1

Measuring Your Financial Health

How financially healthy are you? When was the last time you reviewed your overall financial situation, including analyzing your spending, savings, future goals, and insurance? If you're like most people, either you've never done this exercise or you did so too long ago.

This chapter guides you through a *financial physical* to help you detect problems with your current financial health. But don't dwell on your "problems." View them for what they are: opportunities to improve your financial situation. In fact, the more areas you can identify that stand to benefit from improvement, the greater the potential you may have to build real wealth and accomplish your financial and personal goals.

Your Credit Score and Reports

You may not know or care, but you probably have a personal credit report and a credit score. Lenders examine your credit report and score before granting you a loan or credit line. This section highlights what you need to know about your credit score and reports, including how to obtain them and how to improve them.

What your credit data includes and means

TIP

A *credit report* contains information such as

- **Personal identifying information:** This includes your name, address, social insurance number, and so on.
- **Record of credit accounts:** When each account was opened, the latest balance, your payment history, and so on.
- **Bankruptcy filings:** Indicates whether you've filed bankruptcy in recent years.
- **Inquiries:** Lists who has accessed your credit report because you applied for credit.

Your *credit score*, which is not the same as your credit report, is a three-digit score based on the report. Lenders use your credit score as a predictor of your likelihood of defaulting on repaying your borrowings. As such, your credit score has a major impact on whether a lender is willing to extend you a particular loan and at what interest rate.

FICO is the leading credit score in the industry. FICO scores range from a low of 300 to a high of 850. Most scores fall in the 600s and 700s. As with university entrance examinations, higher scores are better. (In recent years, the major credit bureaus — Equifax, Experian, and TransUnion — have developed their own credit scoring systems, but many lenders still use FICO the most.)

The higher your credit score, the lower your predicted likelihood of defaulting on a loan. The *rate of credit delinquency* refers to the percentage of consumers who will become 90 days late or later in repaying a creditor within the next two years. Consumers with low credit scores have dramatically higher rates of falling behind on their loans. Thus, low credit scorers are considered much riskier borrowers, and fewer lenders are willing to offer them a given loan; those who do offer loans charge relatively high interest rates.

TIP

The median FICO score is around 720. You generally qualify for the best lending rates if your credit score is in the mid-700s or higher.

How to obtain your credit reports and score

Given the importance of your personal credit report, you may be pleased to know that federal law entitles you to receive a free copy of your credit report annually from the two main credit bureaus in Canada — Equifax and TransUnion. Equifax Canada refers to your credit report as a *credit file disclosure,* while TransUnion Canada uses the term *consumer disclosure.*

TIP

When you visit the Equifax and TransUnion websites, you won't be alone if you think you have to pay — and seemingly a lot! — to get your credit report. Even if you can find your way through the thicket of special offers, packages, and pricey subscription services, you'll be encouraged to pay for quick online access to your credit report.

However, you can obtain a credit report *for free* by using the forms each company provides and mailing them in, along with photocopies of two government-issued pieces of identification. If you're in a hurry, you can speed up the process a little by requesting reports over the phone or online. But make sure you're ordering the free report, which you can only get through the mail.

TransUnion now allows you to access your credit report online once a month for free. But before you do, remember: TransUnion is a business interested in increasing profits. No doubt the company's algorithm wizards have found that this free offering will entice more people to sign up for its paid services.

You can contact Equifax and TransUnion here:

- **Equifax:** 800-465-7166 or `www.consumer.equifax.ca/personal`
- **TransUnion:** 800-663-9980 or `www.transunion.ca` (or 877-713-3393 for residents of Quebec)

When you receive your reports, begin by examining them for possible mistakes (see the upcoming section "How to correct credit report errors" to find out how to fix problems in your reports).

You may be surprised to find that your credit reports do *not* include your credit score. The reason for this is quite simple: Although the credit agencies must provide a free credit report annually to those who request a copy, they aren't mandated to provide a credit score. So, if you want to obtain your credit score, it's going to cost you.

TIP: You can pay Equifax and TransUnion for your credit score, but we say save your money. There are cheaper ways to get your credit score. In fact, you can get your current credit score without paying anything! You can start with the FICO score estimator at `www.myfico.com/free-credit-score-range-estimator`, which provides you with an estimated range for your FICO score based on your answers to a short list of questions about your history with and use of credit.

If you do choose to pay for your current credit score from Equifax or TransUnion, be crystal clear about what you're buying. You may not realize that you're agreeing to some sort of ongoing credit monitoring service for $240 or more per year, an expenditure that generally isn't worth it. The credit bureaus' websites are clearly designed to send you down the wrong — and much more expensive — path.

How to improve your credit reports and score

Instead of simply throwing money into buying your credit scores or paying for some ongoing monitoring service to which you may not give much attention, take an interest in improving your credit standing and score. Working to boost your credit rating is especially worthwhile if you know that your credit report contains detrimental information.

Here are the most important actions that you can take to boost your attractiveness to lenders:

- **Get both of your credit reports and be sure each is accurate.** Correct errors (as explained in the next section) and be especially sure to get accounts removed from your credit report if they aren't yours.
- **Ask to have any late or missed payments that are more than seven years old removed.** Ditto for a bankruptcy that occurred more than ten years ago.
- **Pay all your bills on time.** To ensure on-time payments, sign up for automatic bill payment, a service that most companies (like phone and utility providers) offer. You can also arrange to have your credit card bill automatically paid off in full every month. Just be sure to take the time to review your statements before the payment date.
- **Be loyal if it doesn't cost you.** The older your open loan accounts are, the better your credit rating will be. Closing old accounts and opening a bunch of new ones generally lowers your credit score. But don't be loyal if it costs you!

  For example, if you can refinance your mortgage and save some money, by all means do so. The same logic applies if you're carrying credit card debt at a high interest rate and you want to transfer that balance to a lower-rate card. If your current credit card provider refuses to match a lower rate you find elsewhere, move your balance and save yourself some money (see Chapter 3 for details).

- **Limit your debt and debt accounts.** The more loans, especially consumer loans, that you hold, and the higher the balances, the lower your credit score will be.
- **Work to pay down consumer revolving debt (such as credit card debt).** Turn to Chapters 3 and 4 for suggestions.

How to correct credit report errors

If you obtain your credit report and find a blemish on it that you don't recognize as being your mistake or fault, do *not* assume that the information is correct. Credit reporting bureaus and the creditors who report credit information to these bureaus often make errors.

You hope and expect that if a credit bureau has negative and incorrect information in your credit report and you bring the mistake to its attention, it will graciously and expeditiously fix the error. But if you believe that, you're the world's greatest optimist; perhaps you also think that you won't have to wait in line to renew your passport or dispute a parking ticket.

You're going to have to fill out a form on a website, make some phone calls, or write a letter or two to fix the problems on your credit report. Here's how to correct most errors that aren't your fault:

- **When the credit problem is someone else's:** A surprising number of personal credit report glitches are the result of someone else's negative information ending up on your credit report. If the bad information on your report is completely foreign to you, contact the credit bureau (by phone or online) and explain that you need more information because you don't recognize the creditor.
- **When the creditor made a mistake:** Creditors make mistakes, too. You need to write or call the creditor to get it to correct the erroneous information that it sent to the credit bureau. Phoning the creditor first usually works best. (The credit bureau should be able to tell you how to reach the creditor if you don't know how.) If necessary, follow up with a letter or email to document and provide a record of your request.

TIP

Whether you speak with a credit bureau or an actual lender, make note of your conversations. If representatives say that they can fix the problem, get their names, email addresses, and phone extensions and follow up with them if they don't deliver as promised. If you're ensnared in bureaucratic red tape, escalate the situation by speaking with a department manager.

Tell your side of the story

With a minor credit infraction, some lenders may simply ask for an explanation. Years ago, for example, a man had a credit report blemish that was the result of his being away for several weeks and missing the payment due date for a couple of small bills. When his proposed mortgage lender saw his late payments, the lender asked for a simple written explanation.

You and a creditor may not see eye to eye on a problem, and the creditor may refuse to budge. If that's the case, credit bureaus are generally required to allow you to add a 100-word explanation to your credit file.

Sidestep credit repair firms

Online and in various publications, you may see ads for credit repair companies that claim to fix your credit report problems. In the worst cases, these firms charge outrageous amounts of money and don't come close to fulfilling their marketing hype.

If you have legitimate glitches on your credit report, credit repair firms can't make the glitches disappear. Hope springs eternal, however — some people would like to believe that their credit problems can be magically fixed and expunged.

If your credit report problems are fixable, you can fix them yourself. You don't need to pay a credit repair company big bucks to do it.

The Difference between Bad Debt and Good Debt

Why do you borrow money? Usually, you borrow money because you don't have enough to buy something you want or need — like a university or college education. A four-year university education can easily cost $30,000 to $60,000, and double that if you include residence, room and board, or renting an apartment. Most people don't 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 can set you back $35,000 or more. Although more people may have the money to pay for that than, say, a university education, what if you don't? Should you finance the car the way you finance the education?

The auto dealers and bankers who are eager to give you an auto loan say that you deserve and can afford to drive a nice, new car, and they tell you to borrow away (or lease, which isn't great either). You should say, "No! No! No!" Why? 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 photos, but you have nothing of financial value to show for it. "But," you say, "vacations replenish my soul and make me more productive when I return — the vacation more than pays for itself."

This isn't to say that you shouldn't take a vacation. By all means, take one, two, three, or as many vacations and trips as you can afford every year. But the point is to take what you can afford. If you must borrow money in the form of an outstanding balance on your credit card for many months in order to take the vacation, then you can't afford it.

The definition of bad debt

The term *bad debt* refers to debt incurred for consumption, 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 the associated 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 your other goals.

The relatively high interest rates that banks and other lenders charge for bad (consumer) debt is one of the reasons you're less able to save money when using such debt. Not only does money borrowed through credit cards, auto loans, and other types of consumer loans carry a relatively high interest rate, but it also isn't tax-deductible.

TIP This isn't to say that you should never borrow money and that all debt is bad. Good debt, such as that used to buy real estate and small businesses, 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. And the interest on student loans is generally tax-deductible (see Chapter 5). Taking out good debt, however, should be done in proper moderation and for acquiring quality assets. (See the later section "How to assess good debt.")

Bad debt overload

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 (see the next section). Here the focus is on bad debt, namely the higher-interest debt used to buy items that depreciate.

To calculate your bad-debt danger ratio, divide your bad debt by your annual income. For example, suppose you earn $40,000 per year. Between your credit cards and an auto loan, you have $20,000 of debt. In this case, your bad debt represents 50 percent of your annual income: $20,000 ÷ $40,000 = 0.5, or 50 percent.

The financially healthy amount of bad debt is zero. While enjoying the convenience of credit cards, *never* buy anything with your credit cards that you can't afford to pay off in full when the bill comes at the end of the month. Not everyone agrees with this idea, though. One major credit card company says — in its "educational" materials, which it "donates" to schools to teach students about supposedly sound financial management — that carrying consumer debt amounting to 10 percent to 20 percent of your annual income is just fine.

TIP

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 grow like 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 3 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 later section "How to Analyze Your Savings," you can figure out how much you're saving, and in Chapter 2, you'll determine how much you need to save to accomplish your goals.

TIP

Borrow money only if you're using it for long-term investments (i.e., 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. Don't borrow 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.

How to assess good debt

As with good food, you can get too much of a good thing, including good debt. When you incur debt for investment purposes — to buy real estate, for a small business, even for your education — you hope to see a positive return on your invested dollars.

But some real estate investments don't work out. Some small businesses crash and burn, and some educational degrees and programs don't help in the way that some people hope they will.

There's no magic formula for determining when you have too much "good debt." In extreme cases, entrepreneurs, for example, borrow up to their eyeballs to get a business off the ground. Sometimes this works, and they end up financially rewarded, but in most cases, extreme borrowing doesn't work.

TIP

Here are three important questions to ponder and discuss with your loved ones about the seemingly "good debt" you're taking on:

- Are you and your loved ones able to sleep well at night and function well during the day, free from great worry about how you're going to meet next month's expenses?
- Are the likely rewards worth the risk that the borrowing entails?
- Are you and your loved ones financially able to save what you'd like to work toward your goals (see Chapter 2)?

If you answer "no" to any of these questions, see the debt reduction strategies in Chapter 3 for more information.

The credit card float

Given what this chapter says about the vagaries of consumer debt, you may think that you must always avoid using credit cards. Besides the convenience credit cards offer, there's another benefit when they are used properly: free use of the bank's money until the time the bill is due. (Some cards offer other benefits, such as frequent-flyer miles or other rewards.) Also, purchases made on credit cards may be contested if the sellers of products or services don't stand behind what they sell.

When you make purchases 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 when your bill is due. This is called *playing the float*. Had you paid for this purchase by cash or debit card, you would've had to shell out your money sooner.

If you have difficulty saving money and plastic tends to break your budget, forget the float and rewards games. 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. (For information on alternatives to using credit cards, see Chapter 3.)

How to Analyze Your Savings

How much money have you truly saved in the past year? This means the amount of new money you've 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 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. It may be a pain to find statements showing what your investments were worth a year ago, but it's a useful exercise.

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

Plug your net worth figures from both years into Step 1 of Table 1-1. If you're anticipating the exercise and you're 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 isn't quite that simple. You need to do a few more calculations, which are detailed in Step 2 of Table 1-1. Why?

Well, counting the appreciation of the investments you've owned over the past year as savings wouldn't be fair. Suppose 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 that may have increased your net worth and made you the envy of your friends, the $1,700 of increased value is not "savings." Instead, it represents appreciation on your investments, so you must remove this appreciation from the calculations. (Just so you know, you're not being unfairly penalized for your shrewd investments — you also get to add back the decline in value of your less-successful investments.)

Today Savings and investments	$________	**One Year Ago** Savings and investments	$________
– Loans and debts	$________	– Loans and debts	$________
= Net worth today	$________	= Net worth one year ago	$________
Step 2: Correcting for Changes in Value of Investments You Owned during the Year			
Net worth today			$________
– Net worth one year ago			$________
– Appreciation of investments (over the past year)			$________
+ Depreciation of investments (over the past year)			$________
= Savings rate			$________

Table 1-1: *Your Savings Rate over the Past Year*

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 account — ideally a Tax-Free Savings Account (TFSA) or retirement plan, such as a Registered Retirement Savings Plan (RRSP).

How much do you save in a typical month? Get out the statements for accounts and plans 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 $5,000 to an RRSP, for example, but you depleted money that you had from long ago (in other words, money that wasn't saved during the past year), don't count the $5,000 RRSP contribution as new savings. All you've done is move the same money from one place to another, even if it's a better vehicle for your savings.

Save at least 5 to 10 percent of your annual income for longer-term financial goals such as retirement (Chapter 2 helps you to fine-tune your savings goals). If you're not saving that much, be sure to read Chapter 4 to find out how to reduce your spending and increase your savings.

How to Evaluate Your Investment Knowledge

Congratulations! If you've started from the beginning of this chapter, you've completed the hardest part of your financial physical. The check-up gets much easier from here.

Regardless of how much or how little money you have invested in banks, mutual funds, brokerage accounts, or other types of accounts and plans, 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 Chapter 6, which focuses on investing. ***Note:*** The more "no" answers you reluctantly scribble, the more you need to find out about investing.

_____ 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/territorial) 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 your tax situation?
_____	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, 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 or pork bellies?
_____	Is the money that you've earmarked for longer-term purposes (more than five years) invested to produce returns that are likely to stay 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, competitive position, price-to-earnings ratio versus its peer group, and so on?
_____	If you work with a financial advisor, do you understand what they are recommending that you do, are you comfortable with those actions and that advisor, and is your advisor compensated in a way that minimizes potential conflicts of interest in the strategies and investments that they recommend?

TIP

Making and saving money are not guarantees of financial success; they're prerequisites. If you don't know how to choose sound investments that meet your needs, you'll likely end up throwing money away, which leads to the same 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 Chapter 6 to discover more about investing; otherwise, you may wind up spinning your wheels working and saving.

How to Assess Your Insurance Savvy

In this section, you deal with the prickly subject of protecting your assets and yourself with insurance. The following questions help you get started. Answer "yes" or "no" for each question.

_____	Do you understand what's covered, the types of protection, 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 policy)?
_____	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 if you die?
_____	Do you know when it makes sense to buy insurance through fee-for-service advisors and companies that sell directly to the public (bypassing agents) and when it doesn't?
_____	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 your 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 bad — nine out of ten people make significant mistakes when buying insurance. Find your insurance salvation in Chapter 7. If you answered "yes" to all the preceding questions, you can spare yourself from Chapter 7, but keep in mind that many people need as much help in this area as they do in other aspects of personal finance.