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MAKING SENSE OF FINANCE

The financial news is still rather gloomy. I have been reading a very interesting book on personal finance: All Your Worth: The Ultimate Lifetime Money Plan (New York: Free Press, 2005). The authors are Professor Elizabeth Warren (of Harvard Law School – and very much in the news at present as a Congressional advisor on the global financial crisis) and her daughter Amelia Warren Tyagi (a financial commentator based on the West Coast).

Their approach to getting started is novel: no complicated lists, no spending diaries to monitor expenditure, no counting every cent.

Instead, they have three broad categories: regular monthly bills, money to be spent “just for fun”, and money for savings: Your Must-Haves, Your Wants and Your Savings.

The trick is to keep them in balance. Broadly:

- Must-Haves 50 per cent of the income
- Wants 30 per cent
- Savings 20 per cent.

The rules of the game have changed. In the old days, if a couple could not afford something they simply couldn't get it because there was no way they could get it. But now the strict regulation of credit has gone and they can borrow big (which helps to explain some of the current US financial crisis!) In the old days, a couple contemplating buying their first home were obliged to come clean with all their financial details to prove they could afford to pay the mortgage because each bank was very cautious as to how its money was to be lent out. Now (as we have seen with the US sub-prime crisis) the money has been lent out too easily – getting approved for a mortgage now is no guarantee that you can actually afford it.

If people, for example, intend to buy a huge McMansion, then they need to ask whether they can service the mortgage within the strict Must-Have formula. If they can't, they shouldn't take on such a huge financial commitment

The “Must-Haves” can be identified by a three-way test:

- Could you live in safety and dignity without this purchase (at least for a while)?
- If you lost your job would you keep spending money on this?
- Could you live without this purchase for six months?

✓ **Therefore, paying off a mortgage is a Must-Have, visiting Disneyland for a vacation is not!**

The Must-Haves list should be re-evaluated every two years. It is also OK to go over the 50 per cent limit for specific events eg the birth of a baby or the launching a new business.

The authors warn against using credit cards and suggest greater use of cash. I have done this over the years but I have found that in the US a person paying with cash is now treated with suspicion: is the person too poor to have a good credit-rating?!

If you're worried about carrying cash in the US and the risk of getting mugged, the authors note that a person stands statistically a far higher risk of losing money through the credit card companies and their charging policies than from any mugger! The companies hire the best psychologists and marketing experts to make people feel good about taking on debt. They want people to get into debt because that is how they make their money.

Debt is yesterday's spending taken from tomorrow's income. Avoid it as far as possible. The authors very much reaffirm the value of savings and being cautious with money. This is an old-fashioned message that can never be repeated enough. Judging from all the bankruptcies now underway, many people still need to hear the message.

Overall, a good book full of interesting ideas.

Keith Suter