PART I

ESSENTIALS OF SUCCESSFUL INVESTING

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Chapter One

Choose a Sound Financial Lifestyle

Drive-in banks were established so most of the cars today could see their real owners.

—E. Joseph Grossman

It's an old statistic that has held very consistent over time. Take 100 young Americans starting out at age 25. By age 65, one will be rich and four will be financially independent. The remaining 95 will reach the traditional retirement age unable to self-sustain the lifestyle to which they have become accustomed.

Without assistance from government programs such as Social Security, Medicare, and Medicaid, many would literally starve. And if you are harboring dreams of the government providing you with a full and prosperous retirement, it's time to wake up. Although the government won't let you starve, it's not committed to making your golden years golden. That's up to you. A lifestyle totally based on government handouts has always been uncomfortable at best.

With 76 million baby boomers in or nearing retirement, it could get a whole lot worse.

We live in the richest country in world history. Our wealth is enormous and growing. Yet only 5 percent of us manage to become financially independent by age 65. Why is this? More often than not, the answer lies in what we choose to do with the money that comes into our lives.

WHAT'S YOUR FINANCIAL LIFESTYLE?

Although you might not be aware of it, you have chosen the financial lifestyle that you currently live. For purposes of simplicity, let's look at three common financial lifestyles lived by three different couples. As you read about each lifestyle, you will likely be reminded of people you know. But the most important question is, "Which financial lifestyle is closest to yours?"

The Borrowers

"Forget about tomorrow, let's live for today." That's the creed of Bill and Betty Borrower. It's a financial lifestyle literally built on a house of cards—credit cards. To the Borrowers, paying cash for almost anything is unheard of. They drive the newest and best cars, wear the latest high-fashion jewelry and clothing, and live in a great big house, all financed by enormous debts. The big house was purchased with little or no money down and the balance is financed with an interest-only, variable-rate mortgage. Similarly, the cars are leased or financed to the max with hefty car loans. And anything that can be charged to credit cards is charged to credit cards. To the Borrowers, credit cards are one terrific deal—almost like free money. Just pay the credit card companies only 2 percent of the balance due each month—forever. It's one of the first lessons they learned in college.

Bill and Betty are dying to take that luxury cruise that their friends the Braggarts took and rave about. Unfortunately, the price is light-years past their credit card limits. However, there is a ready source of financing nearby. As fate would have it, Bill and Betty's home has appreciated substantially. So they simply take out a home-equity loan and go cruising. Better yet, since the interest on the loan is tax deductible, part of the money spent to take the cruise is courtesy of Uncle Sam. Isn't America great?

Unless the Borrowers make drastic changes, their financial future is headed over a cliff. Not only are they failing to build wealth, they're building negative wealth, better known as debt. A job loss here, an accident or illness there, and the Borrowers' high living is history. Cars are repossessed. The mortgage is foreclosed, and they are forced out of their home.

They declare bankruptcy, and many of their prized possessions are auctioned off to pay creditors. Friends and neighbors are totally shocked, and remark, "They appeared to be doing so well." (In Texas, this syndrome is known as "big hat, no cattle.") Bill and Betty declare themselves victims of bad luck. The reality is that they robbed tomorrow to pay for today.

The Consumers

Fortunately, most Americans are more responsible than the Borrowers. Instead, their financial lifestyle more closely parallels that of Chad and Cathy Consumer. While the Borrowers spend with a credit card mentality, the Consumers spend with a paycheck mentality. Instead of borrowing to the max, Chad and Cathy spend to the max based on their combined net incomes. They look at their take-home pay, see how much it is, and then go out and buy as much stuff as they can afford. After all, isn't that why they work?

Like most Americans, Chad and Cathy can't afford to pay cash for major purchases such as a home, a new car, or that big-screen HDTV like the one their neighbors have. When it comes to making a major purchase, the buying decision usually boils down to finding the answer to the magic question:

Can we afford the monthly payments?

They never stop to consider how much they're adding to the cost of the purchase or how long they will be paying for it. Details like that just don't interest them. If they can swing the payments, they're buying the goods. Their financial lifestyle is all about earning to spend.

Chad and Cathy have heard about Roth IRAs, where they can accumulate money tax-free for retirement. And both of their employers have 401(k) plans in which the employer provides a company match of any money that they are willing to save and invest on a tax-deferred basis. However, they pass up the offers of free money and the opportunity to build wealth tax-free. Of course, they would like to save. Unfortunately, there are too many things they need right now: a new car, that big-screen TV, an iPod, a new cell phone with a digital camera, a trip to Disney World, and scores of other life necessities. Their soul may belong to God, but Madison Avenue is in control of their wallet.

About the only good thing you can say for the Consumers' financial lifestyle is that it's better than the Borrowers'. Although Chad and Cathy believe they own their lifestyle, the truth is that they are just renting it. Like the Borrowers, a job loss, accident, or illness could hold dire financial consequences. Without a cash cushion and a long-term plan for achieving financial independence, they will continue to live a rented lifestyle until they choose to retire, or can no longer work. From then on, they will live a very spartan financial lifestyle dictated to them by a government bureaucracy.

The Keepers

While most Americans go through life with a credit card or paycheck mentality, a third, very wise group has a different financial mind-set. As Ken and Kim Keeper put it, "Debt is deadly, and earning to spend gets you nowhere. The people who reach financial freedom focus on accumulating wealth over time." While others pay attention to their net income, the Keepers are far more interested in their net worth.

The Keepers have no higher income than the Borrowers or Consumers. In fact, they may earn less. But over the course of a lifetime, they will likely have far more money to spend and more work-free years to enjoy it than the other two couples.

What's the difference? It begins with what the Keepers do with money as soon as they earn it. The first thing they do with every paycheck is to make a payment toward their future financial freedom. A minimum of 10 percent of their take-home pay is taken off the top to be saved and invested. They eagerly participate in any employee saving and/or matching programs at work. They contribute the maximum legal amount to their Roth IRA accounts every year.

Do they have debts and credit cards like the Borrowers and Consumers? Yes, they do. However, their debts are likely to be in the form of a home mortgage with a payment they can well afford, or a student loan to pay for an education that boosted their earning potential significantly. If they have car loans, they are likely to be for two- or three-year-old cars they purchased and plan to keep for a long time. They know that depreciation in the first few years of a car's life is the greatest cost of owning one. They look for a car that's a good buy, in good condition, and let the original owner take the depreciation hit. As for credit cards, they use them for convenience and pay the full balance each month without fail.

Are Ken and Kim cheapskates who lead lives of high deprivation in the hope of being rich one day? No, they are not. After setting aside a regular amount each month, they spend most of the money they earn. They wear nice clothes, live in a nice home, dine in fine restaurants, take vacations, and enjoy many of the good things money can buy. They simply realize something that the Borrowers and Consumers either don't know or choose to ignore. By making a long-term commitment and having a financial plan to build wealth over time, the odds are they will always have more money than they need, and someday may have more than they want.

TAKE THESE STEPS BEFORE YOU START INVESTING

The fact that you are taking time to read this book tells us that you are concerned about your financial future. You want to learn the basics of sound investing to achieve important life goals, such as living in a nice home, paying for your children's college education, and having a comfortable retirement. At the same time, you want to have enough spending money to be able to enjoy the present. Millions of others have achieved all these goals, and you can, too. But before we discuss the basics and you begin investing, we strongly recommend that you do the following three things, if you haven't already done so:

1. Graduate from the paycheck mentality to the net worth mentality.
2. Pay off credit card and high-interest debts.
3. Establish an emergency fund.

Graduate from the Paycheck Mentality to the Net Worth Mentality

From the time we are old enough to understand, society conditions us to confuse income with wealth. We believe that doctors, CEOs, professional athletes, and movie actors are rich because they earn high incomes. We judge the economic success of our friends, relatives, and colleagues at work by how much money they earn. Six- and seven-figure salaries are regarded as status symbols of wealth. Although there is a definite relationship between the income and wealth, they are very separate and distinct economic measures.

Income is how much money you earn in a given period of time. If you earn a million in a year and spend it all, you add nothing to your *wealth*. You're just living lavishly. Those who focus only on net income as a measure of economic success are ignoring the most important measuring stick of financial independence. It's not how much you make, *it's how much you keep.*

The measure of wealth is net worth: the total dollar amount of the assets you own minus the sum of your debts. So, the first thing we want you to do is calculate your net worth. Calculating your net worth is very simple. First, add up the current dollar value of everything you own. Such items include the following:

- Cash in checking and savings accounts, credit unions, or money market funds
- The cash value of your life insurance
- Your home and any other real estate holdings
- Any stocks, bonds, mutual funds, certificates of deposit, government securities, or other investments
- Pension or retirement plans
- Cars, boats, motorcycles, or other vehicles
- Personal items such as clothing, jewelry, home furnishings, and appliances
- Collectibles such as art or antiques
- Your business, if you own one and were to sell it
- Anything else of value that you own

Once you have the total current value of what you own, add up the total amount of all debts that you currently owe. These include the total amount due on the following:

- The mortgage on your house or any real estate holdings
- Credit cards
- Car loans
- Personal loans
- Educational loans
- Life insurance loans
- Home-equity loans
- Accounts payable in your business
- Any other debts

Subtract what you owe from what you own, and that's your net worth. Simply go to Google.com, type "net worth calculator" in the search box, and you will get links to literally thousands of net worth calculators. Choose one, fill in the blanks, and your net worth will be calculated for you.

Once you calculate your net worth, you may find it useful to see how it measures up against the net worth of others in your age and income category. Every three years the Federal Reserve surveys household net worth in the United States. The latest figures available are for 2010. At that time, the median family net worth in the United States (meaning half had less, half had more) was $77,300.

As you might expect, odds favor the well educated and self-employed. Families headed by a college graduate had a median net worth of $195,200, compared to $56,700 for families headed by a high school graduate. And the self-employed enjoyed the highest median net worth of $285,600.

Not surprisingly, median net worth tends to rise with age and with income, as illustrated:

Median Net Worth as It Relates to Age

Age	Median Net Worth
Less than 35	$ 9,300
35–44	$ 42,100
45–54	$117,900
55–64	$179,400
65–74	$206,700
75 and more	$216,800

Median Net Worth as It Relates to Percentile of Household Income

Percentile of Income	Median Net Worth
Less than 20	$ 6,200
20–39.9	$ 25,600
40–59.9	$ 65,900
60–79.9	$ 128,600
80–89.9	$ 286,600
90–100	$1,194,300

Make it a habit to calculate your net worth once a year. Charting a course to financial freedom begins with and requires knowing where you are.

Pay Off Credit Card and High-Interest Debts

Our greatest hope is that when you calculate your net worth, you have no high-interest debts or revolving credit card balances. However, if you do, you should probably pay them off before you start investing.

We recommend doing that simply because it's the highest, risk-free, tax-free return on your money that you can possibly earn. Credit card balances are the most insidious of all. You might think you are outsmarting the credit card companies when you transfer existing balances from one card to another promising you a low interest rate for the next several months. Don't fall for it. Pay them off. By maintaining a revolving balance, you are making the credit card companies richer and you poorer.

For example, let's assume a household carries a credit card balance of $8,000, makes the minimum monthly payment of $160, and is being charged an interest rate of 18.9 percent. If no additional charges are added to the balance, it will take about 8 years and more than $7,000 in interest charges to pay it off. That means the credit card holder will spend more than $15,000 to buy $8,000 worth of goods and services. If you think that's a good deal, seek medical attention.

Have you ever read the very fine print in the contracts that credit card companies send you? If you do, you may be shocked to learn just how much power they have. Miss one payment and that bargain interest rate of 6 percent can skyrocket to 25 or 30 percent or more without informing you. Thanks to credit reporting services, they can check to see if you are paying your other outstanding debts on time. Be late with a payment on your mortgage, another credit card, or any other debt, and they reserve the right to raise your interest rate to any level that they choose. You have no say in the matter, and there is no federal limit on the interest rate a credit card company can charge. By agreeing to their terms, you risk placing your financial future in the hands of companies with the power to become legalized loan sharks.

Do you realize that over the course of a lifetime, your total income will likely be in the millions of dollars? Well, the banks and credit card companies sure do, and they want a piece of it. Every high-interest debt you don't pay off is siphoning off dollars from your potential net worth and shifting it to the net worth of lending companies. Maybe that's why they own large skyscrapers. Maybe that's why they bombard us with TV commercials and endless pieces of junk mail offering us credit cards with all kinds of perks, such as airline miles, cash rebates, and the like. Maybe that's why they can afford to sponsor high-profile major sporting events and we can't. By paying off your credit cards, you get a guaranteed, tax-free return of 12, 18, 30, or more percent.

If you're on the credit card merry-go-round, get off. If the balances are very large and you own your home, consider taking out a home-equity loan to pay off the credit cards. The interest rate will probably be lower and the interest will be tax deductible.

Once the revolving balances are paid, pay off the balances due each month so you don't incur any interest charges. If carrying credit cards causes you to overspend, cut them up and close the accounts. Pay cash or switch to debit cards. Let somebody else keep the lenders in high cotton. Trust us; they will do just fine without your help.

Establish an Emergency Fund

The final prerequisite to investing is to have a readily accessible source of cash on hand for emergencies. Accidents, natural disasters, illness, job loss, widowhood, and divorce can wreak financial havoc. Worse yet, financial emergencies have a way of showing up when least expected. The two ways to minimize their damage is to carry the proper types and amount of insurance and have a cash cushion handy in case it's needed. The basics of insurance are covered in Chapter 21.

How big of an emergency fund you need depends largely on your net worth and job stability. On the one hand, if you have a very stable job, such as that of a tenured university professor, a cash reserve of as little as three months' living expenses may be more than ample. On the other hand, if you are self-employed or work in a profession where layoffs are common, you may want to have as much as a year's worth of living expenses stashed away. For most people, six months' living expenses is probably adequate.

Keep your emergency fund in an account that is safe and liquid. Bank savings accounts, credit union accounts, or money market mutual fund accounts are all satisfactory. With a good emergency fund you'll sleep better at night. It also lessens the possibility that you will have to invade funds invested toward achieving your long-term financial goals.

If you know your net worth, have paid off your high-interest debts, and have established a ready cash reserve, congratulations! You are now ready to become a Boglehead investor.