Chapter 1

Improving Your Financial Fitness

In This Chapter

- Understanding and conquering obstacles to personal financial success
- Overcoming real and imagined financial hurdles
- Comprehending common money problems
- Understanding bad debt, good debt, and too much debt
- Determining assets, liabilities, and your (financial) net worth
- Calculating your rate of savings
- Assessing your investments and insurance

We're barely acquainted, but we do know that you're not dumb. Real dummies don't read and educate themselves. And real dummies don't understand the value of investing in their education. Real dummies also can't deflate their egos enough to admit that they need help and guidance.

Here's what dumb is: Dumb is the crook who walked into a convenience store, put a $20 bill on the counter, and asked for change. When the cashier opened the register, the man pulled a gun and demanded all the cash. The thief took the loot — $15 — and fled, leaving his $20 bill on the counter. Or how about the criminal who robbed a person who lacked cash? The victim offered the assailant a cheque, which the assailant later attempted to cash at the bank, where — surprise, surprise — he was arrested. Both of these stories are true!

So you're most definitely not dumb! But you may not be literate when it comes to personal finances.

Targeting the Trouble Spots

Unfortunately, most Canadians don't know how to manage their personal finances because they were never taught how to do so. Nearly all our high schools and universities lack even one course that teaches this vital skill we all need throughout our lives.

In the handful of schools that do offer a course remotely related to a personal finance class, the class is typically an economics course (and an elective at that). "Archaic theory is being taught and it doesn't do anything for the students as far as preparing them for the real world," says one high school principal we know. Having taken more than our fair share of economics courses, we understand the principal's concerns.

Some people are fortunate enough to learn the financial keys to success at home, from knowledgeable friends, and through good books like this one. Others either never learn the keys to financial success, or they learn them the hard way — by making lots of costly mistakes. The lack of proficiency in personal financial management causes not only tremendous anxiety but also serious problems. Consider the following sobering statistics:

- About 75,000 personal bankruptcies are filed in Canada annually. That's about one in every 100 households. So in the next ten years, nearly one in every ten households in Canada — one of the most affluent countries in the world — will file bankruptcy.
- Studies show that many people aren't saving adequately for retirement. Most years only about half of Canadians even intend to make an RRSP contribution, and only around 10 percent contribute the maximum they are allowed in their plan.
- One out of every two marriages ends in divorce. Studies show that financial disagreement is one of the leading causes of marital discord. In a survey conducted by *Worth* magazine and the market research firm of Roper/Starch, couples admitted to fighting about money more than anything else (more than three times more often than they fight about their sex lives). And a staggering 57 percent of those surveyed agreed with the statement, "In every marriage, money eventually becomes the most important concern."
- Almost half of all Canadians think one can deduct the interest on a home mortgage (they can't!), and that they reduce their risk by only putting their money into Canadian investments (they don't!). Further, one survey found that almost 80 percent of people feel that the lowest-risk investments make the most sense when saving for retirement (they don't because most people need to make their money grow in order to be able to retire).
- In a Princeton Survey Research Associates investing basics test, approximately one-third of the people who took the quiz answered fewer than 50 percent of the questions correctly. These results are all the more stunning when you consider that the questions offered only two or three multiple-choice answers as options!

- Nearly 80 percent of consumers do not know how the grace period on a credit card works. An even greater percentage doesn't understand that interest starts accumulating immediately for new purchases on credit cards with outstanding balances.
- Fifty-three percent of people who took a multiple-choice investing quiz did not know that total return was the best measure of a mutual fund's performance.

The overall costs of personal financial illiteracy to our society are huge. The high rate of spending and low rate of saving in Canada leads to lower long-term economic growth and higher interest rates. Annually, billions of dollars are wasted in North America through the purchase of inferior and inefficient financial products.

Talking money at home

We were both fortunate that our parents taught and instilled in us the importance of personal financial management. Our moms and dads taught us a lot of useful things that have been invaluable throughout our lives — among them were sound principles for earning, spending, and saving money. Our parents *had* to know how to do these things, because they were raising large families on (usually) one income. They knew the importance of making the most of what you have and of passing that vital skill on to your kids.

In many families, however, money is a taboo subject — parents don't level with their kids about the limitations, realities, and details of their budgets. Some parents we talk with believe that dealing with money is an adult issue, and that kids should be insulated from it so that they can enjoy being kids. In many families, kids may hear about money only when disagreements and financial crises bubble to the surface. Thus begins the harmful cycle of children having negative associations with money and financial management.

In other cases, parents with the best of intentions pass on their money-management habits. Unfortunately, some of those habits are bad habits. Now, we're not saying that you shouldn't listen to your parents. But in the area of personal finance, as in any other area, poor family advice can be problematic. Think about where your parents learned about money management, and then consider whether they had the time, energy, or inclination to research choices before making their decisions. For example, your parents may mistakenly think that banks are the best places for investing money. (You can find the best places for investing your money in Part III of this book.)

In still other cases, the parents have the right approach, but the kids go to the other extreme out of rebellion. For example, if your parents spent money carefully and thoughtfully, you may tend to do the opposite, such as buying yourself gifts the moment any extra money comes your way.

Although we can't change what the educational system and your parents did or didn't teach you about personal finances, you now have the ability to find out what you need to know to manage your finances. And if you have children of your own, we're sure you'll agree that kids really are amazing. Don't underestimate their potential or send them out into the world without the skills they need to be productive and happy adults. Teach them about personal finance as they are growing up, just as you do manners, personal hygiene, and staying safe — and do it *before* they head off to university or begin their first job.

Teaching personal finance in schools

Nancy Donovan teaches personal finance to her grade five math class as a way to illustrate how math can be used in the real world. "Students choose a career, find jobs, and figure out what their taxes and take-home paycheques will be. They also have to rent apartments and figure out a monthly budget," says Donovan, adding, "Students like it and parents have commented to me how surprised they are with how much financial knowledge their kids can handle." Donovan also has her students invest $10,000 (play money) and then track the performance of their investments.

Urging our schools to teach the basics of personal finance is just common sense. We should be teaching our children about how to manage a household budget, about the importance of saving money for future goals, and about the consequences and dangers of overspending. Unfortunately, few schools offer classes like Nancy Donovan's. In most cases, the financial basics aren't taught at all.

Some people argue that teaching children financial basics is the job of parents. However, this well-meaning sentiment is what we're relying on now, and for all too many it isn't working. In some families, financial illiteracy is passed on from generation to generation.

We must recognize that education takes place in the home, on the streets, *and* in the schools. Therefore, schools must bear some responsibility for teaching this very important life skill. And with more and more teenage students holding down after-school jobs, teaching money management know-how through the schools makes even more sense.

Lobby your schools! Make sure that financial basics are taught in schools at all levels. If you think that you're powerless to change the situation, you're mistaken. Many changes to our education system have started as grassroots movements.

Identifying unreliable sources of information

Some people are smart enough to realize that they're not financial geniuses. So they set out to take control of their finances by reading or consulting a financial adviser. Because the pitfalls are so numerous and the challenges so mighty when choosing an adviser, we devote Chapter 18 to the financial planning business and tell you what you need to know to avoid being fooled.

Reading is good. Reading is fundamental. But reading to find out how to manage your money can be dangerous if you're a novice. Misinformation can come from popular and seemingly reliable information sources, as we explain in the following sections.

Won't investment gurus make me rich?

One formerly best-selling personal finance book (*Wealth Without Risk,* by Charles Givens) advises you to "Buy disability insurance only if you are in poor health or accident prone." Putting aside the minor detail that no insurance company (at least, not one interested in making a profit) is going to issue you a disability policy *after* you fall into poor health, how do you know when you're going to be accident-prone? Because health problems and auto accidents cause many disabilities, you can't see most disabilities coming!

Consider the investment seminars by Wade Cook. These seminars lured people in by promising outrageous and unrealistic returns. The stock market has generated average annual returns of about 10 percent over the long term. Cook, a former taxicab driver, promoted his seminars as follows: "A live, hands-on, do the deals, two-day intense course in making huge returns in the stock market. If you aren't getting 20 percent per month, or 300 percent annualized returns on your investments, you need to be there."

Cook's get-rich-quick seminars — which cost more than $6,000 — were so successful at attracting people that his company went public in the late 1990s and generated annual revenues of more than $100 million U.S.

Cook's "techniques" included trading in and out of stocks and options on stocks after short holding periods of weeks, days, or even hours. His trading strategies can best be described as techniques based upon technical analysis — that is, charting a stock's price movements and volume history and then making predictions based on those charts.

The perils of following an approach that advocates short-term trading with the allure of high profits are numerous:

- You're going to rack up enormous brokerage commissions.
- You're not going to make big profits — quite the reverse. You're going to underperform the market averages if you stick with this approach.
- You're going to make yourself a nervous wreck. This type of trading is gambling, not investing. Get sucked up in it and you'll lose more than money — you may also lose the love and respect of your family and friends.

"The past history of stock prices cannot be used to predict the future in any meaningful way. Technical strategies are usually amusing, often comforting, but of no real value," says Burton Malkiel, a Princeton University business professor and author of the investment classic, *A Random Walk Down Wall Street*.

If Cook's followers were indeed earning the 300-percent annual returns his seminars claim to help you achieve, any investor starting with just $10,000 would vault to the top of the list of the world's wealthiest people (ahead of Bill Gates and Warren Buffett) in just 11 years!

Understanding how undeserving investment gurus get popular

You may be wondering how Charles Givens and Wade Cook became so popular despite the obvious flaws in their advice. Givens made the most of his talent for working the media and his great self-promotion through seminars. One of the problems with the mass media is that hucksters like Givens can get good coverage and publicity. Many members of the media are themselves financially illiterate. And they love a good story. So Givens got all sorts of free publicity, getting quoted in the press and invited to appear on a number of popular programs such as *The Today Show*, *Oprah*, and *Larry King Live*.

Thousands of people went to seminars conducted by Givens, partly because of the credibility Givens built through media appearances. As has now been well documented by some of those same members of the media, many unsuspecting investors were sold commission-laden products, including risky limited partnerships, through his organization.

Consider the case of Helen Giszczak, a 69-year-old retired secretary. She invested nearly two-thirds of her modest life savings in limited partnerships, which she said were described to her by Givens as "probably the most conservative investments we know of." But some of her limited partnerships ended up in bankruptcy, while the others lost much of their value.

Helen Giszczak appeared on the *Donahue* talk show with John Allen, an investment broker turned securities lawyer who helped her sue Givens's organization to get her money back. After a lengthy dialogue with Giszczak and Allen, Phil Donahue asked Helen how a smart person like her could get sucked in like that. She replied, "He was on your show and Oprah's. You gave him credibility. You gave him free advertising."

Wade Cook promoted his seminars through infomercials and other advertising, including radio ads on respected news stations. The high stock market returns of the 1990s brought greed back into fashion. Our experience has been that you see more of this greed when the market is hitting new highs than when it's in the basement.

The attorneys general of numerous U.S. states sued Cook's company and sought millions of dollars in consumer refunds. The suits alleged that the company lied about its investment track record (not a big surprise — this is the company that claimed you'd make 300 percent per year in stocks!).

Cook's company settled the blizzard of state and U.S. Federal Trade Commission (FTC) lawsuits against his firm by agreeing to accurately disclose its trading record in future promotions and give refunds to customers who were misled by past inflated return claims.

According to a news report by Bloomberg News, Cook's firm disclosed that it lost a whopping 89 percent of its own money trading during the last reporting year. As Deb Bortner, director of the Washington State Securities Division and president of the North American Securities Administrators Association, observed, "Either Wade is unable to follow his own system, which he claims is simple to follow, or the system doesn't work."

WARNING!

Don't assume that someone with something to sell, who is getting good press and running lots of ads, is going to take care of you. That "guru" may just be good at press relations and self-promotion. Certainly, talk shows and the media at large can and do provide useful information on a variety of topics, but you need to be aware that bad eggs sometimes turn up. These bad eggs may not always smell bad upfront. In fact, they may hoodwink people for many years before finally being exposed.

Pandering to advertisers

Thousands of publications and media outlets — newspapers, magazines, Web sites, radio, television, and so on — dole out personal financial advice and perspectives. Although many of these "service providers" collect revenue from subscribers, virtually all are dependent — in some cases, fully dependent (especially those on the Internet, radio, and television) — on advertising dollars. Although advertising is a necessary part of capitalism, advertisers can taint and, in some cases, dictate the content of what you read, listen to, and view.

Consider this case from a non-financial publication — *Modern Bride* magazine. *Harper's* magazine got hold of an apologetic letter (which it humorously entitled "To Love, Honor and Obey Our Advertisers") that *Bride's* fashion advertising director sent to the magazine's advertisers. Here's an excerpt:

> *Bride's* recommends that its readers (your customers) negotiate price, borrow a slip or petticoat, and compare catalogue shoe prices, and tells its readers that the groom's tuxedo may be free. It is difficult to understand why *Bride's* was compelled to publish this information. With 57 years of publishing experience and support to the bridal industry, *Bride's* could and should have been more sensitive to the retailers that it purports to serve. All of us in the bridal business must concentrate on projecting full-service bridal retailing in a positive light.

We don't find it difficult to understand why the writer of the criticized *Bride's* article revealed cost-saving strategies to its readers — she was trying to give them useful information and advice! Now, revealing letters like this one are hard to come by, so how can you, a consumer of financial information, separate the good publications from the advertiser-biased publications? After writing and working for a number of publications, and observing the workings of even more, we've developed some ideas on the subject.

First, consider how dependent a publication or media outlet is on advertising. We find that "free" publications, radio, and television are the ones that most often create conflicts of interest by pandering to advertisers. (All three derive all of their revenue from advertising.) Much of what is on the Internet is advertiser-driven, as well. Many investing sites cater to offering advice about individual stocks. Interestingly, such sites derive much of their revenue from online brokerage firms seeking to recruit customers. (See Part III for more information about your investment options.)

Next, as you read various publications, watch TV, or listen to the radio, note how consumer-oriented these media are. Do you get the feeling that they're looking out for your interests? Or are they primarily creating an advertiser-friendly broadcast or publication? For example, if lots of auto manufacturers advertise, does the media outlet ever tell you how to save money when shopping for a car, or the importance of buying a car within your means?

Jumping over Real and Imaginary Hurdles

Perhaps you know that you should be living within your means, buying and holding sound investments for the long term, and securing proper insurance coverage. However, you can't bring yourself to do these things. We all know how difficult it is to break the detrimental habits we've practised for many years. The temptation to spend money lurks everywhere we turn. Ads show attractive and popular people enjoying the fruits of their labours — a new car, an exotic vacation, and a lavish home.

Maybe you felt deprived by your tightwad parents as a youngster, or maybe you're bored with life and you like the adventure of buying new things. If only you could hit it big on one or two investments, you think, you could get rich quick and do what you really want with your life. As for disasters and catastrophes, well, those things happen to other people, not to you. Besides, you'll probably have advance warning of pending problems, so you can prepare accordingly.

Your emotions and temptations can get the better of you. Certainly, part of successfully managing your finances involves coming to terms with your shortcomings and the consequences of your behaviours. If you don't, you may end up enslaved to a dead-end job so that you can keep feeding your spending addiction. Or you can spend more time with your investments than you do with your family and friends. Disasters and catastrophes can happen to anyone at any time.

Discovering the real hurdles holding you back

A variety of personal and emotional hurdles can get in the way of making the best financial moves. As we discuss earlier in this chapter, a lack of financial knowledge (which stems from a lack of personal financial education) can stand in the way of making good decisions.

However, we've seen some people get caught in the psychological trap of blaming something else for their financial problems. For example, some people believe that all our adult problems can be traced back to our childhood and how we were raised. Our roots supposedly cause behaviors ranging from substance abuse and credit card addiction to sexual infidelity.

We don't want to diminish the negative impact particular backgrounds can have on some people's tendency to make the wrong choices during their lives. Exploring your personal history can certainly yield clues to what makes you tick. That said, we are adults making choices and engaging in behaviours that affect ourselves as well as others. We shouldn't blame our parents for our own inability to plan for our financial futures, live within our means, and make sound investments. At the very least, if they are indeed partly to blame, it's still up to you — and certainly to your benefit — to change your ways.

Some people also have a common tendency to blame their financial shortcomings on not earning more income. Such people believe that if they only earned more income, their financial (and personal) problems would melt away.

Our experience with people from diverse economic backgrounds has taught us that achieving financial success — and, more importantly, personal happiness — has virtually nothing to do with how much income a person makes but rather with what she makes of what she does have. We know financially wealthy people who are emotionally poor even though they have all the material goods they want. Likewise, we know people who are quite happy, contented, and emotionally wealthy even though they're struggling financially.

Canadians — even those who have not had an "easy" life — should be able to come up with numerous things to be happy about and grateful for: a family who loves them; friends who laugh at their stupid jokes; the freedom to catch a movie or play, or read a good book; a great singing voice, sense of humour, or a full head of hair; or the fact that they live in a country not at war with any other country.

Financially speaking, Canadians are pretty spoiled. The majority of the people in the world have a standard of living that is a fraction of the Canadian average.

Practising good habits

After you understand the basic concepts and know where to buy the best financial products when you need them, you'll soon see that managing your personal finances well is not much more difficult than other things you do regularly, like tying your shoelaces and getting yourself to and from work each day.

TIP

Regardless of your income, you can make your dollars stretch farther if you practise good financial habits and avoid mistakes. In fact, the lower your income, the more important it is that you make the most of your income and savings (because you don't have the luxury of falling back on your next fat paycheque to bail you out).

More and more industries are subject to global competition, and you need to be on your financial toes now more than ever. Job security is on the wane. Layoffs and retraining for new jobs are on the increase. Putting in 20 or 30 years for one company and retiring with the gold watch and lifetime pension are becoming as rare as never having problems with your computer.

Speaking of company pensions, odds are increasing that you work for an employer that has you save toward your own retirement rather than provide a pension for you. Not only do you need to save the money, you must also decide how to invest it.

Managing your personal finances involves much more than just managing and investing money. It also includes making all the pieces of your financial life fit together. It means lifting yourself out of financial illiteracy. Like planning a vacation, managing your personal finances means formulating a plan for making the best use of your limited time and dollars. (We discuss common financial problems in the next section.)

REMEMBER

Intelligent personal financial strategies have little to do with your gender, ethnicity, or marital status. We all need to manage our finances wisely. Some aspects of financial management become more or less important at different points in your life, but for the most part, the principles remain the same for all of us.

Knowing the right answers isn't enough. You have to practise good financial habits just as you practise other good habits, such as brushing your teeth. Don't be overwhelmed. As you read this book, make a short list of your financial marching orders and then start working away. Throughout this book, we highlight ways you can overcome temptations and keep control of your money rather than let your emotions and money rule you.

REMEMBER

You probably don't like being made to feel stupid or told that you're doing something wrong. And what you do with your money is a quite personal and confidential matter. We endeavour not to be paternalistic in this book, but to provide guidance and advice that is in your best interest. You don't have to take it all — pick what works best for you and understand the pros and cons of your options. But from this day forward, please don't make the easily avoidable mistakes or overlook the sound strategies that we discuss throughout this book.

If you're young, congratulations for being so forward-thinking as to realize the immense value of investing in your personal financial education. You'll reap the rewards for decades to come. But even if you're not so young, you surely have many years to make the most of the money you currently have, the money you're going to earn, and even the money you may inherit!

Throughout our journey together, we hope to challenge and even change the way you think about money and about making important personal financial decisions — and sometimes even about the meaning of life. No, we're not philosophers, but we do know that money — for better but more often for worse — is connected to many other parts of our lives.

Common Financial Problems: You've Got Company

How financially healthy are you? You may already know the bad news. Or perhaps things aren't quite as bad as they seem.

When was the last time you sat down surrounded by all your personal and financial documents and took stock of your overall financial situation, including reviewing your spending, savings, future goals, and insurance? If you're like most people, you've either never done this exercise, or you did so a long time ago.

Financial problems, like many medical problems, are best detected early (clean living doesn't hurt, either). Here are some common personal financial problems we've seen:

- **Not planning.** Human beings were born to procrastinate. That's why we have deadlines — and deadline extensions. Unfortunately, you may have no explicit deadlines with your overall finances. You can allow your credit card debt to accumulate, or you can leave your savings sitting in lousy investments for years. You can pay higher taxes, leave gaps in your retirement and insurance coverage, and overpay for financial products. Of course, planning your finances isn't as much fun as planning a vacation, but doing the former can help you take more of the latter.
- **Overspending.** The average Canadian saves less than 5 percent of his or her after-tax income (in contrast to those in other industrialized countries, where the savings rate is two to three times that rate). Simple arithmetic helps you determine that savings is the difference between what you earn and what you spend (assuming that you're not spending more than you're earning!). To increase your savings, you either have to work more (yuck!), know a wealthy family who wants to leave its fortune to you, or spend less. For most of us, the thrifty approach is the key to building savings and wealth.
- **Buying with consumer credit.** Even with the benefit of today's lower interest rates, carrying a balance month-to-month on your credit card or buying a car on credit means that even more of your future earnings are going to be earmarked for debt repayment. Buying on credit encourages you to spend more than you can really afford.

- **Delaying saving for retirement.** Most people say that they want to retire by their mid-60s or sooner. But in order to accomplish this goal, most people need to save a reasonable chunk (around 10 percent) of their income, starting sooner rather than later. The longer you wait to start saving for retirement, the harder it will be to reach your goal. And you'll pay much more in taxes to boot if you don't take advantage of the tax benefits of investing through particular retirement plans.
- **Falling prey to financial sales pitches.** Great deals that can't wait for a little reflection or a second opinion are often disasters waiting to happen. A sucker may be born every minute, but a slick salesperson is born every second! Steer clear of those who pressure you to make decisions, promise you high investment returns, and lack the proper training and experience to help you.
- **Not doing your homework.** To get the best deal, you need to shop around, read reviews, and get advice from disinterested, objective third parties. You need to check references and track records so that you don't hire incompetent, self-serving, or fraudulent financial advisers. But with all the different financial products available, making informed financial decisions has become an overwhelming task. We do a lot of the homework for you with the recommendations in this book. We also explain what additional research you need to do and how to go about doing it.
- **Making decisions based on emotion.** You're most vulnerable to making the wrong financial moves after a major life change (a job loss or divorce, for example), or when you feel under pressure. Maybe your investments plunged in value. Or perhaps a recent divorce has you fearing that you won't be able to afford to retire when you planned, so you pour thousands of dollars into some newfangled financial product. Take your time and keep your emotions out of the picture. In Chapter 21, we discuss how to approach major life changes with an eye to determining what changes you may need to make to your financial picture.
- **Not separating the wheat from the chaff.** In any field in which you're not an expert, you run the danger of following the advice of someone who you think is an expert but really isn't. This book shows you how to separate the financial fluff from the financial facts. Look in any mirror to see the person who is best able to manage your personal finances. Educate and trust yourself!
- **Exposing yourself to catastrophic risk.** You're vulnerable if you and your family don't have insurance to pay for financially devastating losses. People without a savings reserve and support network can end up homeless. Many people lack sufficient insurance coverage to replace their income. Don't wait for a tragedy to strike to find out whether you have the right insurance coverages.
- **Focusing too much on money.** Placing too much emphasis on making and saving money can warp your perspective on what's important in life. Money is not the first or even the second priority in happy people's lives. Your health, relationships with family and friends, career satisfaction, and fulfilling interests should be more important.

Most financial problems can be fixed over time with changes in your behaviour. (That's what the rest of the book is all about.)

The rest of this chapter guides you through a *financial physical* to help you detect problems with your current financial health. But don't get depressed and dwell on your "problems." View them for what they are — opportunities for improving your financial situation. In fact, the more areas for improvement that you can identify, the greater the potential you have to build real wealth and accomplish your financial and personal goals.

Defining Bad Debt and Good Debt

Why do you borrow money? Usually, you borrow money because you don't have enough of it to buy something you want or need — like a university education. If you want to buy a four-year post-secondary education, you can easily spend $30,000 or more. Not too many people have that kind of spare cash. So borrowing money to finance part of that cost enables you to buy the education.

How about a new car? A trip to your friendly local car dealer shows you that a new set of wheels will set you back at least $15,000 … and usually much more. Although more people may have the money to pay for that than, say, the university education, what if you don't? Should you finance the car the way you finance the education?

WARNING!

The auto dealers and bankers who are eager to make you an auto loan say that you deserve and can afford to drive a nice, new car, and they tell you to borrow away.

We say, "*NO! NO! NO!*"

Why do we disagree with the auto dealers and lenders? For starters, we're not trying to sell you a car or loan from which we derive a profit! More importantly, there's a *big* difference between borrowing for something that represents a long-term investment and borrowing for short-term consumption.

If you spend, say, $1,500 on a vacation, the money is gone. Poof! You may have fond memories and even some Kodak moments, but you have no financial value to show for it. "But," you say, "vacations replenish my soul and make me more productive when I return. In fact, the vacation more than pays for itself!"

Great. We're not saying that you shouldn't take a vacation. By all means, take one, two, three, or as many as you can afford yearly. But that's the point — *take what you can afford*. If you have to borrow money in the form of an outstanding balance on your credit card for many months in order to take the vacation, you *can't* afford it.

We refer to debt incurred for consumption as *bad debt,* because such debt is harmful to your long-term financial health.

You'll be able to take many more vacations during your lifetime if you save the cash in advance. If you get into the habit of borrowing and paying all that interest for vacations, cars, clothing, and other consumer items, you'll spend more of your future income paying back the debt and interest, leaving you with *less* money for vacations and all your other goals.

The relatively high interest rates banks and other lenders charge for bad debt is one of the reasons why you have less money when using such debt. Money borrowed through credit cards, auto loans, and other types of consumer loans not only carry a relatively high interest rate but also is not tax-deductible.

We're not saying that you should never borrow money and that all debt is bad. Good debt, such as that used to buy real estate or a small business, is generally available at lower interest rates than bad debt and is usually tax-deductible. If well managed, these investments may also increase in value. Borrowing to pay for educational expenses can also make sense. Education is generally a good long-term investment, because it can increase your earning potential.

Knowing How Much Bad Debt Is Too Much

Calculating how much debt you have relative to your annual income is a useful way to size up your debt load. Ignore, for now, good debt — the loans you may owe on real estate, a business, an education, and so on. We're focusing on bad debt, the higher-interest debt used to buy items that depreciate in value.

For example, suppose that you earn $30,000 per year. Between your credit cards and an auto loan, you have $15,000 of debt. In this case, your bad debt represents 50 percent of your annual income.

$$\frac{\text{bad debt}}{\text{annual income}} = \text{bad debt danger ratio}$$

The financially healthy amount of bad debt is zero. (Not everyone agrees with us. One major U.S. credit card company says — in its "educational" materials, which it gives to schools to teach students about supposedly sound financial management — that carrying consumer debt amounting to 10 to 20 percent of your annual income is just fine.)

Playing the credit card float

Given what we have to say about the vagaries of consumer debt, you may think that we're always against using credit cards. But if you pay your balance in full each month, there's a benefit in addition to the convenience credit cards offer in not having to carry around extra cash. You get free use of the bank's money extended to you through your credit card charges. (Some cards offer other benefits, such as frequent flyer miles. Also, purchases made on credit cards may be contested if the seller of the product or service doesn't stand behind what it sells.)

When you charge on a credit card that does not have an outstanding balance carried over from the prior month, you typically have several weeks (known as the *grace period*) from the date of the charge to the time when you must pay your bill. Financial types call this *playing the float*. Had you paid for this purchase by cash or cheque, you would have had to shell out the money sooner.

If you have difficulty saving money, and plastic tends to burn holes through your budget, forget the float game. You're better off not using credit cards. The same applies to those who pay their bills in full but spend more because it's so easy to do so with a piece of plastic.

WARNING!

When your *bad debt danger ratio* starts to push beyond 25 percent, it can spell real trouble. Such high levels of high-interest consumer debt on credit cards and auto loans are like cancer. As with cancer, the growth of the debt can snowball and get out of control unless something significant intervenes. If you have consumer debt beyond 25 percent of your annual income, see Chapter 4 to find out how to get out of debt.

How much good debt is acceptable? The answer varies. The key question is: Are you able to save sufficiently to accomplish your goals? In the "Savings Analysis" section later in this chapter we help you figure out how much you're actually saving, and in Chapter 2 we help you determine what you should be saving to accomplish your goals. Take a look at Chapter 13 to find out how much mortgage debt is appropriate to take on when buying a home.

REMEMBER

Avoid borrowing money for consumption (bad debt) — for spending on things that decrease in value and eventually become financially worthless, such as cars, clothing, vacations, and so on. Borrow money only for investments (good debt) — for purchasing things that retain and hopefully increase in value over the long term, such as an education, real estate, or your own business.

Determining Your Financial Net Worth

Your financial net worth is an important barometer of your monetary health. Your net worth indicates your capacity to accomplish major financial goals, such as buying a home, retiring, and withstanding unexpected expenses or loss of income.

Your financial net worth has absolutely, positively *no* relationship to your worth as a human being. This is not a test. You don't have to compare your number with your neighbour's. Financial net worth is not the scorecard of life.

Your *net worth* is your financial assets minus your financial liabilities.

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Financial Assets – Financial Liabilities = Net Worth
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Financial assets

A *financial asset* is worth real money or is something you can convert to hard dollars that you can use to buy things now or in the future.

Financial assets generally include the money you have in bank accounts, stocks, bonds, and mutual fund accounts (see Part III, which deals with investments). Money that you have in retirement plans (including those with your employer) and the value of any businesses or real estate that you own are also included.

We generally recommend that you exclude your personal residence when figuring your financial assets. Include your home only if you expect to someday sell it or otherwise live off the money you now have tied up in it (perhaps by taking out a reverse mortgage, which we discuss in Chapter 14). If you plan on someday tapping into the *equity* (the difference between the market value and any debt owed on the property) in your home, add that portion of the equity that you expect to use to your list of assets.

Assets also include your future expected Canada Pension Plan (Or Quebec Pension Plan) benefits and company pension payments (if your employer has such a plan). These assets are usually quoted in dollars per month rather than as a lump sum. We explain in a moment how to account for these monthly benefits when tallying your financial assets.

Personal property such as your car, clothing, stereo, and wine collection does *not* count as a financial asset. We know that adding these things to your assets makes your assets *look* larger (and some financial software packages and publications encourage you to list these items as assets), but you can't live off them unless you sell them.

Financial liabilities

To arrive at your financial net worth, you must subtract your *financial liabilities* from your assets.

Liabilities include loans and debts outstanding, such as credit card and auto loan debts. When figuring your liabilities, include money you borrowed from family and friends (unless you're not gonna pay it back — we won't tell). Include mortgage debt on your home as a liability *only* if you include the value of your home in your asset list. Be sure to also include debt owed on other real estate — no matter what.

Your net worth calculation

Table 1-1 provides a place for you to figure your financial assets. Go ahead and write in the spaces provided, unless you plan to lend this book to someone and you don't want to put your money situation on display.

Important note: See Table 2-1 in Chapter 2 to estimate your Canada Pension Plan benefits.

Table 1-1 Your Financial Assets

Account	***Value***
Savings and investment accounts (including retirement plans):	
Example: Bank savings account	$5,000
______________________	$_________
______________________	$_________
______________________	$_________
______________________	$_________
______________________	$_________
______________________	$_________
Total =	$_________

Account		***Value***
Benefits earned that pay a monthly retirement income:		
Employer's pensions		$________ / month
Canada Pension Plan (or QPP)		$________ / month
		× 240*
	Total =	$________
	Total Financial Assets (add the two totals) =	$________

** To convert benefits that will be paid to you monthly into a total dollar amount, and for purposes of simplification, assume that you will spend 20 years in retirement. (Ah, think of two decades of lolly-gagging around — vacationing, harassing the kids, spoiling the grandkids, starting another career, or maybe just living off the fat of the land.) As a shortcut, multiply the benefits that you'll collect monthly in retirement by 240 (12 months per year times 20 years). Inflation may reduce the value of your employer's pension if it doesn't contain a cost-of-living increase each year in the same way that Canada Pension Plan does. Don't sweat this now — you can take care of it in the section on planning for retirement in Chapter 2.*

Now comes the potentially depressing part — figuring out your debts and loans in Table 1-2.

Table 1-2 Your Financial Liabilities

Loan		***Balance***
Example: Gouge 'Em Bank Credit Card		$4,000
____________________		$________
____________________		$________
____________________		$________
____________________		$________
____________________		$________
____________________		$________
	Total Financial Liabilities =	$________

Now you can subtract your liabilities from your assets to figure your net worth in Table 1-3.

Table 1-3 Your Net Worth

Find		*Write It Here*
Total Financial Assets (from Table 1-1)		$_________
Total Financial Liabilities (from Table 1-2)	–	$_________
	Net Worth =	$_________

Interpreting your net worth results

Your net worth is important and useful only to you and your unique situation and goals. What seems like a lot of money to a person with a simple lifestyle may seem like a pittance to a person with high expectations and a desire for an opulent lifestyle.

In Chapter 2, you can crunch some more numbers to determine your financial status more precisely for such goals as retirement planning. We also discuss saving toward other important goals in that chapter. In the meantime, if your net worth (excluding expected monthly retirement benefits such as those from the Canada Pension Plan or Quebec Pension Plan and company pensions) is negative or less than half your annual income, take notice. You have lots of company — in fact, you're with the majority of Canadians. If you're in your 20s, and you're just starting to work, a low net worth is less concerning. Getting rid of your debts — the highest-interest ones first — is the most important thing. Then you need to build a safety reserve equal to three to six months of living expenses. You should definitely find out more about getting out of debt, reducing your spending, and developing tax-wise ways to save and invest your future earnings.

Savings Analysis

How much money have you actually saved in the past year? By savings, we mean the amount of new money you added to your nest egg, stash, or whatever you like to call it.

Most people don't know or have only a vague idea of the rate at which they're saving money. The answer may sober, terrify, or pleasantly surprise you. In order to calculate your savings over the past year, you need to calculate your net worth as of today *and* as of one year ago.

The amount you actually saved over the past year is equal to the change in your net worth over the past year — in other words, your net worth today minus your net worth from one year ago. We know it may be a pain to find statements showing what your investments were worth a year ago, but bear with us; it's a useful exercise.

If you own your home, ignore this in the calculations. (You can consider the extra payments you make to pay off your mortgage principal faster as new savings.) And don't include personal property, such as your car, computer, clothing, and so on, with your assets.

When you have your two figures, plug them into Step 1 of Table 1-4. If you're anticipating the exercise and are already subtracting your net worth of a year ago from what it is today in order to determine your rate of savings, your instincts are correct, but the exercise is not quite that simple. You need to do a few more calculations in Step 2 of Table 1-4. Why? Well, counting the appreciation of the investments you've owned over the past year as savings wouldn't be fair. Suppose that you bought 100 shares of a stock a year ago at $17 per share, and now the value is at $34 per share. Your investment increased in value by $1,700 during the past year. Although you'd be the envy of your friends at the next party if you casually mentioned your investments, the $1,700 of increased value is not really savings. Instead, it represents appreciation on your investments, so you must remove this appreciation from the calculations.

Note: Just so you know, we're not unfairly penalizing you for your shrewd investments — you also get to add back the decline in value of your less-successful investments.

Table 1-4 Your Savings Rate over the Past Year

Step 1: Figuring your savings.			
Today		***One Year Ago***	
Savings & investments	$_________	Savings & investments	$_________
– Loans & debts	$_________	– Loans & debts	$_________
= Net worth today	$_________	= Net worth 1 year ago	$_________
Step 2: Correcting for changes in value of investments you owned during the year.			
Net worth today		$_________	
– Net worth 1 year ago		$_________	
– Appreciation of investments (over past year)		$_________	
+ Depreciation of investments (over past year)		$_________	
= Savings rate		$_________	

TIP

If all this calculating gives you a headache, you get stuck, or you just hate crunching numbers, try the intuitive, seat-of-the-pants approach: Save a regular portion of your monthly income. You can save it in a separate savings or retirement plan.

How much do you save in a typical month? Get out the statements for accounts you contribute to or save money in monthly. It doesn't matter if you're saving money in a retirement plan that you can't access — money is money.

Note: If you save, say, $200 per month for a few months, and then you spend it all on auto repairs, you're not really saving. If you contributed $3,000 to a Registered Retirement Savings Plan (RRSP), for example, but you depleted money that you had from long ago (in other words, it wasn't saved during the past year), you should not count the $3,000 RRSP contribution as new savings.

You should be saving at least 5 to 10 percent of your annual income for longer-term financial goals such as retirement. If you're not, be sure to read Chapter 5 to find out how to reduce your spending so that you can increase your savings.

Measuring Your Investing Knowledge

Congratulations! If you stuck with us from the beginning of this chapter, you completed the hardest part of your financial physical. The physical is a whole lot easier from here on in!

Regardless of how much or how little money you have invested in banks, mutual funds, or other types of accounts, you want to invest your money in the wisest way possible. Knowing the rights and wrongs of investing is vital to your long-term financial well-being. Few people have so much extra money that they can afford major or frequent investing mistakes.

Answering yes or no to the following questions can help you determine how much time you need to spend with our "Investing Crash Course" in Part III, which focuses on investing. *Note:* The more "no" answers you reluctantly scribble, the more you need to find out about investing, and the faster you should turn to Part III.

_________ Do you understand the investments you currently hold?

__________ Is the money that you'd need to tap in the event of a short-term emergency in an investment where the principal does not fluctuate in value?

__________ Do you know what marginal income-tax bracket (combined federal and provincial) you're in, and do you factor that in when choosing investments?

__________ For money outside of retirement plans, do you understand how these investments produce income and gains, and whether these types of investments make the most sense from the standpoint of taxes?

__________ Do you have your money in different, diversified investments that aren't dependent on one or a few securities or one type of investment (that is, bonds, Canadian and foreign stocks, real estate, and so on)?

__________ Is the money that you're going to need for a major expenditure in the next few years invested in conservative investments rather than in riskier investments such as stocks?

__________ Is the money that you have earmarked for longer-term purposes (more than five years) invested to produce returns that are well ahead of inflation?

__________ If you currently invest in or plan to invest in individual stocks, do you understand how to evaluate a stock, including reviewing the company's balance sheet, income statement, business strategy, competitive position, price–earnings ratio versus its peer group, and so on?

__________ If you work with a financial adviser, is that person compensated in a way that minimizes potential conflicts of interest in the strategies and investments he or she recommends?

REMEMBER

Making and saving money is not a guarantee of financial success but rather a prerequisite. If you don't know how to choose sound investments that meet your needs, you'll more than likely end up throwing money away, which leads to the same end result as never having earned and saved it in the first place. Worse still, you won't be able to derive any enjoyment from spending the lost money on things that you perhaps need or want. Turn to Part III to discover the best ways to invest; otherwise, you may wind up spinning your wheels working and saving.

Measuring Your Insurance Savvy

In this section, you must deal with the prickly subject of protecting your assets and yourself with *insurance*. (The following questions help you get started.) If you're like most people, reviewing your insurance policies and coverages is about as much fun as a root canal. Open wide!

_________ Do you understand the individual coverages, protection types, and amounts of each insurance policy you have?

_________ Does your current insurance protection make sense given your current financial situation (as opposed to your situation when you bought the policies)?

_________ If you wouldn't be able to make it financially without your income, do you have adequate long-term disability insurance coverage?

_________ If you have family members who are dependent on your continued income, do you have adequate life insurance coverage to replace your income should you die?

_________ Do you buy insurance through discount brokers, fee-for-service advisers, and companies that sell directly to the public (bypassing agents)?

_________ Do you carry enough liability insurance on your home, car (including umbrella/excess liability), and business to protect all your assets?

_________ Have you recently (in the last year or two) shopped around for the best price on insurance policies?

_________ Do you know whether your insurance companies have good track records when it comes to paying claims and keeping customers satisfied?

That wasn't so bad, was it? If you answered "no" more than once or twice, don't feel dumb — more than nine out of ten people make major mistakes when buying insurance. Find your insurance salvation in Part IV. If you answered "yes" to all the preceding questions, you can spare yourself from reading Part IV, but bear in mind that many people need as much help in this area as they do in other aspects of personal finance.