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 to 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 FINANCIAL PLAN

Developing a personal financial plan is a highly recommended starting point in improving your present financial condition and enhancing your future. Two critical 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 you need to accomplish your goals. The subject of how to invest your investment plan's money is described later 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 specific 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 down payment for a new car. These goals should have a deadline, as shown in Exhibit. An investment table that shows how much money you need to reach the goal is a useful addition to these goals. 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 enables you to 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 selecting 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 water heater this February." A long-term goal might be to "accumulate enough money for a recreational vehicle within ten 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.

Step 3. ***Estimating expenses***. The best way to estimate expenses is to keep close track of what you are 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 oversized items in your spending plan that they deserve a separate category. It is possible that your current expenses will soon decrease (such as paying off a loan) or increase (such as joining a health club). Plan for significant expenses to be 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 purchasing a suit until the following 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 on foot or by bicycle.

Step 4. ***Comparing expenses and income***. Add the figures to your spending plan. Now, compare the total with your estimate of income for the planning period. If the two figures balance, you are in neutral financial condition. Suppose your income exceeds your estimate of expenses. In that case, 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 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 various 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 exceeds 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 the $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 for three consecutive months. If your spending was quite different from your plan, find out why. If your plan did not meet your needs, it must be revised. You cannot live with a spending plan that allows for no food on the last four days of the month. If the plan fits your needs but you have 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 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 before 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 support 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 benefit from early and regular investments fully. 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 earned approximately $60,000, while those who reinvested the dividends would have stocks worth roughly $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 accumulating enough 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. After 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 drops 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 their demand is deficient and sell when the demand is very high. When others are discouraged about purchasing real estate, and there are 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 use 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 more promising values than those provided domestically. One way to invest internationally is to purchase mutual funds for this purpose. They are investing in savings accounts known as certificates of deposit (CDs) that might pay a higher interest rate 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. For example, 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 typical 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 primary 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 by 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

Once you have a basic understanding of investing principles, you can start choosing from different types of investments. These are an essential part of managing your finances. Investments can be broadly categorized into lending money (fixed-income investment) or owning assets (equity investment). For instance, buying a corporate bond means lending money that will pay a fixed rate of return, while buying stocks means owning an asset. Our discussion on choosing investments includes assessing their relative risks and returns, exploring different types of investments, and selecting the right mix for your portfolio.

Tolerance for Investment Risks

As an investor, it's essential to be willing to take some risks. Even investments considered "safe" come with a certain level of risk. So, it's up to you to decide how much risk you can handle and what kind of risk you're comfortable with. For example, someone might not be satisfied with the ups and downs of the stock market, while another person might worry about inflation eating away at the value of their savings. The longer the investment horizon, the more risk people tend to be willing to take. For instance, someone with 30 years until retirement might be more open to investing in a technology stock than someone about to retire. Ultimately, it's up to you to decide how much risk you can handle to achieve your investment goals.

A significant 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 firmly risk-averse might prefer to choose investments where the risk of severe downward swings in value is less probable, such as real estate.

Understanding how much and what kind of risk you can tolerate will help you map your best investment strategy. 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.