Chapter 1

Exploring the Basics

In This Chapter

- Benefiting from getting a grasp on your finances
- Looking at your financial picture
- Working out how you can get out of debt
- Figuring out what you want from your finances
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Congratulations! You've decided to get to grips with your finances and start building up your savings and investments for the future. Making sure you are in control of your finances enables you to do what you want – upgrade your car, get on the first step of the property ladder, or start building funds for retirement.

In this chapter I start by giving you the lowdown on working out what your financial goals are and how you can achieve them. I offer advice on clearing your debts before you begin building up your savings and investments, and the importance of seeking independent financial advice. Only once you have the basics under your belt can you ensure your finances work for you – rather than limiting you from doing all the things you want to do.

Looking at the Benefits of Being on Top of Your Finances

Sorting out your money by clearing your debt and building up your savings and investments makes you master of your financial future. It also brings several benefits:

- **You stop paying expensive fees and charges for being in debt.** Debt is pricey, with high rates of interest and often extra fees and charges. If you are in a lot of debt and pay a significant amount of interest on it, you may find that you simply can't clear what you owe as all your money goes towards servicing the debt and paying the interest. Clearing your debt removes the debt itself and the cost of financing it.
- **You get rid of your guilt.** Being in debt can be a worry, particularly if it has got out of hand and you can't see any way of escaping the situation. Some people also regard being in debt as a stigma – something to be ashamed of and hidden from friends, family, and colleagues. Any way you look at it, debt is a burden and getting rid of it can be a huge weight off your shoulders.
- **You feel more confident about the future.** With the state providing little financial support in retirement (see Chapter 15 for more on this), you may be concerned about how you are going to make ends meet. But if you have savings and investments spread across a range of funds, pensions, and property, you can rest easy with regard to the future. You may even be able to look forward to giving up work, rather than dread it.
- **You open up a range of financial options.** If your finances are in order, you can afford to take time off to travel or try a new career. But if you have lots of debt or little in the way of savings, you may not have the option to do what you like. This can make you feel rather resentful.

Pondering Money Matters

To stay on top of your finances, you need to review major investments – such as savings accounts, unit and investment trusts, shares, and your pension – at least once a year, to ensure you are still earning the best returns. It is also worth getting into the habit of spending a couple of hours a week keeping things ticking over: Paying bills before they are late or moving surplus cash from your current account to a high-interest-paying savings account. You should also use this time to plan what you're going to do next.

Once you find the best financial products available, keep a careful eye on them. As soon as they start to look uncompetitive, consider switching to a better deal with a more attractive rate of interest. Don't become complacent, or you could lose out.

If you aren't prepared to track your own financial investments, consider using an independent financial adviser (IFA) to do this for you. An IFA can make suggestions as to what you should be investing in and whether you should move out of existing investments. See 'Using a financial adviser' later in this chapter for more details.

In the following sections, I look at how you can start getting on top of your finances.

Working out how much money you have

You should know off the top of your head roughly how much your assets are worth, but if you aren't on top of your finances you may not have a clue. Or if you are in a lot of debt you may know the depressing answer straight away – nothing.

Many people have lots of savings accounts and investments dotted around with a few pounds in each. The money in such accounts often has been languishing there for years and earning a poor rate of interest. If the interest rate is halfway decent, it's more likely to be down to luck than careful financial planning.

As a first step to getting a clear view of your finances, make an inventory of what you have: List all your savings and investments so that you can see all your assets at a glance. Don't forget those windfall (free) shares you got when your building society demutualised (listed on the stock market), those premium bonds granny bought you when you were born, or that odd £20 sat in a National Savings account. It all adds up.

Don't forget payments into your pension (if you have one) and equity in your home (you can work this out by subtracting your outstanding mortgage from the market value of your property). These are all assets.

From there, you can assess whether your money is in the best place to earn you the highest returns.

Calculating your debts

If you're like most people, you have a bit of debt. Or you may have quite a lot of it, depending on your financial situation and attitude towards credit.

Debt isn't always bad: The low interest rates of the past few years made it possible to pick up cheap personal loans and credit cards charging 0 per cent for an introductory period on new purchases or balance transfers. Making use of cheap money is a smart financial move, so long as you keep up with the payments and avoid expensive fees. And make sure you switch to another 0 per cent deal when the introductory period on your credit card runs out so that you don't find yourself paying a much higher rate of interest.

On the other hand, if you ignore bills and credit card statements for fear of what you might find within the envelope, you will never get out of debt. It may not make for pretty reading, but facing up to your debts is the first step to getting rid of them. A bit of short-term pain now will lead to stronger finances in the longer term. Bite the bullet and open the envelope.

Before you can attack your debts – getting rid of the most expensive ones and chipping away at the rest – you need to make a list of exactly what you owe.

Compile a list and arrange it so that your most expensive – rather than your greatest – debt is at the top. For example, you may owe £150,000 on your mortgage and £2,000 on a store card, but paying off the store card is more of a priority because you pay a lot higher interest on it. While you may be paying around 5 per cent interest on your mortgage, it is possible that you are paying six or seven times this much on the store card. It therefore makes sense to clear the store card debt in the short term, and the mortgage debt in the longer term. (Go to Chapter 8 for more on store cards and Chapter 14 for the lowdown on mortgages.)

Clearing Your Debt – and Starting to Save

Once you know how much debt you've got and what savings you have, use the latter to clear the former. This is particularly worthwhile if your savings are languishing in uncompetitive accounts while your debt is expensive.

If you don't have enough surplus savings to make much of an impact on your debt, at least shift store and credit card balances onto cheaper plastic. This reduces the interest you pay: Instead of paying back just the interest each month, you can chip away at the outstanding debt as well.

It is always reassuring to have some savings, but if you've got expensive debt it doesn't make much sense to have money just sitting in an account. Use the savings to clear some of the expensive, short-term debt, as you generally pay more interest on the debt than you earn on your savings. Only after you clear your expensive short-term debts should you start building up savings for an emergency or rainy day. (The chapters in Part II give tips for clearing your debt.)

After you clear your debt, your next step is to start your emergency fund – for if the boiler packs up, for example – which is vital to your financial health. It prevents you from slipping into expensive debt in the first place.

Make sure your emergency savings are easily accessible. There is no point choosing an account where you have to give 90 days' notice before you can get your money – it defeats the whole object. The amount you save should be the equivalent of three to six months' worth of outgoings: The exact amount you need depends on what you are personally comfortable with and how much you spend each month. If you are the main breadwinner, you may need more cash than someone with a wealthy partner with a good income. Chapter 9 has more on saving for a rainy day.

Establishing Your Financial Goals

Until you know what you are saving or investing for, it is impossible to decide how you should proceed. Thus, you need to decide what you want before you begin.

Once you've got your emergency savings covered, you can be more adventurous with your money. However, before you get carried away, remember that how you invest depends on what you want the money for and when you want it:

- If you are investing for the **short term** – less than five years – to pay for a holiday or new car, for example, some form of high-interest savings account is your best bet, rather than stocks and shares, which can go down in value as well as up. If you need to raise a set amount of cash in the short term you can't afford to take risks. Instead, opt for low-risk investments so that you end up with enough cash to enable you to achieve your goals.
- If you want to raise a sum of money for use in 10 or 15 years' time or more, you need to invest for the **long term.** You may want to raise cash to pay for your children's school fees or cash to put towards your pension. You can afford to take on more risk if you don't need the money for a few years. The idea is that you have longer to ride out the ups and downs of the stock market.

Riskier investments should generate greater returns in the long run, but make sure that you don't need to get your hands on the cash in the short term and that you aren't investing cash you can't afford to lose.

Assessing how much risk you're happy with

A crucial factor to finding the right investments to suit you is how much risk you're willing to take on.

You can afford to take on more risk the longer you can allow your money to stay invested. As you near retirement, or need to get hold of your cash, you should switch to less risky investments so you have less chance of losing your money.

Planning for retirement

One of the main reasons people invest is to ensure they have enough income in retirement. You can't rely on the state to provide a generous enough pension – you have to make your own provision.

A pension is one way of generating retirement income, but it isn't the only one. It is always sensible to diversify and spread your risk across a broad range of investments.

Pensions come with excellent tax breaks (see Chapter 15 for details) but they are inflexible. If you tie up all your spare cash in a pension, and need some money in an emergency before you reach retirement age, you may not be able to get hold of it.

A sensible approach is to combine pensions with property, individual savings accounts (ISAs), and other investments to build a broad portfolio of products to provide you with an income in retirement. That way you won't put all your eggs in one basket but will expose yourself to a diverse range of products.

Taking Advantage of the Tax Breaks on Saving and Investing

Never look a gift horse in the mouth, particularly when it comes to savings and investments. You have to pay enough tax to the Government without paying more than you need to. You can save tax on your investment returns – completely legitimately – by opting for tax-free products.

If you don't pay income tax as a general rule, you don't have to pay tax on your savings. Ensure your savings account provider knows this by filling out form IR85 – available from your bank or building society, or the Inland Revenue (`www.inlandrevenue.org.uk`).

If you do pay tax, opt for tax-free investments such as individual savings accounts (ISAs). These enable you to invest in cash, equities, and insurance up to a maximum of £7,000 each tax year (6 April to 5 April the following year), reducing to £5,000 a year from April 2006.

There are other tax-free investments available, such as those offered by National Savings and Investments. But the rates on these aren't always the most competitive (Chapter 10 has more on these) so don't be blinded by the tax-free benefits.

WARNING!

It isn't wise to choose an investment simply because returns are tax free. It may not suit your attitude to risk or your investment aims or fit in with the other products in your portfolio. Consider each investment as part of the wider picture and you'll minimise your chances of opting for the wrong product.

Using a Financial Adviser

One of the easiest ways to choose the right investments for you is to use an independent financial adviser (IFA). I advise opting for one who is totally independent and can recommend you any product on the market, rather than a salesperson who is restricted to a limited range of investment products.

TIP

You don't always need a financial adviser. If you're opting for simple products, such as a savings account, credit card, or personal loan, you should be0 able to choose one yourself. Do your research beforehand and opt for a product only if you understand exactly how much it is going to cost you in the long term.

If you are an experienced investor, you may not need advice either. But most people could always use a bit of advice, so it may be worth paying a bit of cash to ensure you get the best investment. It could save you money in the long run. (Go to Chapter 2 for more on choosing an IFA.)