A comprehensive personal finance/reference book for all Americans.

Your Money Rules for Financial Freedom

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For Financial Freedom

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1. Getting Started

Recommendation: Read everything in this section. It's fairly brief, provides solid money-saving tips and strategies, and will give you an idea of where I'm coming from.

Why I Wrote This Book

Describes some of the key changes in law and finances, from the move toward **defined contribution** retirement instead of **defined benefit** to how credit card debt legally can cripple you. I also give you tips on achieving financial independence.

Who Should Read This Book—and Why?

Tells you who and what the book is for. I also identify reliable, no- or low-cost sources of information on most aspects of finances.

The Cost of Living and the Facts of Life

Gives my personal views on ways to reduce costs and deal with things outside of your control, such as taxes.

Do I Really Need This?

Gives you some good questions to ask before making purchases as you seek to save money, reduce clutter, and avoid debt.

My Thoughts on Basics You Should Have

Gives you what is my personal take on how to help kids be savvy financially. I also provide tips for older folks on how to avoid serious financial problems.

Why I Wrote This Book

When you hear the word *deadbeat,* what comes to your mind? Someone who does not pay his bills, right? That's what people usually mean. However, you may be surprised to learn that, under the "new rules" in the financial world since about 1980, deadbeat now has the opposite meaning: To someone working in the credit card business these days, a deadbeat is a person who *pays his monthly bill in full.* Why? Because the lender can't hope to make a mountain of money off debt that the customer can't afford.

The definition of deadbeat isn't all that's been stood on its head in the financial world in the last quarter century, either.

Changing Rules in the World of Finance

Since the late 1970s in the U.S., it is as though quite a few power brokers got together and changed the rules of personal finance. Depending on your age, you may be surprised to find out that credit cards originated in the 1920s (but they were company-specific, like department-store accounts). The first "universal" credit card—one that was accepted by a variety of merchants—was issued by Diners Club in 1950. However, not everyone got credit cards in those early days. Typically, outside of buying a house, if you wanted to buy something, you paid cash. For the last several decades, however, obtaining credit has become much easier. We've all heard stories of the family dog or the newborn baby receiving direct-mail offers for preapproved credit cards. This easy credit—combined with the fact that, in the 1980s, **usury laws** (limiting how much lenders could charge in interest and fees) effectively disappeared—means that many people can now obtain credit they cannot afford. They can rapidly charge up balances they cannot pay. As a result, they can be hit with a wide assortment of fees, and the effective interest rates are typically in the double digits. As you can see from my discussion of **compound interest,** carrying such balances can easily spell financial disaster for a person. If the debt continues to increase, eventually he can never hope to pay it off.

To prevent this sad situation, you must become savvy about what you can afford. Again, in the old days, if you wanted to purchase a car, you could either pay cash for it or you'd get financing from a bank. If you wanted financing, the bank wanted to be repaid, so it would carefully analyze your income and expenses and tell you how much you could afford to borrow. Again, the rules have changed, and banks (and auto dealerships) will be happy to let you get into more debt than you'll be able to repay. Since they can charge more in fees and interest than in the old days, they'll make money off of your struggles to keep afloat as you try to meet your obligations. They'll enjoy their profits (and the tax write-offs if you default), and you'll be out the repossessed car and all the money, and will have a lower credit score to show for it.

New Realities of Mortgages

At least, with a car, there is a limit to how badly you can harm yourself financially. Defaulting on a $20,000 loan is a major problem, but it won't necessarily ruin you for life. But the new rules have altered mortgages as well. Now the National Association of Realtors states that 25 percent of homes purchased in 2004 were financed with no money down. That means 100 percent of the home's sales price is mortgaged. Can people afford that? Those loans automatically will cost more than if a person has put down at least 20 percent of the cost of the home. Typically, if the down payment is less than 20 percent of the sales price, lenders will demand a monthly **PMI** (private mortgage insurance) fee to be paid to them. This PMI will protect the lender, but it will do absolutely nothing for the buyer. It's not like an insurance policy that pays the loan off for you if you have a problem and can't meet your bills. The interest rate on 100-percent financing will be more than on 80-percent financing because it's a "riskier" loan. Perhaps that's why the default rate for people with 5 percent or less money down is 15 to 20 times as high as it is for those who put down 20 percent.

Some types of mortgages have become available to the general public recently. Years ago, only wealthier people had access to these types of loans. These include **ARM** (adjustable rate mortgage) loans and **interest-only loans** in which the interest is due monthly, but no equity is being built in the home. In fact, some new loans work so that the monthly payment doesn't even cover all the interest and fees, and the person ends up owing more money the longer he is in the home. This is called **negative amortization**. As interest rates rise, as they will have to do eventually, some people may not be able to meet their obligations. To complicate matters with the interest-only loans, the option to pay only the interest each month expires after a period of time (which may well be only three years, probably no longer than 10). Then those payments will jump as the principal is factored in and mortgage rates are adjusted upward.

People may think they'll simply refinance their way out of an undesirable loan. However, consider that: 1) loans must be qualified for; 2) your credit score will affect what is available to you; 3) there are fees (usually thousands of dollars) involved in any loan refinancing; 4) your home will be appraised and market values may have fallen; and 5) you may have to pay PMI for a new loan, as well. You also want to be sure any loan you took in the past or any loan you consider to refinance it doesn't have a **prepayment penalty**, usually amounting to thousands of dollars for paying off the loan early.

Are these facts being presented clearly when people are making what is likely to be the most expensive decision of their lives? Perhaps not. Foreclosure rates are guaranteed to soar within the next few years as a result. The people who default and are foreclosed on will be harmed, as will all the rest of us taxpayers. That's because the federal government could end up holding the bag: Most mortgages are resold on the secondary market, the bulk of them to **Fannie Mae** (Federal National Mortgage Association). Fannie Mae pools those mortgages and sells them as mortgage-backed securities. Some of the mortgages are government-backed, but most are not. Although people seem to believe that the government will back any products that Fannie Mae sells, it is not required to do so. So one of two things can happen if the foreclosure rate zooms upward: Private investors (and that could be your pension fund) will lose a great deal of money, or the taxpayer will have a tremendous tab to pick up. A high foreclosure rate does serious damage to the people of the U.S. and our economy. For all our sakes, people must be able to afford the debt they carry on their homes, whether in the form of mortgages or home-equity loans. One thing is sure: The lenders will not be the losers if things go wrong.

Surprising Facts About Retirement Plans

Retirement plans have also changed tremendously. Especially for younger folks, the financial rules their parents or grandparents played by are now obsolete. Quite simply, these days there are more dangers and fewer protections for young consumers. With the passage of **ERISA** (Employee Retirement Income Security Act), the law that regulated private pension plans changed. There are still some protections afforded to employees, but employers can now take steps to reduce their costs, steps that will ultimately water down employee benefits. Quite common now are **defined contribution plans**, in which the specific percentage of your wages that will go toward your retirement plan is spelled out. Your employer may or may not match that money—you have to look at your specific plan. On average, employers are contributing 2 percent of an employee’s pay to a **401(k)**. However, in the past, in the **defined benefit plan**, the average was more in the 6-7 percent range. Unlike the defined benefit plan, the new defined *contribution* plan does not guarantee you any set amount of money upon retirement. Some people do not appear to understand about the new rules of defined contributions that: If you put nothing in, you will get nothing out—no matter how long you work for your employer.

For those who do put their money into their retirement plans, the plan administrators typically invest it in the stock market. Then, when a large group of people retire at the same time (or if they just wish to cash out at the same time), the price of the stocks they have in the plan portfolio will drop because of the law of supply and demand. To complicate matters, many pension plans even of large companies are under-funded, adding a further element of risk.

Don’t Count on Social Security

Planning to rely on Social Security payments is also risky; Social Security was never meant to completely cover living expenses. Congress intended the Social Security check to be used as a supplement to personal savings and investments, as well as to a company or private pension http://www.ssa.gov/history/stool.html). I don’t think most people know the actual history and intent of Social Security. There is also a great misunderstanding about Social Security being an “entitlement” that is protected as though it were a contract between the worker and the government. However, the government’s official position is summarized in a famous court case on the Social Security web site at history/nestor:

> There has been a temptation throughout the program's history for some people to suppose that their FICA payroll taxes entitle them to a benefit in a legal, contractual sense. That is to say, if a person makes FICA contributions over a number of years, Congress cannot, according to this reasoning, change the rules in such a way that deprives a contributor of a promised future benefit. Under this reasoning, benefits under Social Security could probably only be increased, never decreased, if the Act could be amended at all. Congress clearly had no such limitation in mind when crafting the law. Section 1104 of the 1935 Act, entitled ‘RESERVATION OF POWER,’ specifically said: ‘The right to alter, amend, or repeal any provision of this Act is hereby reserved to the Congress.’ Even so, some have

> thought that this reservation was in some way unconstitutional. This was settled by *Flemming v. Nestor.*

As you can see from the examples I've given, there is a great deal of misinformation out there about all aspects of personal finance. But the people who are doing the misinforming will not be paying the bills of those who have relied upon their inaccuracies. I have taught college since the early 1980s, and as I've covered the occasional financial topic, students have routinely been shocked when confronted with the facts. Much of the time, the real situation contradicts what they've assumed, been told, or read in the general media. Learning the facts when you're still young will allow you to do some more research about your particular situation and make informed decisions.

The Truth About Bankruptcy

Many people don't heed warnings. Typically, the way people find out the facts of financial life is as the result of a crisis. One financial crisis is **bankruptcy**. The bankruptcy rate has been going up, enough so that the laws were rewritten in 2005 to make it more difficult to declare bankruptcy. However, it's interesting to note that about 90 percent of the bankruptcy cases filed in any given year are the result of job loss, serious illness, or divorce. Bankruptcy isn't on the rise because people charged lavish vacations on high interest credit cards and planned to never pay. Rather, it happens because people didn't plan to deal with such crises in their lives. Furthermore, about 95 percent of bankruptcies are also "no asset" cases, meaning that the person filing has nothing left. (Bankruptcy is such an established concept in our culture that it's included in our U.S. Constitution. It's in Article I, Section 8, Clause 4.)

One Major Cause: Fiat Money

Another reason why money-management problems are the norm, in my view, is that all currency in the world is now **fiat money**, which means, in effect, that the government says "this is the value of our currency because we say so." For centuries before this, currency typically was backed by government stores of precious metals, such as gold (the Brits used Sterling silver). The market value set by trading gold internationally determined the price of that commodity and, hence, the value of the currency. Not surprisingly, the government backed away from the gold standard over time by redefining it. In 1971, U.S. currency officially had no more connection with gold. So we're left with each government saying what its currency is worth (in a very interdependent world). Other countries decide if they effectively accept each currency's value or not by the amount of business they do with the issuing country. They can no longer rely on any governmental stores of gold (a tangible asset the free market could put a value on). This also means that governments can decide how much money to print and circulate. So the government's monetary policies affect market forces more than they once did. The unpredictability of government policy is yet another reason why it is important for people to have savings, to live on much less than they make, and to never rely on the government to aid them in any way. Despite the fact that Social Security was always intended to be a little "supplement" for their retirement, an amazing 44 percent of current retirees who receive Social Security say that it is their primary source of income.

Here's an interesting quotation from Thomas Jefferson, third President of the United States, who clearly was no fan of the concept of fiat money:

> I believe that banking institutions are more dangerous to our liberties than standing armies. . . . If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around [the banks] . . . will deprive the people of all property until their children wake-up homeless on the continent their fathers conquered. . . . The issuing power should be taken from the banks and restored to the people, to whom it properly belongs." — *Letter to the Secretary of the Treasury Albert Gallatin*

(1802); later published in The Debate Over The Recharter Of The Bank Bill *(1809).*

Savvy Financial Principles

To sum up, heed the following reversals of time-honored assumptions: 1) financial "experts" might very well loan you more credit than you can handle (in fact, they have incentives to do so); 2) you won't necessarily receive a pension from your employer just because you work there for decades; and 3) you can't expect the government to provide Social Security payments you can live on. Instead of trying to become a financial planning expert yourself, just be aware of some of the changes in the financial marketplace and recognize a few key points that could keep you from financial disaster:

- **Don't make assumptions**—at least, not about the major things in life, such as benefits at work, the cost of a mortgage, leases on houses or apartments or cars, or marriage. Before entering into major life or financial decisions, do a little homework and listen to several professionals who are current and knowledgeable in the area that concerns you.

- **Recognize that ultimately you are responsible for your financial situation.** "Ignorance of the law is no excuse" is a good maxim to live by. Some laws and business policies, such as bankruptcy, are being changed because too many people, in the opinion of lenders and politicians, are having these difficulties. That situation should be a red flag: If "too many" have such problems, it's not at all difficult or unlikely that anyone, including you, could end up in a bad situation.

- **Periodically review your finances**. Ask: Have laws changed? Has your situation changed? (Are you now married? A parent? A homeowner? Do you now have to care for your parents? Have you become disabled?)

- **Always do your homework and comparison shop.** Never rely on an organization's reputation alone to deliver you the best product at the best price. For big expenses in life, do your homework, and if it's something you must renew, such as insurance, every year or two at the most, see if there is a better deal out there for your needs.

- **Live beneath your means.** There are many people who have been rich or have earned fabulous sums of money who nevertheless went broke. A well-crafted financial plan, reviewed annually, can greatly reduce the likelihood that such a thing will happen to you. Stretch yourself intellectually, but not financially. *Keep your essential expenses (housing, food, and medical care) to under half of what you bring home, and you'll probably be financially sound no matter what life throws at you.*

- **Do not expect the government to provide for you in any way.** As you can see from the facts just presented, you have no binding contract with Social Security. No one is guaranteed benefits. Those receiving them now are receiving them because of potential political fallout if they do not. The plan is not economically sound because it is "pay as you go," *not* an investment plan. Historically, every addition to Social Security (such as the creation of Medicare and the expansion of those benefits) has cost many times what the experts said it would. Compared to the situation years ago, today there are fewer workers having to contribute to pay for many more retirees with expanded benefits. This situation can't go on much longer. That is why benefits *likely will* be reduced for people who are near younger than age 55 as of 2005. *Specifically, there will likely be at least a 26 percent reduction in benefits for workers who were born in 1970 or later.* This sobering fact is from the Social Security Administration's Web site at **http://www.ssa.gov/qa.htm**.

- **You are responsible for funding your retirement.** Defined benefit plans, which pay you a guaranteed pension amount when you retire, are now rare. And Social Security is on the way out for younger people though politicians won't admit it yet. The importance of these changes to you is that personal savings, IRAs, and any pension plan you might have at work will be your main sources of retirement benefits. If you have a pension plan at work (and not everyone does), it is likely a 401(k). But if you don't fund it, you won't receive benefits from it. Remember also that you will have to pay taxes on those benefits when you start withdrawing them during your retirement unless you take advantage of the Roth 401(k) available January 2006 which few employers are offering. Non-Roth plans are funded with pretax dollars.

  Many experts say you will want to have 80 percent of your pre-retirement income coming in during your retirement years to maintain your standard of living. This is why you can't afford to have a mortgage, car note, credit card debt, or any other major debt when you are ready to retire. Unless you are a "trust-fund baby" and your rich relatives have guaranteed you'll have millions all your life, *the best time to start funding your retirement is age 16,* when you'll probably start earning income and will have no real expenses. This way, even with conservative investments, compound interest will

> work for you so that you can afford to retire one day. You'll need to make sure you live so as to be able to retire debt-free. *So, no matter your age, retirement planning must be an essential aspect of your financial plan for life.*

The idea behind this book, then, is for you to read the general information and then consult it before you enter into major financial decisions—getting a credit card, signing a lease, getting married, and other types of obligations most of us take on. This will enable you to *discuss your situation intelligently with a professional as needed*—he won't be covering the basics and you'll have better, more focused questions he can address. If you do that, you should not end up in a world of financial hurt. In fact, you may end up financially secure at an early age—without having to live a miserable life of denial to save for retirement.