Managing Your Personal Finances

Learning Objectives

After studying the information and doing the exercises in this chapter, you should be able to:

- Do a better job of managing your personal finances
- Establish a tentative financial plan for yourself and your family
- Pinpoint basic investment principles
- Identify several major forms of investments
- Create a strategy for maintaining your credit reputation
- Review your finances annually

People who examine their spending closely can often find ways to save some money from expenses and use that money for other enjoyable things. Also, they will have more money to put aside for savings and investments.

Managing personal finances well can help money bring happiness instead of stress. Financial troubles can cause other troubles. Having a hard time focusing because of money worries may affect work quality. Many relationship issues come from disagreements about finances.

Financial stress can also take away energy that could be spent to improve your career or your personal life.

This chapter aims to provide information that should help you begin the journey to financial well-being and avoid financial troubles. Our approach is to cover the fundamentals of personal financial planning, investment principles, selecting investments, controlling and avoiding debt, reviewing your finances yearly, and retiring wealthy.

YOUR PERSONAL FINANCIAL PLAN

A highly recommended starting point in improving your present financial condition and enhancing your future is to develop a personal financial plan. Two key elements of a personal financial plan are financial goals and a budget. The spending plan, or **budget,** helps you set aside the money for investments that you need to accomplish your goals. The subject of how to invest the money your investment plan provides is described at later points in this chapter.

ESTABLISHING FINANCIAL GOALS

Setting goals can help you perform better in the area of personal finance. A usual way to set financial goals is to state how much money you want to earn by certain dates. You might have annual financial goals, adjusted for inflation. Or you might have goals for every five years. Another usual financial goal is to save enough money to pay for a specific thing, such as a new car's down payment. These goals should have a deadline, as shown in Exhibit. A useful addition to these goals is an investment table that shows how much money you need to reach the goal. Financial goals can also be about how you use your money. Some examples are:

- Saving pay raises or paying off debt
- Joining a savings or retirement plan that takes money from each paycheck
- Putting 10 percent of each net paycheck into a mutual fund

Money can be more inspiring as a financial goal when it is linked to the kind of life you want to live with certain sums of money. In this way, money becomes the tool for the outcomes that bring joy and fulfillment.

Developing a Budget (Spending Plan)

Many people associate the word budget with cheap products or stingy spending habits. But that's only part of the story. A budget is a way of planning how to spend your money wisely and avoid spending more than your income. John Gilligan, the executive director of a consumer credit counseling service, stresses the importance of having a budget. He says that when most clients come to his agency for help, they don't have a budget or don't know how to make one.

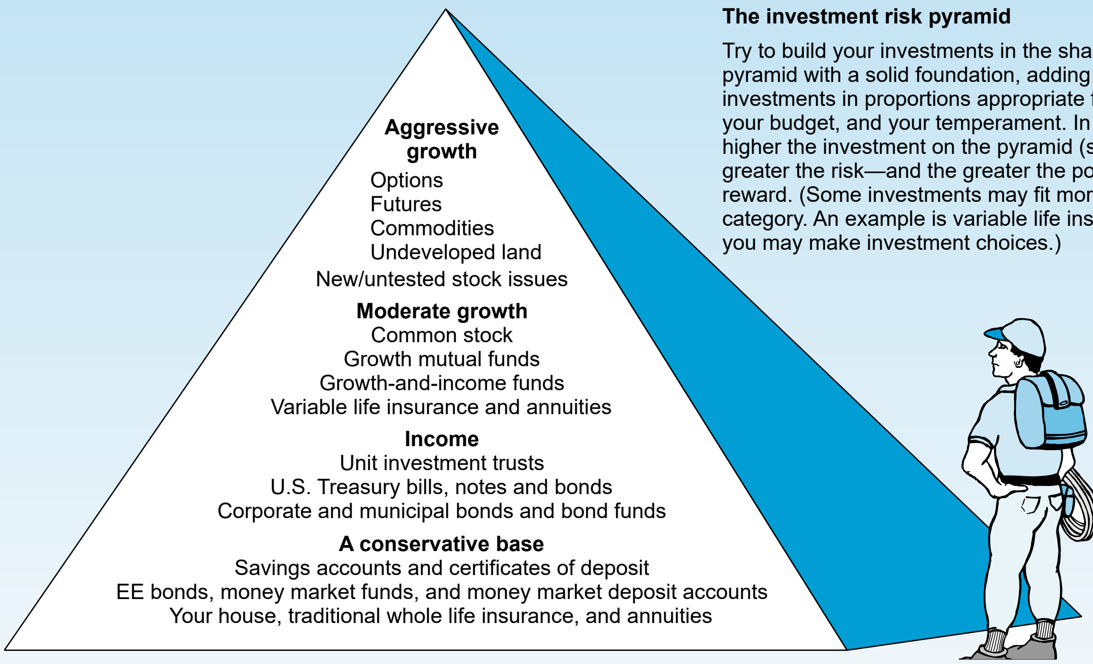
Making a budget can be done in several logical steps. Exhibit 15-2 shows a worksheet to help you with the process. Many people today use software that helps you create a budget. A monthly budget works best for most people because many expenses are paid monthly.

Step 1. ***Establishing goals***. Decide what you or your family need and want. If you are establishing a family budget, it is best to involve the entire family. For the sake of simplicity, we will assume here that the reader is preparing an individual budget. Individual budgets can be combined to form the family budget. Goal setting should be done for the short, intermediate, and long term. A short-term goal might be to “replace the hot water heater this February.” A long-term goal might be to “accumulate enough money for a recreational vehicle within 10 years.”

Step 2. ***Estimating income***. People whose entire income is derived from salary can readily estimate their income. Commissions, bonuses, and investment income are more variable. So is income from part-time work, inheritance, and prizes.

EXHIBIT 15-2

The Investment Risk Pyramid



The investment risk pyramid

Try to build your investments in the shape of a pyramid with a solid foundation, adding riskier investments in proportions appropriate for your age, your budget, and your temperament. In general, the higher the investment on the pyramid (see below), the greater the risk—and the greater the potential for reward. (Some investments may fit more than one category. An example is variable life insurance, where you may make investment choices.)

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Step 3. ***Estimating expenses***. The best way to estimate expenses is to keep close track of what you are actually spending now. After listing all your expenses, perhaps for two weeks, break them down into meaningful categories such as those shown in Exhibit 15-3. Modify the specific items to suit your particular spending patterns. For instance, computer supplies and Internet service might be such big items in your spending plan that they deserve a separate category. It is possible that your current expense will soon decrease (such as paying off a loan) or increase (such as joining a health club). Plan for large expenses so that they are spaced at intervals over several years. If you purchase a car one year, plan to remodel your kitchen another. If you buy an overcoat one season, you might have to delay buying a suit until the next year.

Use your records and recollections to help you decide whether to continue your present spending pattern or make changes. For instance, estimating your expenses might reveal that you are spending far too much on gas for the car. An antidote might be to consolidate errand-running trips or make some trips by foot or bicycle.

Step 4. ***Comparing expenses and income***. Add the figures in your spending plan. Now compare the total with your estimate of income for the planning period. If the two figures balance, at least you are in neutral financial condition. If your income exceeds your estimate of expenses, you may decide to satisfy more of your immediate wants, set aside more money for future goals, or put the balance into savings or investments.

Remember that the true profit from your labor is the difference between your net income and your total expenses.

Set-asides are considered an expense since you will inevitably use up that money to meet future goals or pay for seasonal expenses. Without a miscellaneous category, many budgets will project a profit that never materializes. Any household budget has some miscellaneous or unpredictable items each month. After working with your budget for several months, you should be able to estimate miscellaneous expenses accurately.

If your income is below your estimated expenses, you must embark on a cost-cutting campaign in your household. If you brainstorm the problem by yourself or with friends, you will come up with dozens of valid expense-reducing suggestions.

Step 5. ***Carrying out the budget.*** After you have done your best job of putting your spending plan on paper or hard drive, try it out for one, two, or three months. See how close it comes to reality. Keep accurate records to find out where your money is being spent. It is helpful to note expenditures at the end of every day. Did you forget about that $29 you spent on party snacks Sunday afternoon? It is a good idea to keep all financial records together. You may find it helpful to set aside a desk drawer, a large box, or other convenient place to put your record book, bills, receipts, and other financial papers. Converting paper records into computerized files is strongly recommended for maintaining a spending plan.

Step 6. ***Evaluating the budget.*** Compare what you spent with what you planned to spend for three consecutive months. If your spending was quite different from your plan, find out why. If your plan did not provide for your needs, it must be revised. You cannot live with a spending plan that allows for no food the last four days of the month. If the plan fitted your needs but you had trouble sticking to it, the solution to your problem may be to practice more self-discipline. Each succeeding budget should work better. As circumstances change, your budget will need revision. A budget is a changing, living document that serves as a guide to the proper management of your personal finances.

BASIC INVESTMENT PRINCIPLES

After you have developed a spending plan that results in money left over for savings and investment, you can begin investing. Consider the eight investment principles presented next to start developing an investment strategy or refining your present one. They are based on the collected wisdom of many financial planners and financially successful people.

1. Spend less money than you earn. The key to lifelong financial security and peace of mind is to spend less money than you earn. By so doing, you will avoid the stresses of debt and worrying about money. A widely accepted rule of thumb is to set aside 10 percent of your net income for savings and investments. For many struggling to make ends meet, the 10 percent rule is unrealistic. These people may implement the 10 percent rule later in their careers. A growing practice is to have savings and investments deducted automatically from your paycheck or bank account. The automatic plans ensure you will set aside some money each month for investments.

2. Invest early and steadily to capitalize on the benefits of compounding. Investments made early in life grow substantially more than those made later. You will slowly and steadily accumulate wealth if you begin investing early in life and continue to invest regularly. Let’s look at a straightforward example. Assume you invest $1,000 at the start of each year for five years. It earns 8 percent annually, compounding the earnings (interest is paid on the accumulated principal plus the accumulated interest). You would have $6,123 at the end of five.

years. If you invested $1,000 at the start of each year for 25 years, you would have $79, 252. To achieve these full results, you must make tax-free or tax-deferred investments.

3. Keep reinvesting dividends. As implied in the second principle, dividends and interest payments must be reinvested to fully benefit from early and regular investments. Here is an illustration based on stock dividends. Assume that a person had invested $5,000 in a representative group of common stocks 35 years ago. The amount accumulated *with* reinvesting dividends is four times as great as *without* reinvesting. The person who did not reinvest the dividends would have accumulated approximately $60,000, while the person who reinvested the dividends would have stocks worth approximately $240,000.

4. Diversify your investments (use asset allocation). A bedrock principle of successful investing is to diversify your investments. This approach is referred to as *asset allocation* because you allocate your assets to different types of investments. Money is typically apportioned among stocks, bonds, short-term instruments like money market funds, and real estate (including home ownership). A starting point in diversifying your investments is to accumulate enough money in cash or its equivalent to tide you over for three months in case you are without employment. Your specific allocation of assets will depend on your tolerance for risk and your time frame. At the conclusion of the section on choosing your investments, we will describe several different investment allocations.

5. Maintain a disciplined, long-term approach. If you have an investment plan suited to your needs, stick with it over time. The patient, long-term investor is likely to achieve substantial success. Investors who make investments based on hunches and hot tips and sell in panic when the value of their investments drop generally achieve poorer returns.

6.Practice contrary investing. If your purpose in making investments is to become wealthy, follow the principle of **contrary investing**— buy investments when the demand for them is very low and sell when the demand is very high. When others are discouraged about purchasing real estate and there are very few buyers around, invest heavily in real estate. When others are excited about real estate investing, sell quickly before prices fall again. In the words of the late billionaire J. Paul Getty, "Buy when everybody else is selling, and hold until everyone else is buying." This is not merely a catchy slogan. It is the very essence of successful investing.[4] For example, the Nasdaq index of stocks sunk to 1,114 on October 9, 2002. By March 6, 2004 the index had jumped to 2048, an upturn of 84 percent. The person who bought a portfolio of stocks in the Nasdaq index in October and sold in June would have profited substantially.

Contrary investing may conflict somewhat with the disciplined long-term approach. However, you might stay with contrary investing as a consistent, long-term strategy.

7.Invest globally as well as domestically. Diversifying your investments among different countries is another contributor to financial success. Financial advisers regularly suggest international stocks and bonds as a diversification possibility. Overseas markets may offer investors values more promising than those provided domestically. One way to invest internationally is to purchase mutual funds geared to this purpose.Investing in savings accounts known as certificates of deposit (CDs) that might pay a higher rate of interest than domestically is possible.

Be aware, however, that overseas investments have two substantial risks. The value of the overseas currency may go down rapidly, thus lowering your return should you sell your stocks or bonds. Another problem is that a politically unstable government can create havoc in the investment markets. One example is that a government might take over a private company and declare its stocks and bonds invalid.

8.Pay off debt. One of the best investment principles of all is the most straightforward. Paying off debt gives you an outstanding return on investment. A common scenario is a person paying about 13 percent on credit card debt while earning 2 percent from an investment. Paying off the 13 percent debt with money from savings would thus yield an 11 percent profit. (We are excluding home equity loans from consideration because they carry tax-deductible interest.)

Another major strategy for paying off debt is to work toward reducing a home mortgage. Making extra payments on a mortgage substantially reduces the time it takes to pay off the mortgage. Suppose a person has a $100,000 mortgage at 8 percent for 30 years. By increasing the mortgage payment just 4 percent each year, the loan will be retired in 15 years and would save $82,845 in interest. At the same time, the additional payments build equity in your house, thus increasing your net worth. A concern, however, is that as you pay down the interest on the mortgage, your tax deduction dwindles.

CHOOSING YOUR INVESTMENTS

After understanding some basic principles of investing, you are ready to make choices among different investments. We describe investments here because they are an integral part of managing your personal finances. Investments can be categorized into two basic types: lending money or owning assets. Lending money is referred to as a *fixed-income investment,* while owning an asset is an *equity investment.* For example, when you purchase a corporate bond, you are lending money that will pay a fixed rate of return. When you purchase stocks,you become an owner of an asset. Our discussion of choosing investments includes their relative risks, relative returns, different types, and selecting the right mix.

Tolerance for Investment Risks

To be a successful investor, you must be able to tolerate some risk.As illustrated in Exhibit 15-2, investments vary in the risk of losing the money you invested. Yet not even so-called *safe* investments are without risk. As an investor, you must decide how much and what kind of risk you can tolerate. One person might not be able to tolerate watching the values of his or her mutual funds fluctuate from month to month.Another person might not be able to tolerate the risk of missing out on big profits in the stock market by putting money in a savings bank. A third person might worry about inflation eroding the value of money in a low-interest savings account (or stored in a safe deposit box).And yet another person might not want to contend with the risk of having too little money for retirement. The longer the time period for investment,the more risk of loss of principal most people are willing to accept. A person with a 30-year horizon might be more willing to invest in a technology stock than would a person approaching retirement.

A major factor in tolerating investment risks is that most people are loss averse,as described in Chapter 3 about problem solving.People feel the pain of an investment loss about two to two and one-half times as strongly as they feel pleasure from good performance.[5] People who are strongly risk averse might prefer to choose investments where the risk of severe downward swings in value are less probable, such as real estate.

Understanding how much and what kind of risk you can tolerate will then help you map the best investment strategy for yourself. To explore your attitude toward investment risks, you are invited to do Human Relations Self-Assessment Quiz 15-1 and visit the associated Web site.

Different Types of Investments

Dozens of different savings plans and investments are available. They include everyday methods of savings as well as exotic investments, such as betting on the fluctuations in the future prices of commodities,such as “pork futures.”Here we summarize a variety of popular investments ranging from the most conservative to the more speculative.

Certificates of Deposit

Banks and savings-and-loan associations offering certificates of deposit (CDs) require that you deposit a reasonably large sum of money for a specified time period.The time period can be anywhere from 30 days to 10 years. CDs come in denominations such as $500,$5,000,and $10,000,paying a rate of return in excess of the rate of inflation.If you have a considerable amount of cash and are not worried about having your money tied up for a fixed time period,CDs are ideal.Also,like other bank deposits,CDs are government insured. If you close one of these accounts before its due date, the amount of penalty lowers the interest rate to approximately that of an interest-bearing checking account.

Money Market Funds

Many people use these high-yielding but uninsured funds as an alternative to an ordinary bank deposit. Paying above the inflation rate, many money market funds can be used almost like checking accounts.Usually you need to invest an initial $2,500 in these funds.An important feature is that you have easy access to your money.Most funds allow you to write checks for amounts of $500 or more. The funds themselves charge a small, almost unnoticed management fee. They invest your money in high-yield, short-term investments, such as loans to the federal government or to top-quality business corporations.

U.S. Treasury Securities

The U.S. government offers five types of secure investments to the public: Treasury bills, Treasury notes, Treasury bonds, U.S. savings bonds, and Treasury inflation-indexed securities (also known as inflation-indexedTreasury bonds). Two notable advantages of Treasuries are (1) that they are exempt from state and local taxes and (2) that they always pay their face value when they mature.You may lose out considerably if you cash in your government bonds early, particularly with the inflation-indexed bonds. A general disadvantageofinvestinginTreasuriesisthattheiryieldisusuallylessthan money market funds or corporate bonds.Long-term government bonds (such as 30 years), however, have returns quite competitive with corporate bonds.

Corporate Bonds

Large corporations sell bonds to the public to raise money to further investintheirbusiness.Manyofthesebondsare20-to30-yearloans.Theypay a fixed rate of return,such as 5 or 7 percent.If you want to cash in your bond early, you may not be able to sell it for the original value, especially if interest rates rise.You would thus take a loss.You can,however,purchase a bond for less than its face value.You might be able to buy a $1,000 bond for $920, collect interest on it, and eventually redeem it for its face value. *Junk bonds* are bonds offering a high yield because they are rated as having a high risk. One reason could be that the firm offering them is facing financial trouble.

Junk bonds are best suited to big investors,but some mutual funds invest in them, making them accessible to smaller investors. High-yield bonds are best for people with a high tolerance for risk and a long-term time horizon.

Bonds can also be purchased through *bond funds* that diversify into many different bonds and are essentially a portfolio of bonds. Bond funds pay income every month, and they soften the risk of investing a large amount of money in the bonds of a company that defaults on its bonds. When the general stock market climbs, bond funds tend to decrease in value. The reverse is also true: When the stock market climbs, bond funds tend to increase in value. The reasoning is that when stocks increase in value, investors are less interested in bonds and vice versa.

Municipal Bonds

Similar in design to corporate bonds,municipal bonds are issued by governments of cities,states,and U.S.territories.“Munis”have strong appeal to many investors because of their tax-free status. Interest income from most municipal bonds is not taxed at the federal level and,in many cases,at state and local levels. Residents of the state in which a municipal bond is issued are also exempt from paying state income tax on the interest. Because of their tax-exempt status, munis pay lower interest rates than comparable taxable bonds.The higher your tax bracket, the more appealing a municipal bond. The formula to determine the tax-equivalent yields (what interest a taxable bond would have to pay to bring the same return) is tax - free yield

If you also figure in state or provincial tax exemption, the taxequivalent yield would be even higher. Paying state and local taxes lowers your effective federal tax rate because state and local taxes are deductible from federal taxes.

Common Stocks

Every reader of this book has heard of the stock market, a place where you can purchase shares of public corporations. On a given business day, it is not unusual for over one billion shares of stocks to be bought and sold on the American and Canadian stock exchanges. Common stocks are actually shares of ownership in the corporations issuing them. Stocks pay dividends, but most investors hope that the stock will rise in value. Most buying and selling of stocks today is done by institutions rather than by small investors. These institutions include pension funds, banks, and mutual funds (described later).

Stock prices rise and fall over such tangible factors as a company’s present and potential earnings,the price of oil, and fluctuations in interest rates. Yet good news in general, such as progress in peace talks, elevates stock prices. An example of the volatility in the stock market took place in 2000, when the stocks of many well-known high-technology companies dropped as much as 85 percent in value. The stock market, in general, dropped about 40 percent in value between the years 2000 and 2003.

To cope with these price fluctuations, investors are advised to use dollarcost averaging. Using **dollar-cost averaging,** you invest the same amount of money in a stock or mutual fund at regular intervals over a long period of time.This eliminates the need for the difficult task of trying to time the highs and lows. Since you are investing a constant amount, you buy less when the price is high and more when the price is low. Over a long period of time, you pay a satisfactory price for your stock or mutual fund. One disadvantage of dollar-cost averaging is that if the value of the stock continues to rise, you would have been better off financially by making a lump-sum investment at the outset.

Mutual Funds

Since most people lack the time,energy,and knowledge to manage their own stock portfolios,mutual funds are increasingly relied on.The concept of mutual funds is straightforward. For a modest management fee, a small group of professional money managers invest your money, along with that of thousands of other people, into a broad group of common stocks. Numerous mutual funds exist to suit many different purposes and risk-taking attitudes. You can find mutual funds that invest in conservative, low-risk stocks or flashy, high-risk stocks. The latter tend to have a larger payoff if the company succeeds. Some funds specialize in particular industries, such as telecommunications or energy. Mutual funding is no longer restricted to stocks. Some mutual funds invest only in corporate bonds, government securities, or municipal bonds.

A type of mutual fund called an *index fund* has grown in favor in recent years. The idea behind an index fund is that it uses passive management. The fund automatically purchases the investments that make up a particular market index. Two such indexes are the Standard & Poor’s 500 index of big-company stocks and the Russell 2000, representing small company stocks. The objective is to meet but not surpass the performance of the fund's benchmark index. If the S&P index gains 15 percent in one month, so would the index fund minus a management fee of about .03 percent. Many investment specialists argue that it is difficult to beat the benefits of a good index fund, particularly because its fees are lower than other mutual funds. Many managers of mutual funds, however, present evidence that their active management results in better investment gains.

The image of mutual funds has been tarnished in recent years because of scandal associated with giving preferential treatment to big customers over ordinary investors.An example would be letting these people purchase funds after hours at prices that would guarantee profits for trading the next day if the value of the fund increased that day. Such "late trading" is illegal.

Real Estate

A natural starting point in making money in real estate is to purchase a single-family dwelling,maintain it carefully,and live in it for many years. Temporary downturns in the housing market should not deter the patient investor. In the long run, most homes increase in value equal to or faster than inflation. A subtle advantage of home ownership (condos included) is that you are likely to hold on the investment for longer than a stock, bond, or mutual fund.Home owners receive many tax benefits,such as income tax deductions on mortgage interest and interest paid for home equity loans (loans using your house as collateral). Real estate taxes are fully tax deductible. As with any other form of real estate investment, the long-term trend has been for homes to increase in value beyond the rate of inflation. In recent years, however, many home owners throughout the United States have had to sell homes at a loss because real estate values declined. Another concern about home ownership as an investment is that houses can become"money pits"that require spending on repairs,insurance,and taxes.

An investment that is really a form of business ownership is income property—real estate that you rent to tenants. The activities required of a landlord include collecting rent, resolving conflicts among tenants, and maintenance, such as fixing broken water pipes and painting rooms. The highest returns from income property are derived from rehabilitating dilapidated property—if the owner does most of the physical work.Many people who own income property receive almost no operating profit from their work and investment in the early years. However, in the long run, the property increases in value. Also, because the mortgage payments remain stable and rents keep increasing, monthly profits gradually appear.

An indirect way to invest in real estate is through a real estate investment trust, or **REIT,** a pooling of many people's money to invest in real estate or mortgages. REITs must distribute at least 90 percent of taxable income to shareholders, but they avoid corporate taxes. REITs invest in properties such as apartment buildings, office buildings, shopping malls, and even real estate companies.The value of REITs as investments rises and falls with the overall real estate market. Real estate mutual funds are another way to invest in real estate without owning physical property because they invest in REITs as well a real estate operating companies.

Gold Bullion

Gold has long been considered a sound long-term investment despite declining prices in recent years. In January 1980, gold sold for $875 an ounce, in early 2001 it sold for $535, and in March 2004 it sold for $399. For many years, hoarding gold coins or bars was considered an intelligent hedge against inflation and global unrest. Gold still has its fans who think that it is a solid investment in an unstable world. Even when the price of gold is rising, it still has two key disadvantages. Gold has to be stored safely, and it pays no dividends or interest.Another way to invest in gold is to purchase gold funds, which tend to perform well during uncertain economic times. For example, in 2002, when most investments plunged in value, gold funds increased an average of 62.9 percent. A caution is that gold jewelry is not likely to increase substantially in value when gold or gold funds increase because much of the value in gold jewelry stems from the handcrafting.

Coins, Antiques, Paintings, and Other Collectibles

An enjoyable way of investing is to purchase coins and objects of art that you think will escalate in value.Almost anything could become a collectible, including stamps, old advertising items, or even today's combination of cell telephone and camera. You have to be both patient and lucky to cash in on collectibles.You should have a sound,diversified investment program before you invest your money in collectibles. If you are looking for an expensive hobby that might pay off financially,however,collectibles are ideal.As an investment, collectibles are high risk

Life Insurance and Variable Annuities

An investment plan should include life insurance for two reasons. First, the proceeds from life insurance protect dependents against the complete loss of income from the deceased provider. Second, most forms of life insurance accumulate cash,thus making such insurance a profitable investment. The exception is term life insurance, which is much like insurance on a house or car. To figure out how much life insurance is necessary, calculate what would be required to support your family members until they can take care of themselves without your income. Take into account all assets in addition to life insurance. If you are single, consider the financial help you are providing loved ones.

Variable annuities are related to life insurance because they offer a death benefit and are geared toward retirement.The beneficiary receives either the initial investment or the plan's current value,whichever is greater. A variable annuity allows the investor to make regular contributions without having to pay taxes on any gains until retirement. The investment, whether it be money market funds, stocks, or mutual funds, compounds tax free until withdrawn. In the past, variable annuities carried high commissions, but now many are being offered online at a much lower cost.

Choosing the Right Mix of Investments (Asset Allocation)

A major investment decision is how to allocate your investments among short-term interest-bearing accounts (including cash), stocks, and bonds, and real estate. The best answer depends on such factors as your career stage, age, and tolerance for risk. In general, younger people are in a better position to take investment risks than those nearing retirement. Yet young people who need money for major items such as education or a down payment on a house or apartment may want to avoid high-risk investments. (In many large cities, apartments are sold just like houses.)

A starting point in choosing the right mix of investments is to use the following rule of thumb: If you invest in stocks, subtract your age from 100, giving you about the percentage that should be in stocks. If you are 25, about 75 percent of your portfolio should be in stocks. About two-thirds of the balance should be in bonds, the rest in cash. The 25-year-old would therefore invest about 17 percent in bonds and 8 percent in cash (or cash equivalents, such as money market funds). If you are 100 years old, take all your money out of the stock market and put it in bonds and cash.A default position for people who are uncertain about what mix of investments is best is to invest 60 percent in equities and 40 percent in fixed-income instruments. In selecting the right mix of investments, choose among five diversification strategies with respect to risk:

1. *Capital preservation*—you want to preserve you capital without taking too much risk
2. *Income*—you want your investments to generate income
3. *Income and growth*—you want to generate income from your investments but you also want growth
4. *Growth*—you want your investments to grow
5. *Aggressive growth*—you are willing to take high risks to win big

Nomatterwhichoneofthesefivestrategiesyouchoose,itissoundtohave first invested in real estate,not including REITs,or real estate mutual funds. The rest of your investments can then be placed in the five categories. Remember that real estate is so named because it is *real.*These five investment strategies are the basis for the broad guidelines presented in Exhibit 15-4. The stocks in your portfolio should be mixed among stocks of large company stocks, midcompany stocks, small company stocks, and international stocks.

As implied by the five different investment strategies, selecting the right portfolio of investments for you depends somewhat on emotional factors. For example, if you are a risk taker and thrill seeker, you would feel comfortable with an aggressive growth strategy.A field of study called *behavioral economics* deals with some of the emotional factors in investing.As mentioned earlier, one such factor is the enormous dislike many people have for losing money. People hate losses much more than they enjoy gains. This is why most investors in stocks demand much higher returns from them to compensate for the dread of losses.

Another key behavioral is that people procrastinate. Many people who are well aware of the importance of financial planning early in life keep procrastinating even when they have some discretionary money to get started investing. The chore of planning seems such a burden, and the loss of delaying planning for a few days seems insignificant. In reality, every day without a financial plan can result in lost opportunity in the long run.[6]

Relative Returns of Stocks and Bonds

Another key factor in choosing among investments is their relative returns in the past. The past may not guarantee future performance, but it serves as a reliable predictor.Between 1972 and 2003,large-company stocks have returned about 10.7 percent annually and corporate bonds about 5 percent. Intermediate Treasury bonds have paid about 5.1 percent and threemonth Treasury bills about 3.6 percent. The inflation rate over the same periods has been about 3 percent. Throughout the period 1990–2000, investment yields improved over the long-term historical pattern. During this period,the annual return averaged about 17.5 percent for stocks,12 percent for corporate bonds, and 6 percent for long-term Treasury bills. During the period 2000–2003, investment yields turned sharply down. Stocks returned a negative 9 percent, corporate bonds about 6 percent, and long-term Treasury bills about 4 percent.

The attractive return on investment from stocks over the years is forthcoming only to those who invest in a portfolio of stocks or mutual funds that match or exceed average returns.A person could easily invest in stocks that become worthless or have substantially below-average returns. A person could also invest in bonds of a company that defaulted on the bonds. Mutual funds,including index funds that invest in a portfolio of stocks,are less likely to be poor investments.

Another caution is that investing in stocks, bonds, and mutual funds with taxable returns can be expensive to continue. For example, you must pay income taxes on part of the returns from mutual funds annually, even if you did not cash in the investments. Some people wind up selling off portions of their portfolios or borrowing money just to pay taxes on a profit that exists only on paper.

▲ MANAGING AND PREVENTING DEBT

Debt is inevitable for most people. Few people are wealthy enough or have sufficient self-discipline to avoid debt entirely. Major purchases, such as a house, cooperative apartment, postsecondary education, or automobile, usually require borrowing.Dealing with debt is therefore an important component of managing your personal finances. Here we describe three major aspects of managing and preventing debt:credit management,getting out of debt, and staying out of debt.

Managing Credit Wisely

Credit management is a problem for many people of all career stages. The number of people filing for bankruptcy in the United States has been climbing steadily, with over 1.8 million people filing annually. Millions of other working people struggle with making car payments, installment loans, and insurance premiums. Borrowing money, of course, is not inherently evil. Imagine what would happen to the banking industry and the economy if nobody borrowed money. Some borrowing in your early career is desirable because without a credit record, it is difficult to obtain automobile loans and home mortgages. Good credit is also important because prospective landlords and employers carefully consider an applicant's creditworthiness. Consider the following guidelines for the wise use of credit.[7]

1. Recognize the difference between good debt and bad debt. Good debt finances something that will benefit you in the future, such as a house, education, or self-development. Bad debt typically finances something that you consume almost immediately or that provides little real benefit. Borrowing for a trip to a gambling casino, including money for betting, might fall into this category.

2. Prepare a monthly budget to determine how much debt (if any) you can afford to assume. As a general rule, limit your total borrowing to 15 to 20 percent of monthly take-home pay, not including a house mortgage payment.

3. Stick to one major credit card and perhaps your favorite department store's charge card. At the same time, avoid lending your credit card to friends. Cards on loan to friends can be lost, stolen, or misused. When you own multiple credit cards, there is more temptation to lend one.

4. Before accepting any new extension of credit, review your budget to see if you can handle it easily. You will have less need for a credit extension if you wait two weeks before making purchases that seem desirable at the time. After the two-week cooling-off period, many of the purchases will seem unimportant.

5. A home owner with substantial equity accumulated should consider a home equity loan for financing a major purchase, such as an automobile or educational expenses. The interest on home equity loans is fully tax deductible. However, resist the temptation to pay for a $750 refrigerator for 15 years.

6. Make monthly payments on your debts large enough to reduce the principal on your credit cards and other loans. Otherwise, you may be paying almost all interest and making small progress toward paying off the loan.

7. Even as you are paying off debts, set aside some savings each month.Attempt to increase your savings as little as $15 per month.

Within two years, you will be saving a substantial amount of money.

8. If you are unable to pay your bills, talk to your creditors immediately. Explain your situation and let them know you plan to somehow meet your debt obligations. Agree to a payment schedule you can meet. Never ignore bills. Many employers will not hire a job applicant with a bad credit record.

9. Choose personal bankruptcy only as a last, desperate option.A bankruptcy filing will remain on your credit record for 7 to 10 years. Creditors may look on you as a bad risk even 10 years after filing bankruptcy. Future employers may be wary of hiring a person who was such a poor money manager. Of even greater significance, bankruptcy may result in a substantial blow to your self-esteem.

Working Your Way Out of Debt

Working your way out of debt is a major component of debt management. Heavy debt that forces you to postpone savings and investments can also create adverse amounts of stress. You must therefore assertively attack your debts to improve your general well-being.

How do you know if you are too far in debt?

Human Relations Self-Assessment Quiz 15-1 provides an answer.

A recommended strategy for reducing debt is to concentrate on one bill at a time**.** According to the technique, you first payoff your most effective debt with a variable payment and then concentrate on your next-smallest variable payment debt. You keep concentrating on one bill at a time until the last debt is eliminated. The technique is illustrated and described in Exhibit 15-5.

A financial specialist might rightfully contend that some loans are uneconomic to discharge more quickly than required. The interest rate you pay on such loans might be less than the return you would earn by investing your extra payments elsewhere, such as in growth stocks. Although this is true from a financial standpoint, the biggest return on your investment from a mental health standpoint is getting out of debt.

A more conventional approach to reducing debt is to apply any money available for debt repayment to the loan bearing the highest interest. Ordinarily this would be credit card debt or unsecured loans. (The latter are

lent by finance companies and often carry charges up to 24 percent.) By paying off loans carrying the highest interest, you pay less in debt. Another debt reduction tactic is to pay more than the minimum on all loans that allow for variable payment. If you pay only the minimum demanded by most credit card issuers, it might take 12 years to pay off the balance. In the interim, you would pay far more in interest than the purchase price of the goods and services being bought on time.

Switching to a credit card with lower interest is another way of reducing interest payments. You pay off the old credit card debt by borrowing money from the new credit card. Begin payments the first month to avoid incurring extra interest charges.

If you are having problems getting out of debt despite using the tactics just described, the problem could be that you are spending too much. To remedy the situation, you can either earn more income or reduce discretionary spending. Look for even minor savings. Many people, for example, are surprised to learn how much they are spending on soft drinks. Purchasing store-brand soft drinks in bulk or drinking water instead of soft drinks can result in more money for debt reduction.

Debt consolidation loans are widely used by people whose expenses exceed their income. The consolidation loan means that you pay off all your debts with one large loan and then proceed to tackle the one big loan. The emotional relief can be substantial, but you will be extending your indebtedness well into the future, often at a higher interest rate than the average rate of your existing loans. Suppose you borrowed $10,000 for 60 months at 8.99 percent to consolidate your loans. Your monthly payments would be $210, for total payments of $12,600. You would be paying 26 percent of the $10,000 loan in finance charges.

Staying Out of Debt

No one who bought things for cash only ever went bankrupt. Cash also refers to money orders, checks drawn against funds that you legitimately have on hand, and debit cards. If you buy only things that you can actually pay for at the moment of purchase, you may suffer some hardships. It would be agonizing if you needed dental treatment but had to wait until payday to have a broken tooth repaired. On balance, these are small miseries to endure compared to the misery of being overburdened with debt. For many people, preoccupation with debt interferes with work concentration and sleep.

Staying out of debt is often difficult because the debtor has deep-rooted problems that prompt him or her to use credit. Among these problems are the following:

- Perceiving material objects as a way of gaining status
- Purchasing goods and services to relieve depression
- Incurring heavy charges to get even with a spouse or family member
- Believing that the world owes him or her a higher standard of living

Having problems of this nature may require both debt counseling and personal counseling. Unless the person understands his or her emotional problems surrounding borrowing money, the cycle of going into debt and then struggling to get out of debt will continue.

▲ HOW TO RETIRE RICH

Many people do not prepare adequately for the financial aspects of retirement. According to the Employee Benefit Research Institute, 29 percent of American workers say that have not yet begun to save for retirement.Furthermore, 61 percent have not calculated how much they will need to invest to attain their retirement goal.[10] If you start investing early in your career, you can retire rich even without earning exceptional compensation or winning a lottery.The basic idea is to start a systematic savings and investment plan set aside for retirement only.The dividends and interest paid on these investments are not taxed until retirement, and they keep compounding.As a result, you wind up with an extraordinary amount of money at the end of your career. Details about several of these retirement investment plans are presented next.

Whichever retirement plan you enter, remember to follow the key investment principle of asset allocation. Your retirement funds should be divided among stocks, bonds, short-term notes and cash, and real estate.

In addition to these personal investments, many workers receive retirement income from Social Security,company pension plans or 401(k) plans,and individual retirement accounts. Financial planners often recommend that people will need about 75 percent of their preretirement incomes to live comfortably during retirement. The following paragraphs describe several of the most popular retirement programs.

Social Security Benefits

Citizens who qualify in terms of employment experience received security benefits.The Social Security Administration makes available a Personal Earnings and Benefit Statement that estimates how much retirement income a person can anticipate at ages 62, 65, 67, or older. In addition, the statement estimates survivor and disability benefits. Social Security pays approximately an entry-level office worker salary to individuals who were middle-class wage earners.For example,the average monthly benefit for Social Security recipients in 2004 was $922 for individuals and $1,523 for couples.The maximum benefit was $1,825 per month.

Social Security payments are adjusted for inflation periodically, as measured by Consumer Price Index.Social Security retirement benefits are subject to income tax. For example, a couple with a combined income of more than $44,000 must pay tax on up to 85 percent of their benefits.

Employee Pensions and 401(k) Plans

Many employers in both the private and the public sectors offer pensions to long-term employees. Some of these pensions pay around 60 percent of the employee's salary at the time of retirement in addition to medical insurance. However, not everybody stays with one employer for many years, and some companies go bankrupt or misuse pension funds, thus risking your retirement pay.

The most widely used company-related retirement programs are 401 (k) plans in which the employer and employee both contribute. An employer, for example, might contribute 35 percent as much as the employee contributes. However, the employee essentially owns the money in the plan and can move it from one employer to another. A major advantage of a 401(k) plan is that a person can take the money in a lump sum in retirement rather than receiving a guaranteed monthly payout as with an annuity.

Your 401(k) plan can be invested in stocks, bonds, and other investments. Each plan limits the percentage of your current salary that you can contribute to the plan. The Internal Revenue Service also sets limits of 15 percent of your salary up to a maximum of $10,500 in 2000. Some employers contribute 50 cents or more for every dollar you contribute. Provided that you stay with the employer for a specified period, such as three to five years, you can keep the matching contribution. A 401(k)-plan held for many years goes a long way toward paying for most people's retirement. A problem noted with 401(k) plans is that the employee has too much discretion in allocating and might therefore make imprudent investment decisions.

Supplemental Retirement Annuities

Another way of investing your own money in a company-sponsored plan is to purchase **supplemental retirement annuities (SRAs).** These fixed and variable tax-deferred annuities enable you to invest money through your employer's payroll retirement system on a pretax basis. You make investments beyond the regular retirement plan offered by your employer, and these investments are deducted automatically from your pay. The key advantages of an SRA are that you have a tax-deferred investment and at the same time you lower your tax liability for the current year.The lower tax occurs because contributions are made before you pay taxes, leading to a lower tax bill. A potential disadvantage of an SRA is that your take-home pay may shrink too much to meet current expenses. You might prefer to make variable investments, depending on monthly expenses.

Individual Retirement Accounts and Simplified Employee Plans

Retirement accounts held by individuals rather than offered by employers can be used to invest in most of the types of savings and investments described earlier. Both **individual retirement accounts (IRAs)** and **simplified employee plans (SEPs)** are popular because they offer generous tax savings.An IRA is a supplemental retirement account, fully funded by the individual, that qualifies for certain tax advantages. Anyone, including government employees with earned income, may open an IRA. Single workers may contribute up to $2,000 per year. One-paycheck couples may invest up to $2,250 annually. Two-paycheck couples may contribute up to $4,000 a year if both work and each earns at least $2,000. Your IRA contributions may begin as early as 591/2 but must begin by 701/2. Early withdrawal incurs a 10 percent penalty plus the payment of taxes on the amount withdrawn.

IRA contributions are tax deductible only for individuals not active in an employer-sponsored retirement plan. Also, employees with moderate incomes are eligible for dental benefits from an IRA. Dividends and interest from an IRA are not taxed as long as they are not withdrawn. When you begin with withdrawals, IRA distributions are taxed as ordinary income. Roth IRAs, designed for families earning less than $150,000 annually ($100,000 for individuals), offer several advantages over traditional IRas. Although you cannot deduct Roth contributions, your money grows tax-free, permanently. As long as you leave your savings in a Roth IRA for a minimum of five years and wait until you are 591/2 to withdraw the money, the IRA earnings will never be taxed. All the money can be withdrawn when you reach age 60, and you can even leave some in your estate.

SEPs are retirement plans for self-employed individuals or those who earn part of their income from self-employment. SEPs and IRAs follow many of the same rules, with several exceptions. First, to qualify, you must earn some self-employment income. Second, you can invest up to 15 percent of your self-employment income in a SEP tax-free. An individual can hold an IRA and an SEP.

The dramatic financial returns from an IRA or SEP are shown in Table 15-3, which assumes that a person invested $2,000 yearly. Much of the fund growth is attributable to compound interest and no withdrawals on which to pay taxes. Even though you pay taxes on your IRA and SEP accounts when you withdraw, you profit because you had more money working for the length of your investment. For example, your yearly contribution of $2,000 is invested instead of the $2,000 minus tax you could invest if you did not place the money in an IRA or SEP.

Despite all we have said in this chapter about saving and investing for the long term, all retirement investments must be balanced against the importance of having a joyful present life. You might want to invest in the pleasure of mountain climbing now, even though that same amount of money might be worth ten times as much when you are 85. Yet at 85, you might not be able to climb mountains. Some people contend they want to run out of retirement money on the last day of their life. Few people can plan with such precision, so investing in both the long-term and present happiness is a good bet.