D.I. Wallace, K. Rheinlander

Investing in Someone Else's Future

Annie is a fifty-something single mother of one excellent daughter. As a well-paid professional, Annie has set aside money for her own retirement, has a reasonable size mortgage on a reasonable size house, and generally has her financial act together. However, in two years her daughter, Isabel, will be heading for college. It is becoming clear that Isabel can get into a good school, which is wonderful except for its probable price. Annie is estimating she will have to come up with around $30,000 per year for the four years of Isabel's undergraduate education, even if Isabel gets a modest scholarship and standard government loan.

The government does offer loans to parents, for which Annie would qualify. But the interest rate runs at 7% for these loans, which it hurts to contemplate. Annie would be at retirement age and still paying off these loans, the thought of which makes her panic. So she hits on a plan. She will, in the next year, attempt to save $30,000. She will do this by being cheap. She will continue to drive her beat up car, the oldest car anybody at her office uses by far and much older than the one the janitor drives. She will refuse to eat out except very occasionally. She will reduce her 401k contributions slightly. She will take vacations, but only near places that work sends her anyway. She just wants to see if she can do it. If she succeeds, then she will have some confidence that she can continue to do so through the four years of her daughter's college. And she will also have a cushion of $30,000 to see her through times when she can't extract that much from her annual budget.

The question is, where to put the money as she saves it? It has to be somewhere that she can get it again if and when she needs it. She has thought about the stock market but she really doesn't have time to pay much attention to stocks. She would rather use a mutual fund, such as those recommended by Money Magazine: http://money.cnn.com/magazines/moneymag/bestfunds/index.html. She sets up an online brokerage account for this purpose but then gets a bit overwhelmed by the options, even though she is limiting herself to those recommended by Money.

She has asked you to look at the options on that page and would like your recommendation, given that the time frame for this investment is probably only five years at most. Here is what she wants to know.

1. What are the different categories of funds listed on the Money website above, and what do they mean?
2. Choosing three from each category, how do these funds compare over the last five years in terms of growth?
3. What is the spread in performance in each of the categories? This will give an idea of the error inherent in projected returns over the next five years.

4. Using this research and a spreadsheet, figure out what is likely to happen as Annie adds $2500 to her fund each month for the next 12 months. Look at three different allocations of her money to a mix of different funds.
5. Which choice gave the greatest return? Now look at your error estimate and compute a lowest and highest possible return. Which gave the highest minimum return?
6. Give Annie some advice on what to do, based on your research.