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The Basics **S**
The 7 biggest financial
decisions you'll ever make

How you manage a handful of major life
choices can make or break your financial future.
By [Richard Jenkins](#)

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A lot of people spend a whole lot of time worrying about the small stuff -- a little extra yield on their savings, a few dollars less in mortgage payments, slightly higher returns, slightly lower commissions.

They pore over IRS publications and fat tax guides searching for ways to save a few hundred bucks on taxes. They read personal finance magazines, buy books and scour the Web looking for tips.

Fine. It pays off. But does managing your money really have to be this complicated?

Actually, no. In fact, if you spend all your time focusing on fractions of a point, you may lose sight of the big picture.

The blunt truth is that if you make the right choices early in life on a handful of major decisions, you'll never have to worry about financial security.

1. How you handle risk

• Risk affects all aspects of your life. Would you rather work for a rock-solid company with a strong benefits package, a smaller start-up with great stock options or start your own business? The potential payoffs escalate as you take on more risk, but so do the possibilities for disaster. The same is true for investments.

• Make sure your risks are age-appropriate. If you're young, you can dust yourself off and start again. For people over 40, the ability to absorb losses diminishes rapidly as retirement nears.

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- **Do your homework.** Risk without research is just another form of gambling. Before jumping into any kind of investment, it's vital to do the due diligence required to accurately evaluate risk, the potential for gains and the potential for losses. Don't make yourself a target for unethical advisers and garden-variety con artists.

Example: The long-term rate of return for big-company stocks has averaged 10% yearly over the past 70 years. Joe invests \$2,000 per year in those stocks (via a low-cost S&P 500 index fund in a tax-deferred IRA) while Dexter buys super-safe Treasury bonds paying an average of 5%. They start at age 25 and continue until age 65. Though the rate of return is double, the accumulation is quadruple: at age 65, Joe has \$1,006,513 while Dexter has just \$248,561.

2. Your choice of career

- **There are worse things than a fat paycheck.** Your options depend largely on your education and skills, but some fields will always pay better than others. Getting the training needed for a better job could be the best investment you make. Ask yourself what the long-term salary expectations are for your career field and consider how you could make yourself more valuable.

- **Does your pay depend on distortions in the market?** A lot of semi-skilled but highly paid union workers now know the sting of competition here and overseas. Blue-collar incomes have stagnated over the past 20 years as manufacturers found cheaper workers abroad. Consider what your skills would be worth in a truly open, worldwide market.

- **Will your skills retain their value in the next century?** Knowledge is the key to survival in the years ahead, whether you're a carpenter or a computer programmer. The pace of innovation is staggering, and those who fail to keep up will find their personal stock in a nose dive. Nothing has a more disastrous impact on financial security than a lengthy period of unemployment.

Example: Joe's salary averages \$60,000 over a career of 40 years; Dexter's averages \$30,000 per year. In addition to their IRA accounts, they each put 10% of

their income aside each year in taxable investment accounts that yield 8% annually. At retirement, Joe has \$1,092,093 to Dexter's \$546,047.

3. Your lifestyle

- **You don't have to live like the Unabomber to save money.** Americans are conditioned to overbuy. Shopping has gone from being a chore to a hobby, a lifestyle even. Shoppers are encouraged to define their individuality in terms of "style," which for most people comes down to a matter of which mass-produced goods one chooses to buy.

- **Ask yourself how much house you really require.** The square footage of the average American home has been growing steadily since World War II. In the 1970s and '80s buying ever-larger homes seemed a good, tax-blessed investment. Home values generally outpaced inflation -- by a large margin in many places. But those days are over, barring a return to the monetary policies of yesteryear. And as the baby boom generation starts downshifting into retirement, there are likely to be a lot fewer buyers for those 4,000-square-foot, five-bedroom homes.

- **Every dollar you don't spend on a house saves roughly \$2.40 in mortgage payments.** A lot of people calculate what they can afford to pay for a house and use that as the floor price for their house search. They don't even consider less expensive homes, and no self-respecting, commission-hungry Realtor would suggest it.

Example: Joe and Dexter each have \$40,000 for a down payment on a house. Joe buys a house that requires him to carry a \$180,000 mortgage. Dexter buys a larger house and needs a \$200,000 loan. Buying the lower-priced house saves Joe \$49,317 in mortgage payments over the life of the 30-year mortgage at 7.25% interest.

4. How you manage debt

- **Pay yourself instead of your creditors.** At its most basic, credit is the privilege of spending money you don't have. Prior to World War II, most people avoided it. To help Americans get over that silly notion, credit card debt was a deductible expense prior to 1991. Then, Congress created a new pool of deductible interest in the form of home equity lines of credit. We've learned

our lessons so well that now bankruptcies are at an all-time high, despite a raging stock market and negligible unemployment. Everyone in government is, understandably, shocked and appalled to discover how deeply in debt the typical American is today. Banks make a lot of money lending to people who can't wait to buy things.

Example: Dexter buys his new \$20,000 car with 10% down and a 48-month loan, while Joe postpones the purchase, saving up the money and paying cash. Dexter's monthly payment on the loan is \$448, but Joe only needs to set aside \$344 each month in a 5% taxable money-market account to pay cash for the car at the end of four years. Joe started buying all his cars this way at age 30 and put the \$104 savings in an IRA earning 9%. By the time he retires at 65 he'll have an extra \$352,000.

5. Protecting your assets

- **Your most important asset is your ability to work.** Disability insurance will pay you a percentage of your income, usually from 60% to 80%, if you're sick or injured and totally unable to work, but that income never increases. Living 30, 40 or 50 years on a fixed income is one of the surest roads to lifelong poverty. Consider the financial as well as physical risks when you're tempted to buy that Harley-Davidson or take up cliff diving.

- **You also need to provide adequate protection for the rest of your assets.** That means making sure you have adequate auto and home insurance, and for most people, an umbrella liability policy that provides extra protection against large damage awards in certain civil suits. Just about any lawyer can tell you stories about someone forced into bankruptcy by a damage award that exceeded the limits of his or her insurance coverage.

- **If you're self-employed, insulate your assets.** Consider forming a limited liability corporation. It's easier to set up and maintain than most other corporate forms and will make it much harder for creditors and attorneys to go after your personal assets.

Example: At age 40, Joe and Dexter are each hit by a judgment in a legal case. Joe has an umbrella liability

policy that pays the full amount. The judgment exceeds the limits of Dexter's homeowner's insurance, forcing him to turn over the \$73,329 he had accumulated in his taxable investment account and file for Chapter 7 bankruptcy protection. It will be seven years before his credit rating recovers, but the real damage is the loss of the potential earning power of his investment portfolio. Dexter will have to start saving from scratch at age 40, and instead of a portfolio worth \$546,047 at age 65, he'll wind up with just \$180,220. Not having adequate insurance will thus wind up costing him \$365,827 in lost principal and investment earnings.

3. How many children you have

- **Today, there's a powerful financial disincentive to have children.** Let's start by saying upfront that we all love children. They provide joy and excitement to every family, but this is intended to view them purely from a financial perspective. In the days before Social Security, there was a positive incentive to have lots of children. Not only did they perform necessary labor on the farm or in the family business, but they also were expected to care for their aging parents, come what may. According to the latest figures from the U.S. Department of Agriculture, it now costs \$112,000 to as much as \$224,000 just to raise a child through high school. (Higher-income families tend to spend more.) Add anywhere from \$40,000 to \$120,000 more for a basic four-year college education. There are economies of scale as the number of children you have grows, of course, but there are no multi-child discounts available for college.

- **The cost of a happy accident.** Nobody who wants three children is going to be deterred from having that many, of course. But many people who really wanted to hold the line at two wind up with three, and sometimes four or more, by what is euphemistically called an accident. Just remember that this kind of accident is among the most expensive you can have.

Example: Joe has two children, which will cost him \$446,000 to raise to age 18, and \$80,000 more for a public university, making a total of \$526,000. Dexter had planned to have just two children, but a third came along unexpectedly just as he and his wife turned 40. Even if

Dexter scrimps and saves to spend just half as much per child as Joe, the total tab including college will still add up to \$432,000. And since Dexter's income is just half of Joe's, he can ill afford the extra expense. Now, instead of socking money away for retirement, he and his wife are using that money to raise their kids and send them to college.

7. Marrying for better or worse

• Take everything you own and divide by two.

Deciding whom to marry may not seem like a financial decision, but you'll find out otherwise if you ever have to endure the pain of divorce. Bankruptcy, a legal judgment, even the IRS can't touch certain assets, such as money in retirement plans. But nothing is safe from the divorce attorneys.

• On the positive side, getting married can double your income. While the quaint notion that two can live as cheaply as one is dubious, it doesn't cost twice as much, either. Financial teamwork early in a marriage can yield a substantial payback in later years (provided you stay together). Choosing someone whose long-term financial goals are similar to yours will reduce friction and help you stay on track.

Example: At age 65, Dexter and his wife decide to split up. They've tapped their retirement funds to put the last of their children through college. They've managed to pay off the mortgage on their \$240,000 house, and it now represents the total of their net worth in today's dollars. They've both worked throughout the marriage, so alimony isn't an issue, but they will have to sell their home and divide the proceeds. Instead of living payment-free in the home they struggled 30 years to own, they'll be paying rent again - on two homes.

As the examples of Joe and Dexter show, it isn't necessary to be an investment whiz to accumulate a substantial fortune if you make smart choices on a handful of life's big decisions.

At the end of his career, Joe has a net worth including his home of more than \$2 million. He can retire with the security of knowing his conservative investments, with a 6% annual yield, will provide after-tax income of \$91,000 until he's 95, and leave a \$200,000 cushion.

Dexter's \$120,000 in assets will only give him \$4,000 in annual income after taxes. If he retires at 65, he'll be depending on Social Security for a large part of his living expenses and will only have about two-thirds the income he had when he was working. Even if he works part-time until he's 75, bringing home \$10,000 extra each year, he'll have to save most of that money for the future and will only have \$4,000 extra to bolster his income from Social Security.

8. How Much College Debt You Assume (addition by Pat Craig)

College debt can drag down your entire adult life. A large amount of outstanding loans for college can prevent you from having a good credit rating to take out a loan to buy a new car or own a home. Large monthly student loan bills can also prevent you from renting an apartment you would like to rent, marrying when you want, starting a family as early as you'd like, or taking vacations.

On the positive side, smart choices about your higher education, college major, and where you go to college (and loans), can increase your chances of a very well-paid career. Technical certificates, computer science degrees, nursing, pharmacy, and accounting majors are degrees that can really "pay off." Historically, in most cases, these majors are a good value for the college tuition spent.

Possible Ideas to Minimize College Loans:

Maximize your course load, i.e. take as many credits as possible, and graduate in 3 or 3 1/2 years. In this way you will save at least one semester's college tuition, maybe two semesters.

Forgo college completely and get a certificate in computer programming. Then get real work experience, if you have to, doing computer work for free for your local church or non-profit.

Attend to a Community College and get an Associates (2 year) degree, Then transfer those credits, to UMass so you get your Bachelor's degree from UMass.

**Possible Ideas to Minimize College Loans
(Continued...):**

Get your Associates (2 year) Degree, then work 1 ½ jobs to pay off the loans. Once the college loans are paid off, then attend your final two years of college.

Go to college in the evening and work during the day.

Attend Northeastern University where you attend college one semester, then work at an internship for a semester. One semester at school, one semester at work. (Think this is a 5 year program...)

Work part time as you attend college so you don't need to take out so many loans.

Example (these are real people that Pat knows): Jane attended a community college, with a two-year associates degree program, and she was able to get her R.N. nursing degree. Two years to an R.N.! Jane has had a good life and was able to pay off her college loans early in life. (To digress, the President of Mount Auburn Hospital started her career as a nurse.) Mary wanted to be a physician. She went to a four year college, studied pre-med, and took out extensive loans. However, Mary couldn't get accepted to a medical school and so she became an osteopath. (Osteopaths are considered interchangeable with primary care physicians in many communities.) Mary took out more loans to fund her osteopath education. At 50 years old, creditors are calling Mary's mother, who co-signed some of Mary's education loans, to try to collect on school loans Mary is defaulting on.

