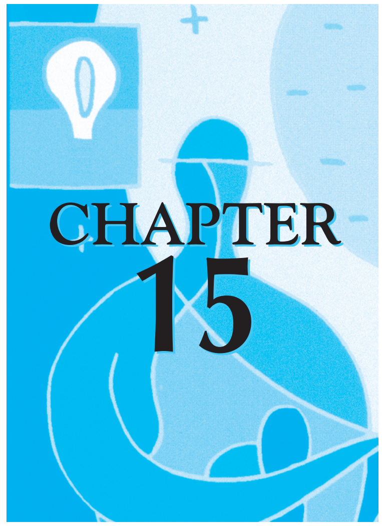


Managing Your Personal Finances

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
- Develop a plan for managing your creditworthiness
- Give yourself a yearly financial checkup

For more than a year, Rachel Hulin paid $90 a month for a gym membership. She used it maybe four times in all—for a per-visit rate of approximately $315. "I sort of felt like an idiot," says the 24-year-old photographer. "I think I signed up for it to try to make myself go." Ms. Hulin later dropped her expensive membership and joined another, less expensive gym at $55 a month. But she admits she hasn't "gone in a while" there, either.

Hulin is not alone in her casual control of her expenses. Research suggests that consumers often pay too much for services, ranging from gym memberships to movie rental clubs, because the overestimate how often they will use them.[1]

The brief mention of the woman who underuses her gym membership and the supporting research illustrate the importance of managing personal finances well. People who do scrutinize their spending will often be able to squeeze some money out of expenses and invest that money into other sources of pleasure. Equally important, they will have more money available for savings and investments.

It is important to manage personal finances in such a way that money becomes a source of satisfaction rather than a major worry. Financial problems can lead to other problems. Poor concentration stemming from financial worries may lead to low job performance. Many relationship problems stem from conflict about finances. Worry about money can also drain energy that could be used to advance your career or enrich your personal life.

The purpose of this chapter is to present information that should enable you to start on the road to financial comfort and escape financial discomfort. Our approach is to cover the basics of personal financial planning, investment principles, choosing investments, managing and preventing debt, giving yourself a yearly financial checkup, and retiring rich.

▲ 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

Personal finance is yet another area in which goal setting generally improves performance. A common approach to financial goal setting is to specify amounts of money you would like to earn at certain points in time. An individual might set yearly financial goals, adjusted for inflation. Another might set goals for five-year intervals. Another common financial goal is to obtain enough money to cover a specific expense, such as making a down payment on a new car. These goals should include a target date, such as shown in Exhibit 15-1. An important supplement to establishing these goals is an investment table that specifies the amount of money needed to achieve the goal (see Table 15-1). Financial goals are sometimes expressed in terms of the allocation of money. Among these goals would be the following:

- Putting pay raises into savings or reducing debt
- Participating in an automatic savings or retirement plan whereby a financial institution deducts money from each paycheck
- Investing 10 percent of each net paycheck into a mutual fund

Financial goals are sometimes more motivational when they point to the lifestyle you hope to achieve with specific amounts of money. In this way, money becomes the means to the ends that bring satisfaction and happiness. Here are two examples of financial goals expressed in terms of what money can accomplish:

- By 2009 I want to earn enough money to have my own apartment and car and buy nice gifts for my family and relatives.
- By 2033, I want to earn enough money to have paid for my house, own a vacation home near a lake, and take a winter vacation each year.

EXHIBIT 15-1

Financial Goal Setting

Goal	Target Date	Years to Goal	Dollars Needed
1. Pay off credit cards	June 2005	$1\frac{1}{2}$	$5,675
2. Pay for son's college	September 2025	18	$175,000
3. Down payment on home	June 2009	$4\frac{1}{2}$	$28,000

TABLE 15-1

MONTHLY SAVINGS NEEDED TO REACH GOAL
(5% AFTER-TAX RATE OF RETURN)

	Dollar Goals				
Years	**$5,000**	**$10,000**	**$20,000**	**$50,000**	**$100,000**
2	198	395	791	1,977	3,954
4	94	188	376	939	1,878
6	59	119	238	594	1,189
8	42	85	169	423	846
10	32	64	128	321	641
20	12	24	48	121	242
30	6	12	24	60	120

NOTE: This chart assumes that deposits are made at the beginning of each month and that interest is compounded monthly.

DEVELOPING A BUDGET (SPENDING PLAN)

When most people hear the word *budget,* they think of a low-priced item or miserly spending habits. Their perception is only partially correct. A budget is a plan for spending money to improve your chances of using your money wisely and not spending more than your net income. John Gilligan, the executive director of a consumer credit counseling service, reminds us of the important of following a budget. He says that 90 percent of clients do not have a budget in place or do not know how to develop one when they first seek his agency's services.[2] Developing a budget can be divided into a series of logical steps. Exhibit 15-2 presents a worksheet helpful for carrying out the plan. Many people today use software that helps you lay out a budget. For most people, a monthly budget makes the most sense because so many expenses are once-a-month items.

Step 1. *Establishing goals.* Decide what you or your family really 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 "replace hot water heater this February." A long-term goal might be "accumulate enough money for a recreational vehicle within 10 years."

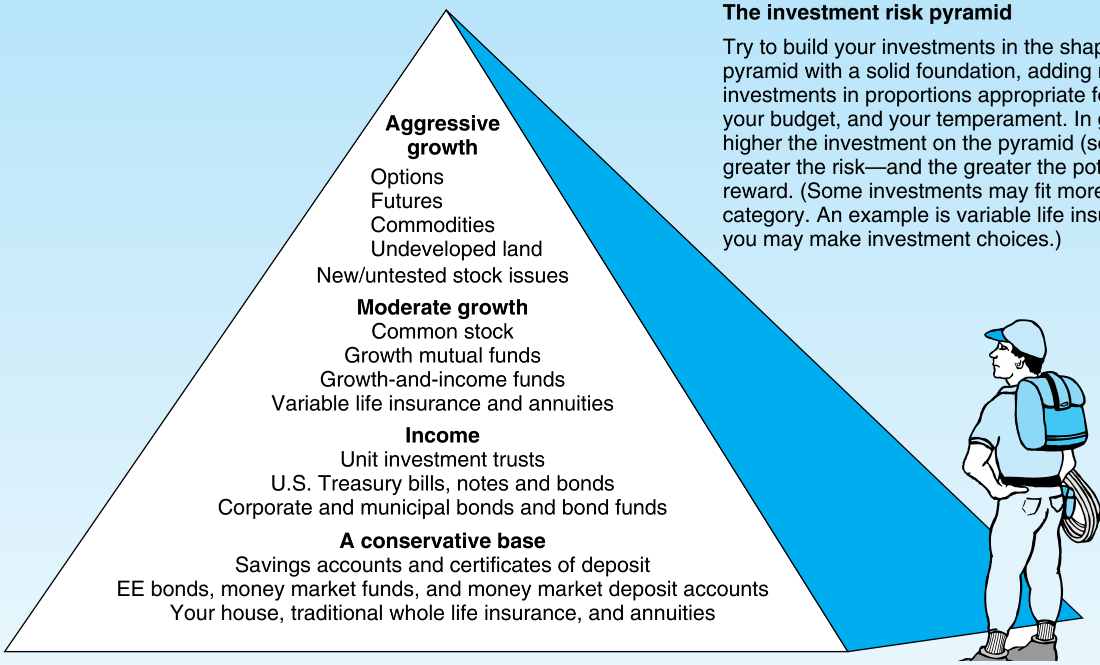
Step 2. *Estimating income.* People whose entire income is derived from salary can readily estimate their income. Commissions, bonuses, and investment income are more variable. So is income from part-time work, inheritance, and prizes.

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.)



SOURCE: Reproduced with permission of The Prudential.

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 the expenses 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 a big item in your spending plan that it deserves a separate category. It is possible that an expense you have now will soon decrease (such as paying off a loan) or increase (such as joining a health club).

Try to plan for large expenses so that they are spaced at intervals over several years. If you plan to 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 pattern of spending or to 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.

EXHIBIT 15-3

Your Monthly Spending Plan

Monthly Expenses		**Monthly Income**	
Fixed:			
Mortgage or rent	______	Salary	______
Property insurance	______	Tips	______
Health insurance	______	Bonuses and commissions	______
Auto insurance	______	Interest and dividends	______
Other insurance	______	Insurance benefits	______
Educational expenses	______	Child support received	______
Child support payments	______	Other	______
Local telephone and Internet service provider	______	Total income	______
Cable or satellite TV	______		
Taxes:		*Summary:*	
Federal	______	Total income	______
State or provincial	______	Less total expenses	______
Social Security	______	Balance for savings and investment	______
Local	______		
Property	______		
Installment loans (auto and others)	______		
Set-aside for emergencies	______		
Variable:			
Food	______		
Household supplies	______		
Home maintenance	______		
Medical and dental	______		
Toll calls and cell phone	______		
Clothing	______		
Hair care and cosmetics	______		
Transportation	______		
Car maintenance	______		
Entertainment including pay-for-view TV	______		
Travel and vacation	______		
Clubs/organizations	______		
Hobbies	______		
Other	______		
Total expenses	______		

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 investment.

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 several months, you should be able to make an accurate estimate of miscellaneous expenses.

If your income is below your estimated expenses, you will have to 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 make a notation of 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. To start developing an investment strategy or refining your present one, consider the eight investment principles presented next. 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 being in 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 people struggling to make ends meet, the 10 percent rule is unrealistic. These people may choose to 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 ensures that 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 that you invest $1,000 at the start of each year for five years. It earns 8 percent a year, and the earnings are compounded (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 would have to 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 that *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. A representative study showed that investors held their shares in mutual funds for an average of 30 months from 1984 through 2002. Along the way, they achieved a yearly gain of 2.6 percent. The Standard & Poor's 500 stock index showed a gain of 12.2 percent during the same time period.[3] Investing regularly often lowers the average cost of your investment purchases. (This technique is referred to as *dollar-cost averaging* and is described later.)

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. It is also possible to invest in savings accounts known as *certificates of deposit (CDs)* that might pay a higher rate of interest than domestically.

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

HUMAN RELATIONS SELF-ASSESSMENT QUIZ 15-1

Your Money Personality

Below is a two-part quiz that addresses you willingness to take risks and your desire to be involved with the investment decision-making process. Take it, and perhaps you'll find out something you didn't know about yourself.

Risk versus Safety

1. If I found a secure job which I thoroughly enjoyed, I would

______ a. probably stay in it indefinitely.

______ b. stay unless a better opportunity came along.

______ c. be on the lookout for a better opportunity or investigate ways to start a business of my own.

2. I would become involved with a new business

______ a. only as a customer.

______ b. as an employee if I've checked it out and it seems as if it's a good opportunity.

______ c. as an investor if there's the chance of a big payoff.

3. Buying a car, I prefer

______ a. an economy model with good performance ratings and an extended warranty.

______ b. an exciting model, still unrated, with a standard warranty.

______ c. a sleek and prestigious vintage car that would increase in value but may be costly to maintain.

4. Visiting a casino, I

______ a. generally feel uncomfortable.

______ b. enjoy some games but budget how much I can afford to lose and stop after that.

______ c. get caught up in the games and sometimes have big losses.

5. I've discovered that I'm most nervous around someone who

______ a. spends frivolously and/or takes big risks with money.

______ b. misses opportunities because of risk or fear.

______ c. never takes a chance in hopes of a big payoff.

High Involvement versus Lack of Involvement

1. At any given time, I know

______ a. my total assets and liabilities, down to the last $200.

______ b. more or less what my assets and liabilities are.

______ c. which bills I have to pay from my latest paycheck.

2. If the interest on my credit card were raised, I would
______ a. shop until I found a lower rate.
______ b. look into a few other cards.
______ c. go on paying as before because it's convenient.

3. My personal checkbook is
______ a. always balanced.
______ b. balanced every few checks of every week.
______ c. only balanced when I receive a statement and sometimes not even then.

4. If suddenly I had a much larger income, I would
______ a. manage all of it myself and enjoy doing it.
______ b. work with my partner as well as with financial experts.
______ c. hire financial experts as well as someone to manage my day-to-day expense money.

5. I'd prefer an investment that
______ a. would make money for me if I kept an eye on it constantly.
______ b. I need to evaluate only every few months.
______ c. I never have to worry about.

Interpretation of Results

Risk Versus Safety

- If you scored three or more a's—you tend to be safety oriented.
- Three or more b's—you tend to be more at ease with some risk.
- Three or more c's—you tend to be a risk taker.

If you are making inappropriate money decisions because you're miscalculating your willingness for risk taking, Kathleen Gurney, chief executive officer of Financial Psychology Corporation, says you might counter those reactions by taking the time to carefully consider any decisions about money before you make them. For those who are overly cautious, her suggestion is to take small, calculated risks to build up your confidence and risk tolerance.

High Involvement versus Lack of Involvement

- Three or more a's—you tend to like being in charge of money.
- Three or more b's—you tend to be responsible, but can share control.
- Three or more c's—you tend to easily relinquish control over money.

According to Gurney, those who score high in involvement need control over their money to have peace of mind. To learn more about your attitudes toward money, visit her Web site at www.finpsych.com. The site contains a 28-question quiz dealing with money habits.

SOURCE: © 1999, Kathleen Gurney, Ph.D. Reprinted in "Your Money Personality Quiz," *Fidelity Focus*, Summer 1999, pp. 13, 15.

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-indexed Treasury 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 disadvantage of investing in Treasuries is that their yield is usually less than 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 invest in their business. Many of these bonds are 20- to 30-year loans. They pay 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

$$\frac{\text{tax - free yield}}{(1 - \text{tax rate})} = \text{tax-equivalent yield}$$

If the tax-free yield of a muni is 3 percent, a taxable bond would have to pay 4.17 percent, assuming you are fortunate enough to be in the 28 percent federal income tax bracket. Here is the basic math:

$$\frac{3\%}{1 - .28} = \frac{.03}{.72} = 0.417 = 4.17\%$$

If you also figure in state or provincial tax exemption, the tax-equivalent 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 the hope of most investors is that the stock will rise in value. The majority of 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 dollar-cost 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.

Table 15-2 illustrates dollar-cost averaging.

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.

TABLE 15-2

HOW DOLLAR-COST AVERAGING WORKS

Month	Investment	Share Price	Shares Purchased
1	$200	$20	10
2	200	18	11.1
3	200	16	12.5
4	200	18	11.1
5	200	20	10
	$1,000	average = $18.4	54.7

NOTE: Your average cost per share is $18.28 (the total invested divided by the number of shares purchased). This figure is lower than if you had invested $1,000 in the first month at $20.

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

No matter which one of these five strategies you choose, it is sound to have 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.

EXHIBIT 15-4

Selecting the Right Mix of Investments

Investor Profile	*Stocks*	*Bonds*	*Cash*
Capital preservation	10%	55%	35%
Income	30%	60%	10%
Income and growth	40%	50%	10%
Growth	70%	25%	5%
Aggressive growth	80%	10%	10%

SOURCE: "Tired of Stock Market Volatility: Bonds May Offer Relief," *Merrill Lynch & You,* June 2000, p. 2.

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 three-month 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.[8]

A recommended strategy of reducing debt is to **concentrate on one bill at a time.** According to this technique, you first pay off your smallest 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

HUMAN RELATIONS SELF-ASSESSMENT QUIZ 15-1

Are You Too Far in Debt?

1. Is an increasing percentage of your income being spent to pay debts?
2. Do you use credit to buy many of the things you bought in the past for cash?
3. Are you paying bills with money targeted for something else?
4. Have you taken out loans to consolidate your debts or asked for extensions on existing loans to reduce monthly payments?
5. Does your checkbook balance get lower by the month?
6. Do you pay the minimum amount due on your charge accounts each month?
7. Do you get repeated dunning notices (letters demanding payments) from your creditors?
8. Are you threatened with repossession of your car or cancellation of your credit cards or with other legal action?
9. Have you been drawing on your savings to pay regular bills that you used to pay out of your paycheck?
10. Do you depend on extra income, such as overtime and part-time work, to get to the end of the month?
11. Do you take out new installment loans before old ones are paid off?
12. Is your total savings less than three months' take-home pay?
13. Is your total installment credit (not counting mortgage) more than 20 percent of your take-home pay?
14. Do you become horrorstruck when you look at your credit card bills?
15. Has a credit card company *rejected* your application in the past two years?

If your answer is yes to two or more of the above questions, financial counselors would advise you to declare war on some of your debts.

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

EXHIBIT 15-5

Heath and Judy Concentrate on One Bill at a Time

After 17 years of marriage, Heath and Judy had acquired an upsetting level of debt. Part of their problem was the debt they had accumulated in the process of acquiring two two-family houses that they used as income property. At the urging of a financial counselor, Heath and Judy scrutinized both their debts and their spending habits. Their debt picture looked like this:

Type of Loan	Approximate Balance on Loan	Monthly Payment
Auto	$2,850	$215
Home improvement	1,975	149
Visa	1,828	85
MasterCard	1,859	95
Furnaces for income properties	2,562	185
Tuition	800	90
Orthodontist	750	75
	$12,624	$894

An indebtedness of $12,624 may not seem extreme. Nevertheless, in terms of their living expenses, including the support of three children, $894 a month of debt was creating stress for Heath and Judy. The couple might have tried the traditional debt reduction program of spreading out their monthly debt reduction fund over all their bills. In so doing, they would have tried to make approximately equal payments to all creditors. Instead, Heath and Judy chose to reduce their debts by concentrating first on the variable-payment debt with the smallest balance. In other words, they concentrated first on the debt that they were capable of eliminating first.

Following this strategy, Heath and Judy began their debt reduction program by first working down the Visa debt. Each month they would put as much money as they could spare into their Visa payment, even though they had previously paid only $85 monthly for that particular bill. The couple kept making minimum payments to MasterCard until their Visa balance was reduced to zero. Then came big progress when they were able to make two double payments. (The general principle is to eliminate, one by one, each of the loans for which variable—rather than fixed—payments are possible. In addition, take on new debts for emergency purposes only.)

The preceding case history indicates that an effective program of debt reduction involves both financial and emotional issues. Getting rid of debts one by one provides an important emotional boost to the debtor. As the debts are peeled off, tension is reduced. The one-debt-at-a-time strategy is also tied in with goal theory. You experience a feeling of accomplishment as each debt is eliminated. Simultaneously, you are motivated to tackle the next variable debt.

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 in comparison with 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.

PREPARING AN ANNUAL NET WORTH ANALYSIS

A potentially uplifting strategy of managing your finances is to chart your yearly financial status. You can accomplish this by annually evaluating your **net worth,** the difference between your assets and liabilities. Net worth is considered a much better barometer of your financial stability than the amount of money you earn or the value of your investment portfolio.[9]

Your asset list should begin with **liquid assets,** those that can be converted into cash relatively quickly. Personal belongings should be valued only at what they could be sold for now, not the purchase price. A house or condominium contributes to your net worth if you have accumulated equity. (Equity is the net price you could receive for a house minus the mortgage balance, real estate commissions, and closing costs.)

Net worth analyses for two years are presented in Exhibit 15-6. The person who prepared both reports was in financial difficulty when the first report was prepared. Notice the progress this individual has made over the

EXHIBIT 15-6

Net Worth Comparison Between Two Years

Assets	**December 31, Year 1**	**December 31, Year 4**
House equity (based on market value)	$28,000	$38,000
Cash in checking account	141	392
Cash on hand	75	315
Savings account	118	792
Mutual fund	—	896
Car resale value	3,600	1,800
Jewelry resale value	850	2,000
	$32,784	$44,195
Liabilities		
Auto payments	$3,500	—
Visa	1,215	$350
MasterCard	2,150	1400
American Express	850	80
Sears charge	1550	1128
Home improvement loan	3,975	—
Loan from uncle	895	—
Property tax due	850	350
School tax due	650	350
Plumber	275	400
	$15,910	$4,058

four-year period. In the first year, his liquid assets aside from his home equity and car resale value totaled $1,184. Including house and car, his assets were $32,784. Thanks in part to both self-discipline and modest inflation, his assets jumped to $44,195 four years later. Without the house equity and car resale value, his liquid assets were $4,395.

The liability picture is even more impressive. In the first year, the man had outstanding debts of $15,910. Four years later, his debts had shrunk to $4,058. His liability position had improved an enviable $11,852. Over the same period, his asset picture had improved $11,411. Adding both improvements together, we are able to give the individual a financial improvement score of $23,263 for the four-year period. Recognize, however, that the $10,000 growth in house equity was a major contributing factor to his financial improvement.

▲ 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 sector 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 putting your retirement pay at risk. 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 many other types of investments. Each plan sets a limit on the percentage of your current salary that you can contribute to the plan. The Internal Revenue Service also sets limits, which were 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 of time, 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 making allocations 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. Distributions from your IRA 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 who are not active participants in an employer-sponsored retirement plan. Also, employees with moderate incomes are eligible for some tax deductions from an IRA. Dividends and interest from an IRA are not taxed as long as they are not withdrawn. When you begin 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 you 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 the entire some in your estate.

SEPs are retirement plans for individuals who are self-employed or for 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 a SEP.

The dramatic financial returns from an IRA or SEP are shown in Table 15-3, which assumes that a person invested $2,000 each year. Much of the growth in funds 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 make withdrawals, 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 10 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

TABLE 15-3

HOW IRAS CAN GROW

	Rate of Return		
Years of Contribution	**8%**	**10%**	**12%**
5	$ 11,733	$ 12,210	$ 12,705
10	$ 12,973	$ 31,875	$ 35,097
15	$ 54,304	$ 63,544	$ 74,559
20	$ 91,524	$114,550	$144,104
25	$146,212	$196,694	$266,667
30	$226,566	$328,998	$482,554
35	$344,634	$542,048	$863,326

NOTE: This chart assumes a $2,000 yearly contribution at year end, compound interest, and no tax payments.

out of retirement money exactly on the last day of their life. Few people can plan with such precision, so a good bet is to invest in both the long term and present happiness.

▲ SUMMARY

An important part of managing your personal life is to manage your personal finances in such a way that money is not a major source of worry and concern in your life. Financial problems often lead to marital problems, for example.

Setting financial goals is an important starting point in managing your personal finances. Such goals can be expressed in dollars, the type of things you would like to accomplish with money, or the type of lifestyle you would like to lead.

A vital aspect of financial management is to establish a budget or spending plan, which can be divided into six steps: (1) establishing goals; (2) estimating income; (3) estimating expenses; (4) comparing expenses and income; (5) carrying out the budget; and (6) evaluating the budget.

An effective spending plan allows room for investing. Basic investment principles include (1) spending less money than you earn; (2) investing early and steadily to capitalize on the benefits of compounding; (3) keeping reinvesting dividends; (4) diversifying your investments (use asset allocation); (5) maintaining a disciplined, long-term approach; (6) practicing contrary investing; (7) investing globally as well as domestically; and (8) paying off debt.

The two basic types of investments are fixed-income investments and equity investments. All investments carry some risk, and you must decide how much and what types of risk you can tolerate.

Among the many ways of investing or saving money are the following: certificates of deposit; money-market funds; U.S. Treasury securities; corporate bonds; municipal bonds; common stocks; mutual funds; real estate; gold bullion; coins, antiques, paintings, and other collectibles; and life insurance and variable annuities.

A major investment decision is how to allocate your investments among short-term interest-bearing accounts, stocks, and bonds. Younger people should typically hold more stocks. In selecting the right mix of investments, choose among diversification strategies with respect to risk. Emotional factors, particularly risk toleration, influence the choice of investments.

Common stocks pay higher rates of return than corporate or government bonds. However, the return on a given stock or mutual fund is less predictable than bonds held to maturity. Yearly taxes must be paid on some of the profits from mutual funds, stocks, and corporate bonds.

Managing and preventing debt is an important component of managing personal finances. To use credit wisely, recognize the difference between good debt and bad debt. Limit your total borrowing to 15 to 20 percent of monthly take-home pay, not including a house mortgage payment. Using credit cards wisely includes such factors as restricting their use, selectively using a home equity loan, and making more than the minimum monthly payments on loans.

One way of working your way out of debt is to concentrate on one bill at a time—try to pay off first your variable payment with the smallest balance. To stay out of debt, pay for goods and services with cash or check and therefore stop borrowing money. We recommend a yearly financial checkup by preparing a list of your liquid assets and liabilities. Progress is measured in terms of the difference between assets and liabilities. The bigger the positive difference, the better your financial health.

People who start a retirement savings or investment program early in their careers may accumulate large sums of money by retirement. Asset allocation is a major strategy for accumulating retirement funds. Social security benefits contributed modestly to retirement. Employee pensions and 401(k) plans (a portable self-directed pension) are major contributors to funding retirement. An SRA is another vehicle for tax-deferred retirement investing. In addition, consider an individual IRA or SEP.

Question and Activities

1. What types of human relations problems might people avoid by carefully managing their finances?
2. Assume that after preparing a budget, you conclude that your expenses must be reduced by 10 percent. What cuts would you make?
3. It has often been observed that the majority of people who file for bankruptcy have incomes that are well above average. How can this be?
4. How might good work habits and time management help a person make good use of a budget?

5. How can a person resolve the conflict between investing money for the long range and buying things he or she wants right now?
6. What is the difference between having a high income and being wealthy? How can this difference in meaning provide people an important lesson?
7. During the stock market downturn during 2000 through 2003, some people heavily invested in technology stocks lost 95 percent of the value of their investments. How does this event influence your attitudes toward investing for the future?
8. If you think you will live at least 100 years, how will this affect your investment strategy?
9. How can you use the Internet to reduce your cost of living?
10. Talk to a retired person and inquire what, if anything, he or she would do differently to plan financially for retirement. Be prepared to discuss your findings in class.

INTERNET SKILL BUILDER: What's Your FICO (Credit) Score?

A necessary part of building a good financial future is to be aware of your credit rating. One of the widely accepted methods of rating people's creditworthiness is FICO, the credit score system offered by Fair Issac Corporation. Your credit score is obviously important when you need to borrow money and is also used by some prospective employers to help judge your dependability. FICO scores range from a low of 300 to a high of 850. Each person has three FICO scores, each based on one of the three national credit reporting agencies, TransUnion, Equifax, and Experian. You are able to purchase your FICO scores and the accompanying credit report and view them online at www.myfico.com for $13 each. Even if you are not ready to invest in obtaining your credit score, you might profit from studying the Score Power® Sample at www.equifax.com. Score Power divides your credit history into different categories and offers suggestions for improving your score over time. After your receive your credit score, compare it to your self-evaluation of your creditworthiness.

A HUMAN RELATIONS CASE PROBLEM

The Problem Budget

The spending plan presented below was submitted by Greg Walters, a 28-year-old man with a good job. He says that owning a home and entertaining his friends are important parts of his lifestyle. Yet he also contends, "I'm committing slow-motion financial

(Continued)

suicide. Each month I go further into debt. Right now I don't see a good way out unless I give up a lot of things that are important to me. You've got to have fun in life, don't you?"

Review Greg's budget and make some specific recommendations to him for improving his financial health. Also, what flaws do you find in his logic?

BUDGET FOR GREG WALTERS

Monthly Expenses		Monthly Income	
Fixed:		Salary	$4,375
Mortgage or rent	$ 825	Tips	
Property insurance	55	Bonuses and commissions	
Health insurance	45	Interest and dividends	1
Auto insurance	55	Insurance benefits	
Other insurance	40	Child support received	
Educational expenses	125	Other	
Internet Service Provider	22		
Satellite TV	45	Total income	$4,376
Taxes:			
Federal	765		
State or provincial	225		
Social security	218	*Summary:*	
Local		Total income	$4,376
Property	190	Less total expenses	4,560
Installment loans (auto and others)	330	Balance for savings and investment	(184)
Set aside for emergencies	0		
Variable:			
Food and beverage	275		
Household supplies	55		
Home maintenance	85		
Medical and dental	50		
Telephone	75		
Clothing	140		
Hair care and cosmetics	65		
Transportation	110		
Car maintenance	135		
Entertainment including pay-per-view TV	175		
Travel and vacation	275		
Clubs/organizations	145		
Hobbies	35		
Total expenses	$ 4,560		

WEB CORNER

Cost-of-living comparisons between cities: www.cityrating.com/costofliving.asp

Mutual fund profiles: http://biz.yahoo.com/i

Personal finance: www.financecenter.com

Social Security retirement planner: www.ssa.gov/retirecharted.htm

Treatment of money disorders related to other addictive behavior: www.themeadows.org

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