focus on controlling spending. To help households find the budgeting strategy that fits their style, we present these two questions:

1. Do you like tracking your expenses constantly?
- ☐ Yes
- ☐ No

2. What is your current priority?
- ☐ Start putting money aside
- ☐ Increase savings rate

Figure 2 lays out four suggested budgeting strategies, depending on the answers.

FIGURE 2.
Find your preferred budgeting style

		Do you like tracking your expenses?	
		No	**Yes**
What is your priority?	**Start putting money aside**	Use the envelope method to categorize expenses	Use zero-based budgeting, starting anew each month
	Increase savings rate	Pay yourself first	Follow a rule of thumb, such as the 50/30/20 rule

Source: Vanguard.

Here are four popular budgeting strategies:

1. **Use the envelope method.** At the start of a pay period, categorize expenses, writing each name on a separate envelope. Today, many banks allow you to create digital wallets that allow for a similar function. For each expense category, put cash in its designated envelope. All that you can spend in that category is the cash in that envelope. If you decide to spend more in a given category, the money must come from another envelope. This method reduces the need to track expenses closely.
2. **Use zero-based budgeting.** Each month, start a new budget, questioning the importance of every expense. Zero-based budgeting pays no regard to what happened in a previous month. What is deemed nonessential is cut. This method takes time and effort, as expenses are reviewed periodically.
3. **Pay yourself first.** Set aside money from income for your savings goal(s) first. After that, you are free to spend remaining money as desired. Followers of this strategy tend to automate their savings, having the money deducted from their paycheck. Automated saving has been shown to be an effective way to save and invest money (Beshears et al., 2022; Madrian and Shea, 2001; Thaler and Benartzi, 2004).
4. **Follow a needs/wants/savings approach.** Allocate money to three categories: living expenses, wants, and savings. Accordingly, followers of this approach could use the popular 50/30/20 method by allocating 50% of income to living expenses, 30% to wants, and 20% to savings (Warren and Tyagi, 2005). Savings include moneys set aside for emergencies, retirement, and other goals. Depending on your goals, you may change the percentages accordingly, but make sure to keep track that the goals are being met.

With an effective budget in place, you may better understand your finances, knowing where your money is going and allowing you to plan ahead. By allocating money according to your priorities, you start building momentum to achieve your goals in both the short and the long term.

Take action

- ☐ **Determine what budgeting style works for you.** Figure out whether you like tracking your expenses and what your main priority is with a budget: Is it to start putting money aside, or to increase your savings rate?
- ☐ **Create an effective budget and try to make it a habit.** Enact your preferred budgeting strategy and be consistent in achieving your budget priorities. If applicable, involve your whole household in the budgeting process so that everybody is working together toward the shared goals.

Maximize your employer-matched savings

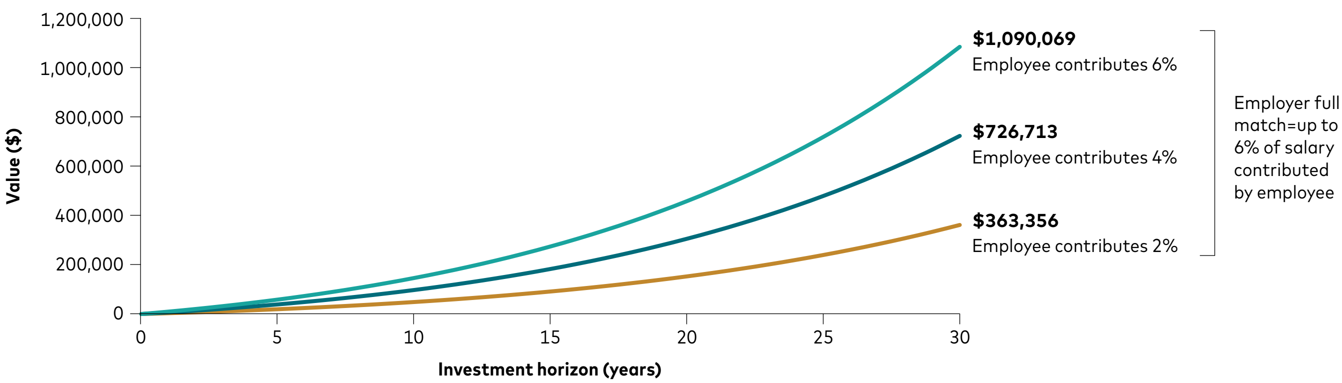
To encourage employees to save for retirement, many employers offer matching contributions to savings put into employer retirement plans. Other types of employer-matched savings are also becoming more common, such as Health Savings Accounts (HSAs), student loan payments, emergency savings, and even 529 plans. Most employers match, in whole or in part, a percentage of contributions to such plans or accounts, while others match contributions up to a given dollar amount. For brevity, our discussion focuses on employer-matched retirement savings into a vehicle such as a 401(k) plan.

Employer-matched savings give workers a sizable head start in saving for retirement, as the match is essentially free money from employers. The return on the dollar invested is high. We find, however, that many workers are not maxing out their plan contributions; 31% of retirement plan participants contribute below their employer match rates, thus leaving money on the table (Vanguard, 2022). Financial Engines (2015) estimates that workers leave $24 billion unsaved by not fully matching their employer contribution.

By taking advantage of and maximizing employer matching, workers can make significant progress toward their goals. **Figure 3** shows three simulations using one of the most common match formulas that employers provide: a 100% match on the first 6% of salary contributed by their workers.[1] The figure varies the salary percentage that investors are contributing to their retirement plan: 2%, 4%, or 6% (meeting the full match). It shows how these investors build wealth over time in their employer plans.

FIGURE 3.

Not taking full advantage of an employer match may mean leaving a lot of money on the table



Notes: The scenarios shown are hypothetical and not meant to depict any particular investment or return profile. The figure assumes annual returns of 6% that compound monthly following geometric averaging. It assumes that the investor earns an $80,000 salary that goes up 3% each year and that they contribute 2%, 4%, or 6% each year to an employer plan. The employer fully matches up to 6% of salary each year. Investor and employer contributions are made at the end of each month. No taxes are considered in this scenario. Matching may be subject to vesting requirements. Assets are also subject to investment risks if invested.

Source: Vanguard.

1 See Vanguard (2022), page 17, for information on the frequency of use of different employer-match formulas.

What becomes evident in Figure 3 is that not contributing up to the full employer match is costly for the future. In the scenarios shown, investors who contribute 6% of their salary to take advantage of the 6% match—thus effectively contributing 12% of their salaries to their employer plan—will reach $1,090,069 in retirement savings over 30 years, with half that value ($545,034.50) coming from the employer contribution and its investment growth. But if investors meet only 2% of the possible 6% match—effectively contributing 4% of their salaries—their plan savings over 30 years will total $363,356, or $726,713 less than had they received the full match. In a nutshell, investors can leave substantial wealth on the table by not fully meeting the employer match.

Take action

- ☐ **Find out the details of your employer plan match.** This information is usually accessible on a company's intranet or through its human resources department.
- ☐ **Make room in your budget to contribute and earn the full match.** An employer match is akin to an immediate return on your money.

Meet minimum payments on debt

Paying down debt is also a top priority for many households. The average U.S. household holds multiple types of debt, most commonly mortgages, student loans, auto loans, and credit card debt.[2] Dealing with multiple debts at once can be overwhelming, especially considering the competing needs to invest toward other financial goals. Where should households start when paying down debt? We recommend budgeting to make the minimum payments due on all your household debts, for two main reasons.

First, when you miss a payment, unpaid interest is typically added to the outstanding principal balance, increasing both the total amount due and the total future interest due. The lender may also charge late penalties and other fees, further straining your household budget.

Second, by not paying the minimum due on a credit or loan balance, households become late on the payment after the lender's grace period, opening the door to being reported to credit bureaus. Once a late payment notice reaches those bureaus, your credit score decreases, affecting your future ability to obtain lower interest rates or even obtain credit at all, depending on the score. According to Demyanyk (2017), a missed loan payment can decrease a credit score by 51 points. In addition, a late payment notice can stay in a credit report for up to seven years, with a potentially long-lasting effect on a household's finances. A lower credit score could drive up a household's interest rates and future borrowing costs far beyond the current impacts, especially with longer-term loans such as mortgages (**Figure 4**).

2 Throughout this guide, *debt* is used interchangeably for loan debt and credit card debt.

FIGURE 4.

A lower credit score can significantly affect your interest rate and total debt cost

FICO® credit score	Mortgage interest rate (APR)	Monthly payment	Total cost of a $300,000 mortgage over 30 years
760–850	6.50%	$1,896	$685,633
700–759	6.72%	$1,940	$701,334
680–699	6.90%	$1,976	$714,288
660–679	7.11%	$2,018	$729,523
640–659	7.54%	$2,106	$761,112
620–639	8.09%	$2,220	$802,252

Notes: The mortgage rates shown are based on a $300,000 loan and the national average of interest rates across different locations. The rates are for single-family owner-occupied properties. They also assume a 30-year fixed-rate mortgage, an 80% loan-to-value ratio, and one mortgage point. Total mortgage cost includes the $300,000 loan, the one point ($3,000) paid up front, and total interest paid over 360 months. Monthly payments and total mortgage cost do not reflect taxes, homeowner association dues, or insurance that a servicer may require to be collected on behalf of the mortgage holder. Rates are rounded to the nearest tenth of a percent, and dollar values are rounded to the nearest dollar. These estimates were captured from myFICO on October 18, 2022.

Sources: Vanguard calculations, based on data from myFICO and Informa Research Services.

Missing loan payments can substantially affect the cost of borrowing funds. Figure 4 shows that having a lower credit score can substantially increase the total cost of a mortgage. Someone with a credit score of 760 to 850 could pay $685,633 in return for a $300,000 loan, whereas another person with a credit score of 620 to 639 could pay $802,252 for the exact same loan, meaning almost $117,000 in additional interest due because of credit score differences.

Always meeting at least the minimum payments will ensure that you keep more of your money and can spend it on other financial goals. For these reasons, we strongly advocate budgeting to meet at least all minimum debt payments before considering investing.

Take action

- ☐ **Find out the minimum payments on all your debts.** Gathering all this information can help ensure that you don't miss a payment, either for accidentally paying less than the minimum or for missing the payment date.
- ☐ **Make sure your budget allows you to consistently pay the minimum on your debt.** Paying the minimum can spare you from having to pay higher interest and costs in the short run and from damaging your credit score, as that might compromise your ability in the long run to obtain credit with favorable interest rates.
- ☐ **Set up payment reminders or consider automating the minimum payment on your debts.** Automating payments can save you time and energy and ensure that you don't fall behind on the payments. Make sure your bank account has enough funds to avoid going into overdraft, as overdraft fees are high and may affect your budget.

Pay down high-interest debt

If compound returns are touted as one of the most powerful forces in finance, then a household with high-interest debt has that powerful force working against it. Given that some loan interest rates can reach two or more digits, it is in a household's best interest to pay high-interest debt quickly.

Paying down debt generally leads to several positive potential outcomes:

- Reducing the total interest paid
- Lowering outstanding balances, which may help improve credit scores, potentially lowering future lending rates[3]
- Unlocking future budgeted loan payments for savings, investment, or other goals
- Relieving mental and emotional burdens involved in having outstanding debt

Given that high-interest debt, if left unpaid, can spiral out of control, the benefits just highlighted show why paying down such debt should be a priority.

What is considered high-interest debt?

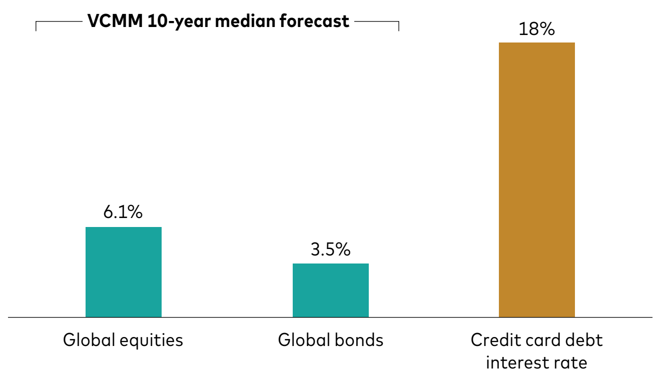
When determining a debt payoff strategy, consider what is high interest for you given your household's financial situation, in order to decide which debt to prioritize for paydown. Paying down debt can be considered a way to obtain a guaranteed return on money (Paradise and Kahler, 2020). Given that premise, we define a high interest rate as one that would be difficult for households to achieve through investments in financial markets.

This framework to determine high-interest debt gives households two primary considerations:

First, credit cards—and especially payday loans—are considered high-interest debts for most, if not all, households. The average credit card interest rate revolves around 18% and 25% (CFPB, 2021), whereas payday loans can have annualized interest rates of over 300%, even exceeding the return on employer-matched savings. It is unlikely that households can consistently earn those returns in financial markets. Therefore, it's best to always pay down payday loans and credit card debt as quickly as possible. **Figure 5** shows how credit card interest rates are substantially higher than the Vanguard Capital Markets Model (VCMM) projections for both global equity and global fixed income over the next 10 years. The figure does not include interest rates for payday loans, as a 300% rate would be well out of the picture.

FIGURE 5.

Paying down credit card debt offers returns rarely met by market returns



IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model (VCMM) regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. Distribution of return outcomes from VCMM are derived from 10,000 simulations for each modeled asset class. Simulations are as of June 30, 2022. Results from the model may vary with each use and over time. For more information on VCMM, see Appendix 1 on page 51.

Notes: The figure compares the median 10-year VCMM projected annualized investment return distributions with common consumer debt interest rates (annual percentage yield, or APY). Credit card debt at an 18% interest rate is a hypothetical example and is not meant to reflect a true cost of lending.

Source: Vanguard.

3 Credit score determinants typically include such factors as payment history, amounts owed, length of credit history, new credit accounts, and types of credit used. Different credit score weighting and scoring models are used for different lending decisions. As a result, credit score impacts may vary.

Second, beyond credit card and payday loans, placing the high-interest-debt label on other debts may vary depending on each household's other outstanding debt rates and risk tolerance.

Take, for example, two people, Pat and Chris. Both are already meeting their available employer match, and each has an outstanding car loan at a 5% rate. Pat is younger and has an aggressive all-equities investment allocation, while Chris is nearing retirement and has a portfolio entirely invested in bonds. Pat's equity-heavy investments have a greater potential to outperform the car loan rate. Pat may not consider that 5% rate high and instead could prioritize it later on. Chris, however, is much less likely to expect to outperform the loan rate, given their more conservative all-bond investment allocation. So Chris could see the 5% rate as high and should consider prioritizing that debt.

Finally, consider household debt aversion. Debt savings are fixed returns, while investing returns are naturally uncertain. Sometimes even when investing appears more likely to outperform the debt rate, paying down debt can make sense. Although there may be lost investment opportunity, if other goals are on track, trading off some inefficiencies for improving well-being and ensuring peace of mind may be reasonable. In either case, be diligent in not reestablishing these high-cost debts; instead, budget future savings toward achieving your other financial goals.

How to consider paying down high-interest debt

Mathematically, paying down high-interest debt first should always produce the lowest total amount of interest paid, saving the investor the most money, especially when extra cash is available to pay more than the minimum payments. By reducing the interest paid, investors also minimize the time it takes to pay down the debt. The method of paying down high-interest debt first is sometimes called debt avalanche.

This strategy entails ranking debts by interest rate and allocating additional payments, above required minimums, from the highest-rate debt to the lowest. Once the first debt is paid off, those payments are added to the second debt until that is paid off. This continues until all prioritized debts are paid off. The avalanche method aims to minimize the total interest paid, keeping more money in the investor's pocket.

When debt is paid off early (in whole or in part), future interest savings are locked in, so paying down high-interest debt will unlock higher future savings potential in your budget.

How can you avoid falling back on high-interest debt?

Once a high-interest debt is paid off, your budget will have more flexibility. Use this flexibility to try to steer clear of high-interest debt. Research has shown that short-term, high-interest debt takes a toll in both a person's productivity and their well-being, so it is best to avoid such debt whenever possible (Carrell and Zinman, 2014; Sweet, Kuzawa, and McDade, 2018). For these reasons, try to avoid high-cost financing options like payday loans and use credit cards responsibly by paying off the statement balance before interest starts accruing. A CFPB analysis found that 80% of people who get a payday loan either roll it over or get another such loan within 14 days (Burke et al., 2014). High-interest debt has substantially higher rates than financial investments typically return, so falling back on it can undo a lot of a household's progress. We offer three suggestions to avoid falling back on high-interest debt or defaulting on a loan.

First, we recommend that households adhere to their budget consistently. Sticking to it may be challenging, but there's a big upside: Over time, you'll have more money in your pocket from paying down high-interest debt and getting spending under control. With extra money in the budget, watch out for lifestyle inflation—the tendency to spend more on your lifestyle when you have more money available to spend as pay increases may occur over time.

Second, if you need credit, consider lower-interest options first. Average interest rates on personal loans and home equity lines of credit (HELOC), for example, tend to be substantially lower than those of payday loans and credit cards. People with workplace retirement plans that allow for loans may also be able to obtain more advantageous rates than credit cards can offer. Be aware, though, of how loans may affect retirement savings, as employer matches may be paused while loans are outstanding or while taxes are due if payments are not made. Shopping for lending options is also advisable, as their cost across different lenders varies widely (Zinman, 2015).

Third, recent research shows that the most common reason for falling behind on debt payments is a negative life event, such as a job loss (Ganong and Noel, 2022). For this reason, we strongly recommend that households build up emergency savings to protect themselves financially against such events. Given how important emergency savings are to financial wellness, we next discuss how to build up those savings.

Take action

- ☐ **Check whether you hold high-interest debt.** Payday loans and credit cards are considered high-interest debt for most households. And check whether your other debts have interest rates higher than what you can reasonably earn in financial markets. If they do, consider those high-interest debt as well.
- ☐ **Rank the interest rates of your high-interest debt.** By paying down the highest-interest loan first, you save money and payoff time.
- ☐ **Allocate as much from your budget as you can toward paying down your high-interest debt.** Increasing the monthly payment toward the debt means saving substantial interest and time.
- ☐ **Take advantage of one-time windfalls, such as tax refunds and work bonuses, to pay down high-interest debt.** Because of such debt's high interest rate, any early payments lock in future interest savings and unlock budgeting potential.

Step 2

Prepare for the unexpected

With finances under control, as one's wealth grows, so does the need for protecting it. Similar to how using asset allocation can protect against investment risk, there are several actions you can take to help protect your valuable financial resources. We'll now review a few valuable risk-control tools that can help mitigate life's uncertainties—from spending shocks to car accidents to job losses to untimely death—and keep your goals on track or close to it.

Set aside emergency savings

Uncertainty is a given in both life and investing. An effective way to help hedge against some financial uncertainties is to establish savings for when an inevitable or unlikely event occurs. Research from the CFPB (2022) finds that people who report having no emergency savings are more likely to overdraw their checking accounts, rely on high-cost loans (such as payday, credit card, and title loans), and withdraw money from their retirement accounts. Each of these actions results in additional costs on top of any unexpected needs and affects other financial goals.

Emergency savings can ensure that you have some cushions in place to help mitigate the potential impacts of such events on your budget, financial plans, and goals. As research by Pew Charitable Trusts (2015) has also shown, these destabilizing shocks can affect family balance sheets not only at the time an event occurs but also for months afterward.

Vanguard recommends that when you think about emergency savings, first evaluate your household's liquidity. We define liquidity as the ability to convert an investment into cash quickly and cheaply (Kahler and Paradise, 2019). **Figure 6** provides guidance in setting aside emergency savings.

FIGURE 6.

Emergency savings help safeguard household spending and income

	Emergency savings: Managing your household's liquidity needs	
	Spending protection	**Income protection**
Examples	A flat tire, heating maintenance, or unexpected travel	Unexpected job loss
How much do I need saved?	At least the greater of $2,000 or half a month of expenses	Generally, three to six months of expenses
Where should I keep these savings?	Checking or savings accounts or money market funds for quick access	Taxable accounts or even a Roth IRA, as contributions can be withdrawn tax-free if needed

Source: Vanguard.

Prepare for spending shocks

How do we define those?
Spending shocks can encompass a wide range of costs that share two defining characteristics: They are unplanned for, and they are unwanted (Kahler and Paradise, 2019). Examples could be a flat tire, air conditioning or heating maintenance, or unexpected travel.

How much do you need?
Having at least the greater of $2,000 or half a month of expenses is a good starting point. We offer two examples for clarification:

- If you spend $3,000 a month, you'll want to target at least $2,000.
- If you spend $10,000 a month, you'll want to target at least $5,000.

You'll also want to consider your insurance coverage, deductibles, and quality-of-life choices for your personal target. For example, the cost to repair or replace a flat tire on a more expensive vehicle can vary significantly from the cost for the same repair on a more modest one. Pew Charitable Trusts (2015) found that the median cost of households' most expensive financial shock was $2,000, with about 60% of those families surveyed reporting at least one event over the prior year. Over time, keep an eye on income and expenses that also may increase with associated quality-of-life changes. This may warrant upward or downward adjustments to keep the amount saved appropriate.

Where's the best place to keep these savings?
Spending shocks come rapidly, typically over short time horizons, and can quickly affect budgeting plans. For these reasons, having savings for such events in transactional accounts (such as a checking, savings, or money market account) that allow for quick access with minimal if any fees or tax impacts is ideal. Some may dislike keeping money in cash or in a low-yield account. But if the emergency fund provides the peace of mind to avoid selling investments in a market downturn, this low-yield emergency savings can have a high return on investment (Housel, 2020).

Be ready for potential income shocks

How do we define income shocks?
Income shocks, such as an unexpected job loss or other unplanned ceasing of income, are less likely to occur than a spending shock for most households but generally have more severe, longer-lasting financial consequences (Kahler and Paradise, 2019).

How much do you need?
Including the amount set aside for spending shocks, you will generally want to target three to six months of expenses as a starting point. Consider your profession, experience, and industry as you define your personal target. Some professions and industries are more prone to turnover than others, while people with specialized expertise may find it either harder or easier to find a job, depending on prevailing employer needs. For example, a teacher or a doctor is likely to need closer to the lower end of the three to six months of expenses. But an entrepreneur or a professional with very specific skills, for whom finding a new job might take some time, should consider having six months or more of expenses saved.

Where should I keep these savings?
Savings for income shocks should be in accessible accounts but not necessarily entirely in transactional accounts. Accessible accounts may include taxable brokerage accounts or even a Roth IRA, from which contributions can be withdrawn tax-free if needed.[4]

4 Taking money from your retirement account can affect how much you'll have to pay in taxes. You'll owe taxes on pre-tax money. You won't owe taxes on Roth earnings as long as you are age 59½ or older and it's been at least five years since your first Roth contribution. You may need to pay a 10% federal penalty tax if you take money out early. Review IRS Publications 590-A and 590-B for more information on Roth IRA contribution and distribution rules.

When considering where to invest these savings, examine not only your job characteristics but also your household structure and spending flexibility. Being the sole income earner or having a large percentage of your budget going to necessary expenses (such as food and utilities) may mean leaning more toward transactional than accessible accounts. For those who invest this portion of savings, also consider adjusting your target amount based on the investment allocation and expected volatility.

Take action

- ☐ **Understand your typical monthly spending and identify available savings.** By knowing this information, you can identify shortfalls or excesses.
- ☐ **Establish or maintain savings for spending shocks.** Given the likelihood of such expenses, saving for them should be a priority. Place the savings in transactional accounts such as checking and savings accounts or money market funds.
- ☐ **Establish or maintain savings for income shocks.** With savings set aside for spending shocks, work to build up savings for income shocks. Place these savings in accessible accounts from which you could withdraw assets, such as a taxable brokerage account or Roth IRA.

Help protect against significant risks with insurance

Insurance is an important component of financial wellness, enabling households to buy protection against unexpected or unwanted financial losses. As your finances improve and your goals evolve, and you acquire more assets, risks arise that may not have been present before. Insurance is a way to help manage those risks.

Given the costs associated with insurance, striking a balance between risks, costs, and coverages is prudent. It is important to consider which insurance features are essential to you and thus worth paying for. Following Weber (2022), one way to approach this is to weigh these four features:

- **Overall affordability.** Consider what you are willing to pay for, given that all households are subject to budget constraints. You may also want to consider buying insurance that may be most affordable not only over a single year but rather over your lifetime. One potential way to bring down costs is to bundle different types of insurance, such as dental, vision, and hearing. Some providers also bundle, for example, auto and home insurance.
- **Plan flexibility.** It is important to consider network or coverage options. With health insurance, for example, does a plan have in-network constraints or require a preapproved referral to see a specialist?
- **Worst-case-scenario protection.** One of the main benefits of insurance is protection against worst-case scenarios. For health insurance, this could be a maximum out-of-pocket limit. For life insurance, it could be coverage in case the head of household dies unexpectedly.
- **Cost predictability**. For some people, the peace of mind that unexpected costs will be covered outweighs the extra expense of more comprehensive insurance. If you think that unexpected bills—such as for a medical procedure, or for extended rental car coverage in case of an accident—could be troublesome, having a more comprehensive insurance package may be reasonable even if you are on a strict budget.

We recommend that households have **at least** the following insurance coverages as relevant to their situation:

Health insurance
Everyone should have some coverage, whether through an employer or the federal health insurance marketplace or, if eligible, through a public insurance program such as Medicare.

Life insurance
Life insurance should be sufficient to take care of loved ones and fund your desired goals, considering available financial resources.

Disability insurance
This is essential, especially for single-income households without ample savings, given the likelihood of a need arising over one's lifetime.

Motor vehicle insurance
Beyond state-specific rules, liability coverage is a minimum, with collision and comprehensive coverage also required for people with vehicle loans.

Homeowners or renters insurance
Liability coverage is a minimum for both homeowners and renters. Dwelling coverage is highly recommended and is required for homeowners with mortgages.

Given that most households have limited financial resources—especially if either a planned or an unplanned expense occurs—insurance can be used strategically to ensure a level of protection to help limit the possibility that an event may derail your financial security or plan. In the next section, we review common types of insurance and cost levers to consider. Be aware that insurance rules and required coverage minimums vary significantly by insurance type and state. Some insurers may also offer bundling options or discounts (for example, for home and vehicle coverage, or for life and disability coverage) that could lower costs for the insured. Review your policy or policies with a qualified insurance agent to help determine the appropriate coverage for your situation.

As we discuss different types of insurance, understand that not all coverage options may be available. For example, with health or disability insurance, you may be limited by what your plan offers. We recommend that you consider your options and make full use of employer-sponsored plan options.

Health insurance

With health care costs seemingly always rising—reported U.S. health spending totaled $4.1 trillion in 2020, or 19.7% of U.S. GDP—having health insurance is especially valuable to protect against high-loss events. Such insurance can aid in protecting against negative financial outcomes due to expected or unexpected expenses (Centers for Medicare and Medicaid Services, 2021). Examining the main drivers of health care costs finds two primary risks: age, and personal and family history. **Figure 7** offers a basic framework for assessing your need for health coverage.

FIGURE 7.

Health insurance coverage needs vary based on age and family history

	Health insurance coverage need	
Age	**No preexisting conditions or family history**	**One or more preexisting conditions or family history**
Younger (<55)	Lower	Medium
Older (55+)	Medium	Higher

Source: Vanguard.

Although people 55 and older constitute about 30% of the U.S. population, they were responsible for 56% of total U.S. health care spending in 2019.[5] Although this may represent the average, an individual's health status and family history are also strong indicators of current or potential health care needs. Most people have a family history of at least one chronic disease, such as cancer, heart disease, or diabetes (Centers for Disease Control and Prevention, 2022a). Having even one of these diseases, regardless of age, also carries a greater chance of incurring higher health care costs.

Seek to align coverage options with your anticipated medical needs, preferences, and budget. Consider the year ahead and any planned or needed procedures. Having a child on the way, a nagging pain that persists, or a family history of illness are among reasons why health insurance may be especially valuable to protect against potentially costly expenses.

5 Source: 2019 Medical Expenditure Panel Survey (MEPS) Household Component, available at meps.ahrq.gov/survey_comp/household.jsp.

Some people may think their health is good enough that insurance might not be needed, but catastrophic risks such as car accidents and sports injuries are real risks that should not go ignored.

To help households evaluate the trade-off decisions between health insurance costs and flexibility, **Figure 8** describes various managed health care plans along with common coverage features that may be available through an employer or HealthCare.gov. Be aware of enrollment windows or significant life events that may allow for changes to or signups for health insurance.

FIGURE 8.

Balance health plan features with needs, preferences, and coverage costs

Relative favorability by category:

● Most favorable (F) ● Medium (M) ● Least favorable (L)

Plan type	Premium costs	Deductibles	Ease of access to specialists	Out-of-network coverage
HMO	● (F) Generally the lowest	● (F) Generally the lowest	● (L) Requires a referral from a primary care physician	● (L) Generally out of pocket
POS	● (M) Between HMO and PPO	● (M) Between HMO and EPO	● (L) Typically requires a referral from a primary care physician	● (F) Generally covers out-of-network care, but with a higher cost than in-network care
EPO	● (M) Between HMO and PPO	● (L) Generally the highest	● (M) May or may not require a referral from a primary care physician	● (L) Generally out of pocket
PPO	● (L) Generally the highest	● (M) Between HMO and EPO	● (F) Does not require a referral from a primary care physician	● (F) Generally covers out-of-network care, but with a higher cost than in-network care

Notes: This comparison of features of various managed health care plans is provided for general information purposes; specific plan details vary and will determine personal relevance. HMO stands for Health Maintenance Organization, POS for Point of Service, EPO for Exclusive Provider Organization, and PPO for Preferred Provider Organization.

Source: Vanguard.

For households that may be willing to bear the risk of higher deductibles, and thus pay more out of pocket, each plan type shown in Figure 8 may be offered with a High Deductible Health Plan (HDHP) option. Deductibles are higher for HDHPs, so their monthly premiums are typically lower than those for lower-deductible plans. An HDHP also allows for use of a Health Savings Account (HSA) to save for future health care costs or even to use today for an unexpected out-of-pocket need (Kahler, Clarke, and Bruno, 2020). Many employers offer health care plans that allow for HSA contributions and are increasingly offering free and/or matching contributions to incentivize participation (Ascensus Savings Trends, 2022).

If you are eligible for Medicare or approaching eligibility, there are health insurance options to consider based on your personal needs and preferences (Weber, 2022).

Take action

- ☐ **Examine your current coverage and evaluate whether it meets your needs.** Understand where shortfalls may exist or where some coverage might not be necessary.
- ☐ **Prepare for enrollment windows.** Get ready for these by creating an inventory of required medications, expected costs, and potential forthcoming treatments.
- ☐ **Select a plan that balances costs with your desired coverage.** Evaluate your coverage options and choose a plan that meets most of your criteria.

Life insurance

Another less obvious risk that many overlook is untimely death. That can place exceptional strain on family finances, reducing—or, in the worst case, eliminating—household income. Although the COVID-19 pandemic made households more aware of the need for life insurance—with 31% of U.S. adults saying the pandemic made them more likely to buy it—only 52% had some form of life insurance in 2021, down from 63% in 2011 (Wood, Leyes, and Scanlon, 2021). Optimal life insurance planning should focus on obtaining sufficient coverage for your current and future needs from reliable providers at a cost-effective price (Lobel and Mizuta, forthcoming).

Planning for life insurance is not so different from planning for achieving your financial goals. First, inventory those goals and how much their financing relies on income and future savings (**Figure 9**). As mentioned in Lobel and Mizuta, the goals likely fall into one of four categories: paying for final expenses, supporting ongoing needs of dependents, paying off obligations, and funding future goals. Understanding these needs is the starting point to crafting an effective life insurance plan. Next, seek insurance quotes and examine your budgeting capacity to set up the appropriate coverage.

Although employers may offer, or subsidize, life insurance as a part of their total compensation package, be sure to review the amount of coverage offered, compare it with your identified needs, and supplement your coverage as needed.

FIGURE 9.

Life insurance needs vary with age and the funding status of household goals

	Life insurance coverage need	
Age	**Household goals are underfunded**	**Household goals are well-funded**
Younger	Higher	Medium
Older	Medium	Lower

Source: Vanguard.

Take action

- ☐ **Understand how much your future goals rely on both their priority and your future savings.** Assess which goals may fall short and which rank highest for you to fund.
- ☐ **Align your coverage with those needs.** Aim to have life insurance in place that can cover your prioritized potential needs.

Disability insurance

Human capital—the ability to work to earn income—is one of a household's largest financial resources. Although most people understand the need for health and life insurance, the sudden inability to work does not often cross our minds. Households therefore must protect against the possibility of becoming disabled and unable to earn income. For example, a 30-year-old who makes $50,000 a year after taxes, assuming no raises or bonuses over the next 35 years, would earn $1.75 million over that time. That is a significant level of assets to leave unprotected.

People in higher-risk jobs, such as construction and medical workers, or in highly specialized jobs, such as surgeons, where a disability may impair the ability to work should consider disability insurance. Employers may offer some form of disability coverage as an employee benefit. If yours does, review the plan details to ensure that you understand the coverage and that it is appropriate for your circumstances. Supplement it with additional private coverage as needed. For households that have only one income earner—or that have two income earners but could not cover all their household expenses on one salary alone—establishing coverage is more urgent.

People underestimate the probability of becoming disabled. Social Security Administration data from June 2020 showed that those born in 2000 had a 12.7% chance of dying before their full retirement age (67), versus a 25.3% chance of becoming disabled (Maleh and Bosley, 2020). People also seem aware of disability risks, yet many do not seem to act. Based on 2021 data, only 14% of Americans say they have disability insurance, yet 48% of Americans acknowledge they may need it, and 45% of families would face financial hardship within six months if a primary wage earner became disabled and unable to earn income (LIMRA, 2021).

People also may be aware of, or plan to rely on, federal programs—such as Social Security—that are available for those with disabilities, but they are often unaware of the strict requirements for meeting Social Security's disability definition. In 2018, according to the CDC, 26% of adults 18 or older reported having a disability (Centers for Disease Control and Prevention, 2022b). That same year, only about 20% of those with a disability qualified for Social Security Disability Income (SSDI) support (Erickson, Lee, and von Schrader, 2022). And even for someone who qualifies, SSDI rarely covers predisability income entirely.[6] Others may plan to rely on workers' compensation, but that covers only on-the-job injuries.

✔ Take action

- ☐ **Understand how much your future goals rely on both their priority and your future income.** Assess which goals may fall short if you become disabled and how much the shortfall would be.
- ☐ **Examine your current coverage and its features.** Determine what disability insurance may be available through an employer and understand your coverage amounts, durations, and conditions.
- ☐ **Fill any gaps with supplemental coverage.** If your existing coverage is insufficient and there are no other assets or other income to provide for the household in case of disability, seek additional coverage.

6 SSDI is based on lifetime earnings. More information is available at www.ssa.gov/benefits/disability/.

Motor vehicle insurance

Nearly every state requires some sort of insurance for motor vehicle owners. There may, though, be hidden risks, or there may be opportunities to review and adjust your coverage to ensure the appropriate level. One way to think about coverage is to split the options into two types: liability and everything else.

Liability insurance covers damage done to others and their property but not to the policyholder or to the policyholder's vehicle or passengers. Although nearly every state requires liability insurance, the minimum required coverage varies in amount ($5,000 to $100,000) and type (bodily injury and/or property). With Kelley Blue Book (2022a, 2022b) reporting that Americans in 2021 paid on average over $47,000 for new cars and $28,000 for used cars, most states' minimum policies could leave $5,000 to $22,000 or more for the policyholder to pay out of pocket for at-fault damages to others' property. Besides property damages, ensuing medical costs could easily run higher than the minimum coverage amounts, given that inpatient hospitalization costs following a motor vehicle accident average $57,000 (Cantalin, 2022).

The "everything else" category includes various types of coverage for the policyholder, such as collision, comprehensive, personal injury protection (PIP), uninsured/underinsured motorist (UM), and business-use (ride-sharing) coverage. Collision and comprehensive both cover the policyholder's property (for example, for damage from accidents or vandalism) and are typically required when taking out a loan to fund a vehicle purchase. Once the loan is paid off, this coverage can be cut back if the policyholder sets aside enough money to potentially repair or replace a vehicle. PIP adds coverage for bodily harm and other expenses for the policyholder and passengers. UM coverage can be helpful even when not required, given an Insurance Research Council estimate, based on claims data, that 12.6% of motorists in 2019 were uninsured (Insurance Information Institute, 2021).

Motor vehicle insurance can also cover several other expenses such as for breakdowns, roadside assistance, or rental cars while repairs are underway, but be aware of the costs and potential for redundant coverage. Finally, rideshare drivers, such as for Uber or DoorDash, should not forget to add business-use coverage, as many policies will not cover accidents and related damages without it.

Take action

- ☐ **Examine your current insurance coverage(s) and understand what may and may not be covered as well as how much is covered.** Understand where your coverage may fall short or be redundant.
- ☐ **Align coverage with your needs.** Make sure your coverage and goals are aligned with your budget, balancing costs with needs.

Homeowners or renters insurance

Households with a mortgage are generally required to have homeowners' insurance, whereas renters insurance is not usually required of renters. Not all coverage is created equal, nor are all damages covered. Most homeowner policies, for example, do not cover damage from flooding or earthquakes. Always consider the cost of your home and of renovations when reviewing your coverage.

Like motor vehicle insurance, homeowners and renters insurance can be thought of as liability coverage and everything else. Every household should at least be insured for liability. This will provide financial protection not only for injuries that non-occupants might sustain on your property, but also for accidental damages you may cause elsewhere. For example, if you are in an art showroom and accidentally knock over an expensive vase, liability coverage could help protect you.

In this case, the "everything else" category includes your dwelling, other structures on your property, and your personal property. For owners with mortgages, dwelling coverage is required; it covers the repair or replacement of damage done to the residence. Make sure coverage is at least 100% of your home's replacement cost should an event result in a total loss. People who may seek to rebuild can also add on inflation protection against rising home costs.[7]

Insurance companies have no way to know about any improvements made to your property unless you tell them. If improvements have been completed recently, it is a good time to check whether increasing your coverage is appropriate. Finally, most dwelling coverage does not apply to unattached structures, such as sheds and detached garages. If you have such assets, then depending on their value, adding "other structures" coverage will protect them. Knowing what is and isn't covered can ensure that you're prepared for the unexpected.

Look around your home and start calculating what your appliances, clothes, electronics, and furniture would cost to replace. We often forget to value the belongings that we see every day. Personal property coverage is therefore highly recommended if you'd be unable to pay for replacing items that may be lost or damaged during a covered event. Like dwelling coverage, personal property coverage has important criteria for how damaged property is valued and replaced. Actual cost means the current value of an item, while replacement cost means the value of a comparable item (or repair to the original item) with no deduction for depreciation.[8] Although premiums are higher for replacement cost coverage than for actual cost coverage, the former generally allows for an adequate replacement for damaged or lost items. Consider the trade-offs between higher premiums and your potential desire or ability to replace possessions.

Take action

- ☐ **Examine your current insurance coverage(s) and understand what may and may not be covered as well as how much is covered.** Determine where you may have shortfalls or redundant coverages.
- ☐ **Align coverage with your needs.** Make sure your coverage and goals are in line with your budget, balancing costs with needs.

7 Some providers may also offer extended replacement coverage or guaranteed replacement cost options.

8 This example is for illustration purposes only. Typically, with replacement value coverage, the insurer will first pay out items at actual cash value and then request receipts before making a second payment up to replacement value. Replacement costs will be governed by the insurance company policy and are subject to those calculations.

Get key legal documents in place

Many people think that setting up legal documents, such as a will or a power of attorney, is only for extremely wealthy or elderly people, but such misconceptions can put anyone's financial and other goals at risk. These documents are valuable for every household, giving you more confidence that your loved ones will be taken care of and your wishes will be followed.

This section reviews some common components of estate planning that we encourage everyone to consider. It examines how they can help protect your goals, preferences, and wishes to help identify potential areas of risk and guide you toward actions to resolve them. Establishing these documents may not be top of mind, but not having them in place may make it difficult, if not impossible, to ensure that your various goals are achieved. Consulting with an attorney on each of the relevant topics is always best before acting on any of them.

Beneficiaries

In addition to account titling, you can use beneficiary designations to establish who receives your assets after death. Retirement accounts—such as 401(k), 403(b), and 457 plans; IRAs; insurance contracts; annuities; and defined benefit plans, such as pensions—commonly have options for electing beneficiaries.[9] If an account offers such elections, it's best to use them to ensure that those assets reach your chosen person(s), charity or charities, and/or organization(s). For another layer of protection, be sure to set up both primary and secondary (contingent) beneficiaries.

Why are beneficiary elections important?
Beneficiary designations overrule any will instructions and bypass the probate legal process, with the specified assets going directly to any person(s) named, or designated by relationship, and/or to the named charity or charities or organization(s).[10] This helps to protect assets from creditors of the estate and generally eliminates the need for beneficiaries to wait for the probate process to end before receiving the assets.[11]

What to watch out for?
Courts rarely overrule beneficiary elections, so keeping this information up to date is crucial to ensuring that your assets reach the appropriate designee(s). Review your designations periodically, especially if you use relationship-based ones, and especially when major life events happen (such as marriage, childbirth, adoption, divorce, or a death in the family), as those may warrant changes to your designation preferences. Explicitly naming beneficiaries is typically best to avoid possible issues but requires diligence to update them over time.

Take action

- [ ] **Examine and update your beneficiary elections.** Are those elections still appropriate given your financial objectives? Checking and updating this information typically requires minimal time.

9 Payable on Death or Transfer on Death accounts are not included here, as assets in such accounts are still subject to deceased creditor claims. This means that when a person dies with debt, it opens up a window for creditors to claim the unpaid debt.

10 Check with your chosen organization(s) to make sure they can receive the assets. Sometimes inheriting a financial account means the organization must open an account at the institution where the assets are held, if the organization does not already have one.

11 This does not protect against creditor claims on liabilities jointly held with the deceased person or creditors of the beneficiary. Proof of death is typically required before assets are accessible for beneficiaries, though many large institutions use electronic systems to help ease this verification process.

Account titling

Account titling designates who owns an account, who can control and distribute its assets during the lifetime of the owner(s), and who receives the assets upon the death of the owner(s).[12]

Account titling accomplishes two main goals for households. First, it specifies who owns an account or asset. Second, it determines how the account or asset is handled should the owner(s) die. Typically, these titles are associated with financial accounts (banking, investments, and loans) and other assets such as a home or car, and they are established when the account is opened or the asset is acquired. Consider account titles carefully, as choosing the improper type may have unintended consequences.

Aligning account titling options with your household members' preferences and wishes will allow them to understand how their assets will treated upon their death to help advance their goals. Using these account titles can be a way to share ownership of assets and liabilities. Each account titling option has its benefits and drawbacks.

Take action

- ☐ **Review your account titles and compare them with your financial objectives.** Will the desired person(s) receive the assets? Will someone else be responsible for an outstanding loan or debt?

Emerson and Finley live together, want to share an investment account, and agree to save all the money toward a future house down payment.

Path 1: They each put $10,000 into an account titled as Joint Tenants With Rights of Survivorship (JTWROS). A few months later, Emerson withdraws $12,000 to buy a car without telling Finley. Because a JTWROS account allows both account owners full access to the assets, Emerson can legally take out the $12,000 or even the full balance.

Path 2: They each put $10,000 into an account titled as Tenancy in Common (TIC). A few months later, Emerson withdraws $12,000 to buy a new car without telling Finley. Because a TIC account allows each owner to access their interest in the account, Finley could seek to recover the $2,000 that Emerson withdrew above his $10,000.

12 Account titling options vary by state. Some options are required, while others may not be recognized by certain states.

Last will and testament

A 2021 Gallup survey found that less than half of American adults—46%—have a will (Jones, 2021). Although many may think their assets may be insufficient to warrant creating one, a will provides crucial instructions for one's final wishes—including provisions for more than just assets—and can have far-reaching impacts on the people or causes closest to them.

A last will and testament allows for control of who oversees a deceased person's estate, who receives the estate assets, and who takes responsibility for any dependents (including pets).[13] If you die without a last will and testament in place—known as dying intestate—federal, state, and/or local law will typically make these determinations for you. Given that these agencies have no idea what your goals and objectives are or were, having a last will and testament is highly recommended for everyone.

A last will and testament also accomplishes a few important tasks. Naming an executor is arguably one of a will's key components. The executor will supervise and handle several duties relating to the instructions laid out in the will.[14] Although you may wish to consider your relationship with your prospective executor, choosing that person is not an easy task, and you should not be motivated solely by emotions when making this decision. Be sure to talk to the person you have in mind and make sure they agree with taking on the responsibility. You also may elect to choose a professional advisor as your executor. This option, though, may cost more and take more time, as the advisor will want to make sure that all decisions are made appropriately in line with your desires.

Also name the desired beneficiary or beneficiaries for any probate assets; this specifies who receives them. Such assets are typically items that would otherwise lack a beneficiary designation or account titling structure to handle the transition of the items, such as furniture, electronics, jewelry, and art.

Finally, name a guardian for minor children, elderly parents, and pets as well as for any property left to them on their behalf.[15] This ensures that the proper person is responsible for looking after those who are closest to you and most vulnerable. Be sure to discuss the guardianship with your prospective designee(s) to make sure they are willing and able to take on the role. When there is no will or specified designee, courts generally choose the closest biological relative, based on the best interest of the dependent(s). This may or may not end up being aligned with your wishes.

Although often an attorney is not required to draft a last will and testament, it is best to work with one to ensure that the document addresses and covers your goals and objectives. The last will and testament should be typed, signed, and dated. Not all states require that it be notarized, but doing so helps prove the document's legitimacy and may help to limit future legal challenges. Also required when signing a will is that you be of sound mind and not acting under duress; otherwise, the document will be considered invalid. This issue can catch many people off guard if a sudden death or incapacitation happens, making it too late to establish a will.

13 This list is not meant to be exhaustive.

14 Executor requirements vary by state; check with local laws before deciding on your designation.

15 Pets are considered property, and property cannot own another piece of property. Assets should not be left directly to pets but instead can fund a trust for their benefit and care.

As with the other items discussed so far, make sure to update any last will and testament as changes to your life circumstances warrant. Costs to establish the document vary. Revisions generally cost less, depending on the magnitude of the changes requested.

Take action

- ☐ **Inventory and review any existing last wills and testaments.**
- ☐ **Identify any deficiencies and act to establish documents or revise existing ones.** Are your account structures appropriate for your goals? Has your family grown? Have your goals and objectives changed?
- ☐ **Make sure that documents are easy to find and that a trusted person can access them.** Without someone knowing about or having access to the estate documents, the work to set them up will be wasted.

Power of attorney (POA) and living wills

Untimely deaths happen, but disability and incapacitation are far more likely to occur. Although not all disabilities result in incapacitation, the CDC reports that about one in four adults have some type of disability that impedes their daily activities (Centers for Disease Control and Prevention, 2020). This highlights the need to have documents in place to allow other people to make decisions should an unexpected injury or accident occur. Having a power of attorney in place can establish trusted persons to help carry out your desires when you may be unable to do so.[16]

What is a POA? This document authorizes one or more people to make specified decisions in your stead. When considering POAs, think about two components: When do you want to give over the authority, and what decisions do you want your POAs to govern?

For estate planning, the *when* typically comes in two forms: durable and springing (**Figure 10**).[17]

FIGURE 10.
Key differences between two types of power of attorney

	POA Type	
	Durable	**Springing**
When it takes effect	Immediately upon its signing	When the principal is incapacitated, or when a specified event occurs
Benefits	It is effective both before and during the principal's incapacitation	The principal maintains decision power until the triggering event occurs
Disadvantages	The principal may not want to give over decision-making power before the need develops	The granting of decision power could be delayed while proof of incapacitation is established

Source: Vanguard.

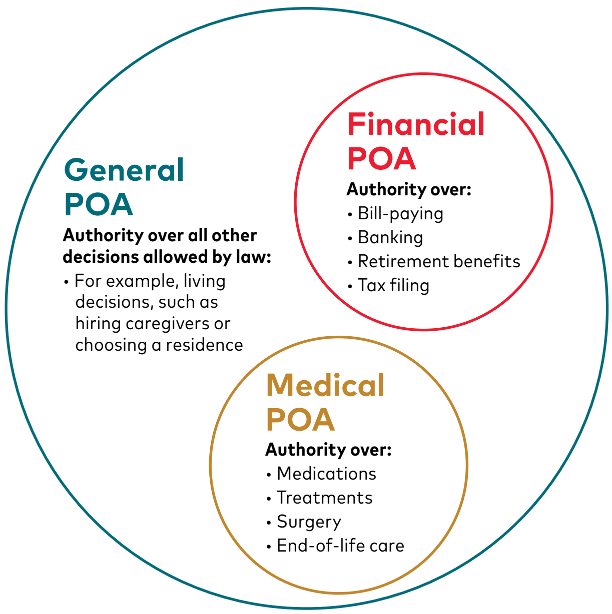
16 Once the principal—the person delegating authority—dies, any POAs are nullified and no longer valid.

17 There are also nondurable POAs, but they generally are less commonly used in estate planning.

Once the timing is determined, the *what* generally follows. POAs can be very specific or broad, based on your desires, but they all accomplish one thing: establishing a trusted person or persons to make important decisions when you cannot do so (**Figure 11**).

FIGURE 11.

Power-of-attorney categories and decision power



Source: Vanguard.

What is a living will? A living will outlines medical treatments that you would and wouldn't want used to keep you alive, as well as other medical decision preferences. Living wills are more limited than POAs; they apply only to decisions about life-sustaining treatment in the event of a terminal illness or injury.

How can you use a POA and living will together? The POA gives decision-making power to a specific person or persons. Adding a living will ensures that your medical decisions are not overruled by the POA or a doctor. For people with strong convictions about the treatment(s) they would like to receive in dire scenarios, a living will can be especially valuable to add another layer of control over care at those times.

Take action

- ☐ **Inventory any existing POAs and living wills.**
- ☐ **Identify any deficiencies and revise existing documents or establish new ones.** Has your household grown? Are your account structures appropriate for your goals? Have your goals and objectives changed?
- ☐ **Make sure that your documents are easy to find and that a trusted person can access them.** Without someone knowing about or having access to them, the work to set up these estate documents will be wasted.

Trusts

A trust is a specific type of account titling that allows for holding and distributing assets on behalf of the beneficiary or beneficiaries. Not every household needs to establish one, but a trust can serve a wide variety of purposes and desires. Given the breadth of reasons that trusts may be considered for both during-life and post-life planning, we focus here only on the additional components that a trust offers compared with a last will and testament.

- **More control over asset disposition**
  Trusts allow for establishing start dates, end dates, and conditions for distributing assets to beneficiaries. This can be especially helpful for setting up asset distributions to support minor children as they grow and develop financial responsibility, or for setting up special needs trusts to take care of disabled children or parents, or even pets, in your absence.
- **Avoidance of probate**
  Trusts can be used to pass assets to beneficiaries outside the probate process, although other options (such as account titling, transfer-on-death/payable-on-death designations, and the naming of beneficiaries) are also available to avoid going through probate.

Consulting an attorney is highly recommended; expect costs for establishing a trust to be higher than a will.

✔ Take action

- ☐ **Inventory any trusts that may already be in place.** Find any existing trust documents you may have.
- ☐ **Identify deficiencies and act to establish documents or revise existing ones.** Is a trust structure appropriate for your goals? Do you have a strong desire or reason to have more control over asset disposition to beneficiaries?

Step 3

Make progress toward your goals

For households to achieve their long-term financial goals, it is wise to first remove impediments to attaining them. Our first step guided households to get their finances under control by setting up an effective budget that helped them take advantage of high-reward opportunities, such as paying down high-interest debt, maximizing their employer plan match, and making minimum payments on all debts. Our second step advised households to protect against unexpected events, such as spending shocks or unemployment.

Now we turn to longer-term goals, which we divide into four categories:

- **Retirement, education, and health.** Households should consider saving more in tax-advantaged accounts to fund a comfortable retirement, pay for education, and cover health expenses now or in the future.
- **Home, vehicle, vacation, and early retirement.** Households are advised to consider using taxable accounts to save for shorter-term goals—such as house and vehicle down payments, vacation, and early retirement—given the flexibility such accounts provide.
- **Paydown of lower-interest debt.** We highlight the importance of paying down lower-interest debt. We also highlight when holding debt may make sense for investors.
- **Charitable giving.** Finally, we use the term "investing in others" to reflect the charitable inclination of many households and their wishes to pass down assets to loved ones.

Making progress toward any of these goals is likely to provide benefits beyond the financial value of achieving them. Securing a comfortable retirement, making the final payment on a mortgage, and helping others are certainly important for most households. Although we present these goals in a given order, consider prioritizing what you believe will provide the most satisfaction to your household. When it comes to household finances, one size does not fit all.

Increase savings in tax-advantaged accounts

In this section, we highlight how increasing your savings and using tax-advantaged investment accounts are critical factors for investing success. Although the notion of investing for retirement can be overwhelming at times given its enormity and uncertainty, we help break down the challenge by showing how even incremental steps now can make a big difference in the future, particularly when you consider the power of compounding in tax-advantaged accounts.

Savings and investing

The media report on market returns every day. Naturally, many people tend to associate investment success with strong investment returns. But even if someone were to follow the most successful investment strategy every year, it would not deliver much in dollar amounts if the person did not have much money invested (Clements, 2016). A 20% gain only turns $1.00 into $1.20, but it turns $1 million into $1.2 million.

The nearly $200,000 difference in outcome highlights the importance of saving and investing money.

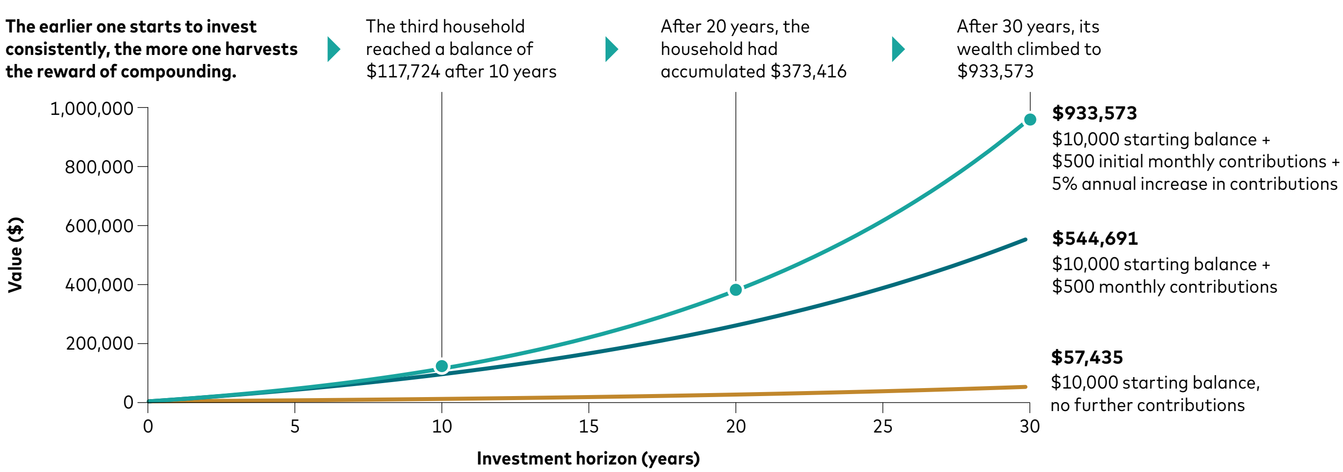
To show how saving and investing affect investment success, we simulate three households' behavior to evaluate the importance of the following savings goals on investment outcomes:

- the initial amount invested
- monthly contributions
- increases in monthly contributions over time

In our example, all three households opened an investment account to fund a goal in 30 years. The first household initially contributed $10,000 to the account. The second household built on the first one but added a monthly contribution of $500 to the account. And the third household built on the second one but increased the $500 monthly contribution by 5% every year. For simplicity, we will assume a fixed rate of return of 6% a year, compounded monthly. **Figure 12** shows their investment outcomes.

FIGURE 12.

Increasing monthly investment contributions can dramatically affect household outcomes



Notes: The scenario shown is hypothetical for illustration purposes only; it does not predict or represent any particular investment product or its expected returns. The figure assumes annual returns of 6%. Monthly returns are assumed to be the geometric averages of these values. Contributions are per month and made at the end of each period. Balances reflect the value at the end of each period. The figure does not account for any taxes.

Source: Vanguard.

The first household, which contributed $10,000 initially to the account with no further investment in it, ends up with $57,435 in 30 years. The second household, which invested $10,000 initially and then $500 a month for 30 years, amasses $544,691 in wealth. Compared with the first household, the second household added almost $500,000 in wealth through its monthly contributions. The third household, which contributed $10,000 initially and increased its monthly $500 investment by 5% every year, ends up with $933,573. Compared with the second household, the third household ends up with almost $400,000 more in wealth because of its yearly increases in contributions. This illustrates how consistency is key for long-term investment success, along with the power of starting to save early.

Tax-advantaged accounts

Households can neither control nor predict market performance, but they *can* control investment costs. Two of the largest costs are fund expense ratios and taxes. Vanguard has popularized the use of low-cost, broadly diversified funds. This guide presumes that these types of funds are used for investing.[18]

Taxes are another large household expense. However, tax-advantaged account options can encourage saving for some of a household's largest financial goals, such as retirement, education, and health care. When possible, households should make use of tax-advantaged accounts. **Figure 13** summarizes the tax benefits they provide as well as some constraints on their use.

We next evaluate how to best use these tax-advantaged accounts for retirement, health care, and education savings.

18 See Vanguard (2020) for more details on how fund costs affect investors' balances.

FIGURE 13.

Tax-advantaged accounts offer many benefits for investing, but with some constraints

Account type	Best purpose	Taxability of contributions	Investment growth	Taxability of withdrawals	Considerations
Roth IRA or employer plan	**Retirement**	Taxable	Tax-deferred	Tax-free	• For 2023, IRA holders are allowed to make contributions of up to \$6,500, or up to \$7,500 for people 50 or older. • Roth IRA contributions may be withdrawn from the account without penalty or taxation.[*] Roth withdrawals from employer plans are always pro rata from contributions and earnings. • For 2023, employer plans generally allow contributions of up to \$22,500 for 401(k), 403(b), and most 457 plans. For people 50 or older, additional catch-up contributions of up to \$7,500 may be available. Other special catch-up rules for 403(b) plans may also apply. • Some plans may allow employees to contribute up to \$66,000 by making after-tax contributions. • In most cases, withdrawals before age 59½ incur ordinary income tax on pre-tax contributions as well as on all earnings, with an additional 10% federal penalty tax (457 plan withdrawals are penalty-free).[‡]
Traditional IRA or employer plan	**Retirement**	Pre-tax[†]	Tax-deferred	Taxable	
Health Savings Account (HSA)	**Health and/or retirement**	Pre-tax	Tax-deferred	Tax-free[§]	• For 2023, contribution limits are \$3,850 for an individual and \$7,750 for a family. • People 55 or older may make an additional catch-up contribution of up to \$1,000. • Money can be used at any time or invested for later use. • Once the owner is 65 or older, withdrawals can be taken for any reason and will be taxed the same way traditional IRAs would.
Flexible Spending Account (FSA)	**Health**	Pre-tax	Not available	Tax-free[§]	• For 2023, contribution limits are \$3,050 for an individual and \$6,100 for a family. • The money contributed cannot be invested, and little of it can be transferred from year to year. • Unused funds return to the plan.
529 college savings plan	**Education**	Taxable	Tax-deferred	Tax-free[§]	• Contributions are considered gifts. The 2023 annual gift limit is \$17,000 per beneficiary per donor.[**] • In most cases, contributions are deductible from state income taxes.

* Review IRS Publication 590-B for more information on withdrawals.

† Contributions may not always be deductible. To learn more, review IRA Deduction Limits at www.irs.gov/retirement-plans/ira-deduction-limits.

‡ There are exceptions, which vary by account type, that may allow for a waiver from the 10% penalty for withdrawals before age 59½.

§ Distributions must be offset by qualified expenses to avoid possible taxation and/or penalties.

** Other methods such as split gifting and "superfunding" may allow for additional contributions to be made without gift-tax consequences. Consult a qualified tax professional for more information. States also have varying aggregate lifetime contribution limits per beneficiary to 529 plans; review plan rules for more information. Also see Appendix 2 on page 51.

Source: Vanguard.

Retirement

Saving for retirement is likely one of the largest and most common goals for many households. With defined benefit (DB) retirement plans having largely given way to defined contribution (DC) plans, the task of saving for retirement has fallen on participants. People over 65 report that Social Security provides only about 30% of their aggregate income, so saving and investing for retirement has become an important task for workers (Dushi and Trenkamp, 2021). With that expected shortfall, investors are encouraged to set aside savings to fund a comfortable retirement.

Employer-sponsored plans

Employer plans can be an especially effective way to save for retirement because many plans offer either employer matching or employer contributions that can increase savings. It's generally best to contribute enough to earn the full match and any available nonelective contributions should your budget allow.[19]

Also, plans allow employees to contribute up to $22,500 (for tax year 2023) for 401(k), 403(b), and most 457 plans, with additional catch-up contribution limits for people who are 50 or older at the end of the calendar year.[20] All plans allow for pre-tax contributions (which reduce an employee's taxable income), and many also offer Roth contributions (which are made with already taxed dollars but allow for tax-free withdrawals later).

Be sure to review a plan's investment options and set up an asset allocation that aligns with the appropriate risks and objectives while considering costs. Many plans have options such as target-date funds, which are an attractive way to build a low-cost diversified portfolio whose risk profile changes over time.[21] Managed account advice may be another option to help select a personalized asset allocation, as access to such offerings have expanded in recent years. Also consider plan withdrawal rules in case an emergency occurs or unexpected needs arise before retirement, as plan assets are generally more difficult to access while you are still employed.[22]

Individual Retirement Arrangement (IRA)

IRAs are another favorable option for retirement savings. They allow for investors to contribute up to $6,500 per year, plus an additional $1,000 in catch-up contributions for people who are 50 or older at the end of the calendar year.[23]

If you are eligible to make Roth IRA contributions and are already meeting any available employer match, a Roth IRA is likely the next best place to contribute your money, given the ability to access it if needed, as contributions may be withdrawn free of income taxes or penalties. IRAs can hold nearly any type of investment, such as mutual funds, ETFs, or individual securities.[24] This can help control investment costs and provide more flexibility for accessing funds later if needed. Top off remaining retirement savings with unmatched employer plan contributions if available.

19 Matching and nonelective employer contributions vary by plan and may be limited by law. Consult plan documents for more information.

20 Some plans may allow for after-tax contributions and have higher employee limits on contributions overall. Catch-up contribution limits also vary by plan type. Consult plan documents for more information.

21 Investments in target-date funds are subject to the risks of their underlying funds. The year in the fund name refers to the approximate year (the target date) when an investor in the fund would retire and leave the work force. The fund will gradually shift its emphasis from more aggressive investments to more conservative ones based on its target date. An investment in target date funds is not guaranteed at any time, including on or after the target date.

22 Terms for plan loans or hardship withdrawals vary by plan. Consult plan documents for more information.

23 Review IRS Publication 590-A for additional important information on contribution rules and limits.

24 Review IRS Publication 590-B for additional important information on distribution rules.

Health Savings Account (HSA)

HSAs can be used as a way to save for retirement. They not only are powerful tools to use for more immediate health care costs but also provide substantial tax advantages when saved for such costs in retirement. People who are enrolled in a High Deductible Health Plan (HDHP) and meet other contribution rules can put away up to $3,850 for oneself only or up to $7,750 for family HSAs for 2023. Those 55 or older can also make catch-up contributions of up to $1,000. (For more on HSAs, see page 38.)

HSA contributions that are made but not spent in the current year can be invested and carry over year to year indefinitely. Whether tomorrow or in 30 years, those contributions and earnings can be taken out tax-free for qualified medical expenses.[25] And once the owner is 65 or older, withdrawals can be taken for any reason and be taxed as traditional IRAs would be.

Take action

- ☐ **Contribute enough to your employer retirement plan to earn the entire match.** The return on your contribution is equivalent to a guaranteed return on your money.
- ☐ **Contribute, if eligible, to a Roth IRA.** You'll never be taxed or pay penalties on withdrawals of your Roth IRA contributions, and after age 59½ you won't be taxed on earnings. A Roth also won't be subject to required minimum distributions (RMDs) during the account owner's lifetime.[26]
- ☐ **Increase contributions to your employer retirement plan.** Consider contributing more to it if you're able. One way is to use an auto-escalation feature, in which your plan automatically increases your contribution amount yearly.

25 You can only use your HSA for medical costs that are covered. Otherwise, you may have to pay income tax on the money you take out. And if you're under age 65, you may also face a 20% federal penalty tax. Review IRS Publication 969 for more information on HSA distribution rules.

26 Withdrawals from a Roth IRA are tax-free if you are over age 59½ and have held the account for at least five years; withdrawals taken prior to age 59½ or five years may be subject to ordinary income tax or a 10% federal penalty tax, or both. (A separate five-year period applies for each conversion and begins on the first day of the year in which the conversion contribution is made.)

Health care

Running out of money for health care during retirement is a concern for 30% of workers (Bearden, 2022). Part of the concern may stem from understanding that people tend to spend more on health care as they age, in addition to medical costs rising faster than broader inflation measures. In fact, medical care inflation has grown at an average annualized rate of 3.22%, compared with 2.46% for the broader inflation measure—the Consumer Price Index for All Urban Consumers (CPI-U)—since HSAs were introduced in December 2003.[27] With medical costs consistently rising, being strategic when saving for health care is ever more important.

Many may not realize there are health care-specific savings accounts that offer significant tax advantages today and into the future, which eliminate the need to rely solely on checking and savings accounts or retirement accounts. Saving for health care generally takes two forms: saving for near-term expenses and for future ones. It is important that investors are prepared in case they need the funds to spend on health care.

Health Savings Account (HSA)

HSAs are flexible for both near-term and long-term needs. For 2023, people who are enrolled in a High Deductible Health Plan (HDHP) and meet other contribution rules can put away, pre-tax, up to $3,850 for oneself only and up to $7,750 for family HSAs.[28] Catch-up contributions of up to $1,000 are also available for those 55 or older. And later withdrawals for qualified medical expenses are then tax-free.[29]

What do these tax features mean? Think of it as an increase in spending power equal to the taxes you would have otherwise paid. Say you have saved $1,000 of income in an HSA and have a marginal federal tax rate of 22%; that means saving $220 in taxes you would have owed had that money gone into a checking or savings account.[30] And that $1,000 can later be withdrawn for qualified medical expenses, with no taxes due.

HSA contributions, then, can be used as a transactional account to cover eligible expenses today or as an investment account to save for future health care costs (including Medicare premiums), or as a little of both (Kahler, Clarke, and Bruno, 2020). Employer matching or nondiscretionary contributions may be available to provide even more value and savings.

Despite its advantageous tax treatments, an HSA may not be an investor's best choice when paying for health care expenses, for two reasons. First, HSAs may not be available for some investors. Second, even when they are, investors may prefer having a low-deductible health plan, which would make them ineligible to use the HSA. Consider your personal situation when deciding the best way to pay and save for health care expenses.

27 Vanguard calculations, based on data from the U.S. Bureau of Labor Statistics and the Organisation for Economic Co-operation and Development from December 2003 through March 2022.

28 Review IRS Publication 969 for additional important information. Most states, except California and New Jersey, allow HSA contributions, growth, and distributions to avoid being taxed, but rules are always subject to legislative changes. Contributions may also be exempt from Federal Insurance Contributions Act (FICA) taxes—which are used to fund Social Security and Medicare—if contributions are made through payroll deductions with an employer Section 125 cafeteria plan. Review plan documents for more information.

29 Review IRS Publication 502 for additional important information regarding qualified expenses.

30 Additional FICA tax savings may be available if contributions are made through payroll deductions with an employer Section 125 cafeteria plan. Review plan documents for more information.

Flexible Spending Account (FSA)

For employees who may not have an HDHP, a health care FSA can also allow you to save pre-tax money (up to $3,050 for 2023) to spend on eligible unreimbursed medical expenses, including copayments, dental work, eyeglasses and contact lenses, and prescriptions.[31] If you have an HDHP with a limited FSA, those expenses are restricted to eligible dental and vision care only.

There are important caveats to remember. Most FSAs require that the expenses be reviewed before being reimbursed, so be sure to have accessible cash on hand while you wait for the reimbursements to go through.

In addition, by law, money put into FSAs cannot be invested or generate any earnings, and there are limits on how much money in an FSA can carry over into future years (for example, up to $610 for 2023, or a grace period into the first few months of the next year, subject to plan rules). Any remaining amounts above the carryover limit, or if unused within a grace period, are forfeited back to the plan. So FSAs are good for near-term expected health care costs, but the carryover limits also make these accounts ineffective for long-term planning.

Take action

- ☐ **Consider using an HSA if an HDHP makes sense for you.** An HSA has a triple tax benefit when used for qualified medical expenses. If you can pay for health care expenses out of pocket, the account can grow tax-free. Even using it as a transactional account is advantageous because of the tax benefits.

- ☐ **Consider using an FSA if you anticipate medical expenses and have no access to an HSA.** Just make sure to use the money in the FSA within the designated time frame. Any remaining amounts above the allowable carryover are forfeited back to the plan.

31 Review IRS Publications 969 and 502 for additional important information.

Education

Planning for educational costs is top of mind for many parents and individuals. This is not surprising given that college tuition has been rising over the last decade by about 3% per year.[32] Given this rapid increase in prices, households should be strategic about how to save for educational expenses.

529 plans

A 529 plan is a tax-advantaged account specifically intended to fund qualified education expenses. Money invested in a 529 grows tax-deferred, and later qualified distributions are tax-free. Some states also allow for tax deductions or credits on contributions. As work by Kahler and Bruno (2021) has shown, 529 plans are one of the most tax-efficient ways to pay for college costs. However, data from Sallie Mae and Ipsos (2021) indicate that funding from 529 plans covered only 11% of total college costs, even though these accounts could be used for up to about 90% of expected 2021–2022 enrollment-weighted costs.[33]

What should you consider about 529 plans? Withdrawals are tax-free if used for a limited range of qualified college expenses. These include tuition and fees, books and supplies, computer software, internet access, room and board, special needs equipment, and even student loans (with a $10,000 lifetime limit on loans). Certain states also allow tax-free withdawals of up to $10,000 per year for K–12 tuition and fees. If you take a nonqualified withdrawal, a 10% penalty plus income taxes apply to the earnings portion of the withdrawal.

What if you cannot use all the money saved in the 529? Several options may allow you to avoid taxes and penalties, such as transferring ownership to a relative of the child who is the plan's named beneficiary.[34] For more information about 529 plans, see Appendix 2 on page 51.

Take action

- ☐ **Consider opening a 529 account.** Most states offer a tax benefit when contributions are made to a 529 plan. Remember, anybody can contribute to a 529, not just the beneficiary's parents or grandparents.

32 Vanguard calculations, based on data from the College Board (2022).

33 Vanguard calculations, based on data from the College Board (2022).

34 Review IRS Publication 970 for important information.

Add flexibility with taxable accounts

Taxable accounts are the most flexible in terms of accessibility, as you can take withdrawals at any time without added tax penalties. This allows you to use money for nearly any purpose without having to worry about extra costs or needing to meet certain criteria to avoid tax penalties.

People using taxable accounts can also choose from a nearly endless supply of investments in the market. However, income and capital gains distributions incur annual taxes, as do any gains when you sell shares.[35] On the other hand, the taxation of such accounts also enables you to use tax-loss harvesting strategies that may help mitigate these potential drags on after-tax performance.[36,37,38]

What goals should taxable accounts be used for?

The flexibility of taxable accounts makes them ideal for a multitude of goals. For shorter-term objectives, such accounts should have conservative investments, as preserving your principal is important. For intermediate-term goals, you can use a taxable account—such as a blend of stocks, bonds, and cash—for a house down payment or a car.

Taxable accounts can also be used for many long-term goals. Some households may find them to be a desirable vehicle for saving more than allowable limits on retirement or health care or education accounts, using more aggressive investment allocations. And by investing in taxable accounts, you gain tax diversification—the ability to strategically withdraw spending money in the future (for, say, retirement or college costs) while minimizing the tax and penalty impacts.

When you need flexibility, a taxable account may be just what you're looking for.

Take action

- ☐ **Consider a taxable account for the flexibility it provides.** Although this type of account does not offer tax benefits, it does provide flexibility. Households can use it to save for short-term goals or early retirement, or as a vehicle for saving more than the amounts allowed in tax-advantaged accounts for retirement, health, and education.

35 Review IRS Form 1040, Schedule D, Publication 550, and Form 8960 for more information.

36 See Paradise, Khang, and Dickson (2021) for Vanguard's position on tax-loss harvesting.

37 Review IRS Publication 550 for additional important information on wash sales.

38 Tax-loss harvesting involves certain risks, including, among others, the risk that the new investment could have higher costs than the original investment and could introduce portfolio tracking error into your accounts. There may also be unintended tax implications. We recommend that you carefully review the terms of the consent agreement and consult a tax advisor before taking action.

Pay off lower-interest debt

When determining a debt payoff strategy, ignoring the investing side of the equation would be imprudent. When allocating money toward debt, the easiest way to determine whether it's best to prioritize payoff is to ask, "What returns would be expected if this money was invested instead?" Depending on your asset allocation, your return and risk expectations for your portfolio may vary. Review the expected return of your portfolio against the proposed prioritized debt rate.

What is considered lower-interest debt?

Usually, debt borrowed to fund longer-term appreciating assets, such as a home or education, may be at interest rates much lower than that of unsecured debt such as credit card and payday loans. These types of loans may also allow for tax deductions that lower total interest costs.[39] It's always best, however, to review the debt interest rate, regardless of the type of borrowing, while deciding what is considered high- or low-interest debt for your household.

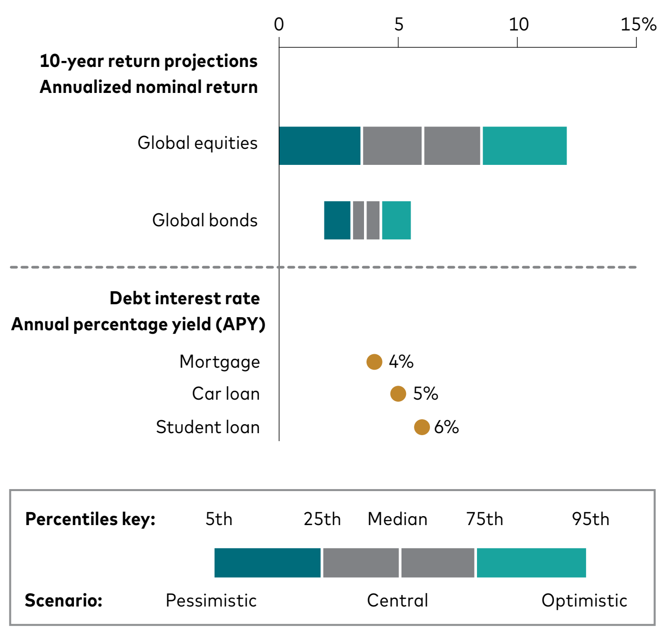
Although we mention home and education loans here as examples of low-interest debt, not all such loans are the same. Over the last five years, federal direct student loan rates for undergraduates varied from 2.75% for the 2020–2021 school year to 5.05% for the 2018–2019 school year. Rates for the Parent Loan for Undergraduate Students (PLUS) program over the same time frame ranged from 5.3% to 7.6% (Federal Student Aid, 2022). Rates for private lenders vary even more. Mortgage rates will similarly vary by several factors, including but not limited to credit score and prevailing interest rate environments at the time of the mortgage's origination or refinancing.

Consider, for example, a recent college graduate who bought their first home with a mortgage and a second person who has just retired and moved and has a mortgage. Both people have similar credit, receive the same 4% mortgage interest rate, and claim the standard income tax deduction.[40]

The recent graduate's comparatively long-term horizon and ability to take risk means that their asset allocation is likely to be more aggressive, with a higher percentage in equities, and their investment returns are more likely to outperform the 4% mortgage rate (**Figure 14**). Consequently, the graduate could focus on investing, while making the minimum payments on the mortgage.

FIGURE 14.

Prioritizing some debts over investing may make sense for some people but not others



Notes: The figure compares VCMM projected annualized investment return distributions over 10 years with common consumer debt interest rates. Simulations are as of June 30, 2022. Debt rates shown are hypothetical and do not represent a potential lending cost.

Source: Vanguard.

39 Deductions are subject to limits and income limitations. Review IRS Publications 970 and 936 for more information.

40 Mortgage interest may be deductible when itemizing deductions. Review IRS Publication 936 for more information.

The retiree typically has a more conservative asset allocation, given the need to preserve rather than grow assets at this phase, with a larger portion of their portfolio in bonds. In this case, investing is less likely to outperform putting money toward paying off the mortgage. So the retiree could focus on paying down the mortgage debt, as paying down a loan is a guaranteed return on the money.

Paying down lower-interest loans should also follow the avalanche method, meaning that investors should start making additional payments toward the debt with the highest interest rates. Depending on your life stage and investment trade-offs, you can choose to either pay down lower-interest debt, using money previously allocated to investing, or to rely on your budget and one-time windfalls to accelerate the paydown strategy.

Other factors to consider

The potential for maximizing after-tax wealth is not the only consideration when paying down debt. Two more factors should be weighed: liquidity preferences and behavioral considerations (Paradise and Kahler, 2020).

First, once cash is used to pay off debt, in whole or in part, that money is generally inaccessible going forward.[41] With lower-interest debts, there may be less value in giving up accessible funds to accelerate payoff, especially if you have other competing short-term needs. For households with less flexible budgets and upcoming underfunded obligations, it may be reasonable to forgo accelerating payoff toward lower-interest loans to make sure you have money on hand when needed to fund other goals. Weigh the flexibility of those needs against the additional interest costs, as returns over very short time frames are unlikely to meaningfully affect goal success, assuming appropriate asset allocations.

Second, don't dismiss behavioral considerations either. Households that are averse to debt, have healthy balance sheets, and are on track for their other goals can afford to be more flexible with prioritizing paying off lower-interest debt. Although investing instead of paying off debt may result in higher net worth, the trade-off for peace of mind may not materially affect your other goal outcomes.

Overall when it comes to debt, eliminating high-interest debt should be a priority. When paying down lower-interest debt, keep in mind investment trade-offs as well as behavioral considerations and your liquidity preferences. What's most important is that the decision to pay down debt brings households closer to achieving financial goals.

When does debt make sense for investors?

Not all debts are the same. Some households carry debt in credit cards or personal loans to finance short-term expenses, such as taking a vacation or balancing an unbalanced budget for a few months. Since these types of debt do not require collateral, they usually charge high interest rates because of the risk the debtor takes when lending the money.

We do not recommend taking on debt to finance short-term expenses. For such needs, we suggest looking for funds in your budget before committing to an unsecured, higher-interest loan. In case of emergencies, setting aside emergency savings will likely help in avoiding short-term debt.

41 Mortgages are the most likely exception to this rule, but accessing property equity requires taking out an additional loan or loans.

On the other hand, households often take out loans to finance long-term investable assets, such as housing and education (human capital). Households may consider taking on debt to finance these costs because, for housing, consumers build equity over time when paying down a mortgage. For education, a college degree may make a substantial difference in lifetime earnings—the median college graduate earns $1.28 million throughout their career, compared with about $630,000 for a high school graduate (Broady and Hershbein, 2020). If you're considering debt for investments in housing or education, we still suggest you research the debt's suitability before making any final decisions. Two main potential issues come to mind:

- First, make sure the investment opportunity will provide the returns to justify the debt. With education loans, to ensure that your expectation is realistic, check whether the chosen institution is accredited and how much its graduates earn.
- Second, make sure the debt repayment fits into your household's budget, so you can reasonably make the loan payments without compromising the ability to do other things in life.

These points are important when determining whether taking on debt to finance investments will be a wise long-term decision.

Take action

- ☐ **Pay off debt, starting with your highest-interest debt.** Paying the higher-interest debt first will save on interest.
- ☐ **Evaluate your debt comfort.** At times, the peace of mind of paying down debt outweighs the benefit of investing extra cash flow that could earn a higher return in the market. If this is true for you, consider directing more money toward paying down debt.
- ☐ **Evaluate your liquidity needs.** Having cash on hand may also be important for your peace of mind. Directing more money toward paying debt forgoes liquidity in the short term. Evaluate whether you need cash in the short term.

Consider investing in others through gifts

If your household is charitably inclined, you may be using, or considering using, your wealth to make a positive impact on the people and/or organizations you most care about. While doing so, you may be able to take advantage of potential tax benefits.

But keep two things in mind: First, although donations to qualified organizations offer potential tax benefits, it is rare that those benefits exceed the total cost of the gift.[42] And second, giving away assets today means that, in most cases, they won't be available for current or future use, and that may affect your ability to achieve other financial goals.

Gifts to individuals: Ensuring that your assets directly help people you know

Personal gifts of cash or noncash assets made today may not save you taxes today, but they can be an effective way to give. With the 2023 annual federal gift tax exclusion of $17,000 for individuals and $34,000 for married couples, you can make a potentially significant impact without incurring additional taxes.[43]

Impactful gifting examples may include:

- making 529 plan contributions for a child or grandchild
- establishing a UGMA/UTMA account for a minor to use later in life
- contributing to an ABLE account for an eligible disabled person[44]
- paying off a debt for a loved one or helping them financially.

Future estate and/or inheritance taxes

For households with significant assets that may be subject to estate taxes, the 2023 federal lifetime estate and gift tax exemption is $12.92 million for an individual or $25.84 million for a married couple. The personal gifts just mentioned can be a way to accelerate current giving to reduce your assets and thus reduce potential future federal estate taxes (which are currently assessed at rates up to 40%).

Certain states also levy separate estate taxes on household estates, or inheritance taxes on the beneficiaries, or—in Maryland—both, on bequests.[45]

Given the complexity of these strategies, and likely other considerations, we strongly encourage you to consult with an attorney, a tax accountant, and a financial planner before pursuing gifting with these objectives. For a more in-depth review of Vanguard's thoughts on charitable giving, see Harbron, Shin, and Greene (2022).

Gifts to charity: Making a positive impact while potentially lowering taxes

Cash donations

Households that itemize deductions on tax returns can donate cash to any qualified organization and may be able to deduct up to 60% of their adjusted gross income (AGI).[46] So if your AGI was $100,000, you would have up to a $60,000 deduction available to go toward reducing your tax liability. If you are charitably inclined, this deduction can be a significant benefit in addition to helping one or more organizations that resonate with your convictions and beliefs. Remember to keep a record or receipt from the charity for when you file your taxes, and be sure to make any contributions before the calendar year ends.

42 See the IRS's research tool at apps.irs.gov/app/eos; certain religious organizations or governmental agencies may not be listed in its database. If such information is missing, review IRS Publication 526, which outlines qualification criteria.

43 Review IRS Form 709 for important tax considerations. Connecticut is currently the only state that assesses gift taxes on gifts that exceed the federal lifetime estate and gift tax exemption.

44 Review IRS Publication 907 for important considerations.

45 Estate taxes are levied by Connecticut, the District of Columbia, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York state, Oregon, Rhode Island, Vermont, and Washington state. Inheritance taxes are levied by Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania.

46 IRS Publication 526 outlines qualification and deduction criteria. Deduction limits vary depending on the type of property given and the type of organization you give it to.

Noncash donations

Households can also make noncash donations. Long-term appreciated assets, held for at least one year, such as stocks or property can be appealing to donate, as they are deductible at fair market value, up to 30% of your adjusted gross income.[47] This enables you to transfer low-basis assets and avoid having to pay taxes on any gains you may have. For noncash assets, proof of value is generally needed. Publicly traded assets such as stocks, bonds, mutual funds, and ETFs make valuation easy given that pricing is easily obtainable. For assets that may be less easy to value, such as a home or art, a professional appraisal is required. For any gifted asset, check with the charity beforehand to make sure it can receive and handle the asset; otherwise, the charity may not be able to derive the intended benefit(s).

Donor-advised funds (DAFs)

DAFs are a popular way to give cash and noncash donations and receive an immediate tax deduction. Once you have funded a DAF, you may recommend an investment strategy for your account, in order to grow the assets over time, and may recommend grants to the qualified organizations you wish to support. You can share management responsibilities with other people you designate, and those can continue after your death if you so choose.

Qualified charitable distributions (QCDs)

If you are charitably inclined, at least 70½, and confident about your assets meeting your retirement needs, QCDs are a great way to support causes you care about while lowering your potential tax liability.[48] Although QCDs are not tax-deductible, they are not treated as income if you took a withdrawal or RMD. In other words, taking QCDs can help satisfy your RMDs while keeping your income lower, resulting in potentially lower Social Security taxation now and lower future Medicare premiums, than if you first take an RMD and then donate the proceeds.[49]

For 2023, the maximum annual exclusion is $100,000 per person. That means a couple could each make QCDs of up to $100,000 from their respective eligible accounts. Make sure the distribution is made out to the charity rather than the account owner, to avoid any disqualification issues.

Complex topics: Trusts and other legal structures

Certain trust structures can serve both present and future giving as well as donor, bequest, and/or charitable purposes. Given that trusts (such as charitable lead or remainder trusts) and other structures (such as private foundations) can be complex, we mention them here only for general awareness. If you are seeking those more advanced strategies, you are strongly encouraged to first consult with an attorney, a tax accountant, and a financial planner to identify relevant options for you.

47 IRS Publication 526 outlines qualification and deduction criteria. Deduction limits vary depending on the type of property given and the type of organization you give it to.

48 Review IRS Publication 590-B for more information.

49 Higher-income Medicare beneficiaries are subject to surcharges on their premium. There is a two-year lookback period for income considered in determining Medicare premiums.

Bequests: Gifting at the end of life

A bequest is simply a gift left to a person or charity after your death. This allows you to retain use of the gift during your lifetime. For people who may not have excessive assets or are concerned about needing them during life, leaving the gift as a bequest can be an appropriate option.

You won't receive an income tax deduction when a bequest is documented, as it is not gifted until your death. When your estate or trust distributes the gift, it can claim a deduction on the estate or trust tax return for the full distribution amount.[50]

For many financial accounts, such as employer retirement plans, IRAs, and insurance policies, you can designate beneficiaries—specified persons and/or organizations, along with bequest percentages—to receive those assets upon your death. Remember to keep beneficiary designations up to date, as life changes and your wishes may evolve over time. And make sure to leave a way to inform your beneficiaries—usually beforehand, or through your will if you're not comfortable telling them during your lifetime. Otherwise, those assets may never reach their intended recipients.

If you have bequest preferences for particular assets (if, for example, you want a certain child to inherit your art collection), make sure to mention those specifics in a will or trust.

Take action

- ☐ **Think through the benefits, timing, and amount of your gifts.** There is much good to do in this world. Think about how you can maximize the impact of your gift.

50 This is called a distributable net income (DNI) deduction. Estates and trusts get a deduction for distributions of income to beneficiaries, not for specific charitable deductions.

Conclusion

Achieving financial wellness is important given the numerous benefits it provides. Having an effective budget and being in control of your finances enables you to take advantage of your employer match opportunity, pay the minimum on all your debt, and pay down high-interest debt. Being prepared for the unexpected allows you to take comfort knowing that despite the curveballs that life may have in store, your family and loved ones are taken care of thanks to your having adequate emergency savings, insurance, and legal documents in place. Finally, making progress toward your goals allows you to build wealth, realize those goals, and more comfortably enjoy life.

A majority of households say money is a significant source of stress. We believe that by focusing on the actions that are within our control, this financial wellness guide will help households improve not only their financial situation but also their overall holistic well-being.

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Appendix 1. About the Vanguard Capital Markets Model

IMPORTANT: The projections and other information generated by the Vanguard Capital Markets Model regarding the likelihood of various investment outcomes are hypothetical in nature, do not reflect actual investment results, and are not guarantees of future results. VCMM results will vary with each use and over time. VCMM results presented are as of June 30, 2022.

The VCMM projections are based on a statistical analysis of historical data. Future returns may behave differently from the historical patterns captured in the VCMM. More important, the VCMM may be underestimating extreme negative scenarios unobserved in the historical period on which the model estimation is based. Our simulations of market returns assume an investor invests 60% of their equity sub-asset allocation to U.S. equities and 40% to non-U.S. equities. For bonds, our simulations assume sub-asset allocations of 70% to U.S. bonds and 30% to non-U.S. bonds.

The Vanguard Capital Markets Model® is a proprietary financial simulation tool developed and maintained by Vanguard's primary investment research and advice teams. The model forecasts distributions of future returns for a wide array of broad asset classes. Those asset classes include U.S. and international equity markets, several maturities of the U.S. Treasury and corporate fixed income markets, international fixed income markets, U.S. money markets, commodities, and certain alternative investment strategies. The theoretical and empirical foundation for the Vanguard Capital Markets Model is that the returns of various asset classes reflect the compensation investors require for bearing different types of systematic risk (beta). At the core of the model are estimates of the dynamic statistical relationship between risk factors and asset returns, obtained from statistical analysis based on available monthly financial and economic data from as early as 1960. Using a system of estimated equations, the model then applies a Monte Carlo simulation method to project the estimated interrelationships among risk factors and asset classes as well as uncertainty and randomness over time. The model generates a large set of simulated outcomes for each asset class over several time horizons. Forecasts are obtained by computing measures of central tendency in these simulations. Results produced by the tool will vary with each use and over time.

Appendix 2. 529 college savings plans

For more information about any 529 savings plan, contact the plan provider to obtain a Program Description, which includes investment objectives, risks, charges, expenses, and other information; read and consider it carefully before investing. If you are not a taxpayer of the state offering the plan, consider before investing whether your or the designated beneficiary's home state offers any state tax or other benefits that are only available for investments in such state's qualified tuition program. Other state benefits may include financial aid, scholarship funds, and protection from creditors. Vanguard Marketing Corporation serves as distributor and underwriter for some 529 plans.

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