COMMON SENSE ECONOMICS ~ WHAT EVERYONE SHOULD KNOW ABOUT WEALTH AND PROSPERITY 2010

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Why Is There Financial Insecurity in the U.S.?

- Do You Think It Is Because Incomes Are Low?
- Are There Other Reasons?
- Let’s Look at Some Statistics…
Historically, U.S. income is rising and has rarely been higher.
TOTAL CONSUMPTION IS ALSO GROWING ALONG WITH INCOME
There is still financial insecurity! So, let’s take a look at possible sources in the private sector with respect to the rates of saving. Remember savings help people to prepare for “rainy day” expenses and their futures.
Since the 1980s, the U.S. Saving Rate is Falling While the Consumption Rate is Rising and rising faster than income ... 

How Can This Be?
Between 1953-1980, required payments on outstanding mortgage and consumer debt by households accounted for 40% to 65% of net income.

Since the early 1980s this debt-to-income ratio has risen at an alarming rate.

In 2007 it reached 135%, a two-fold increase since the mid-1980s.

Source: Economagic.com
Consumer Debt! Payments on Consumer Debt (which do not include mortgages) as a Percentage of Income Rose Considerably in the Years Leading up to the Great Recession.

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Real Consumer Credit debt (credit card balances prior to payment) Per Household Has Almost Doubled Since 1970

Source: Economagic.com
Unpaid Credit Card Balances Per Household Rises Significantly Until Recently

[Graph showing real unpaid credit card balances per U.S. household from 1970 to 2008. The balances increase significantly until recently.]

Source: Economagic.com
Unpaid credit card balances as a share of consumer credit has increased substantially

Unpaid Credit Card Balances as a % of Consumer Credit

Source: Economagic.com

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Let’s Summarize Recent Trends in Household Finance

- Real income per person has risen.
  - But, consumption has risen even more rapidly, and personal savings has declined.
  - Much of the growth in consumption was financed by debt, including credit card debt.
  - The unpaid credit card balances have increased as a share of consumer debt.
THESE TRENDS IN HOUSEHOLD FINANCE

- Illustrate why it is important to get control of your personal finances.
- If you do not control your finances, they will control you!
- As the above slides indicate, many Americans have lost control over their finances. Don’t let this happen to you!
- Take hold of the Twelve Key Elements of Practical Personal Finance
Which Decision Help You Gain Financial Security?

- Decisions to
  - Budget and save regularly,
  - Use credit cards prudently,
  - Consume wisely, and
  - Invest strategically
Why Do We Need or Want Financial Security?

- Live Better
- Less Conflict in Marriage
- Better Health
- More Leisure and Recreation
- More Time with Family
- Help Us Achieve Religious Goals
- Attain Higher Levels of Education
- Retirement is Easier
- Increase Our Charitable Contributions

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PLANNING TO ACHIEVE FINANCIAL SECURITY INVOLVES

TWELVE KEY ELEMENTS OF PRACTICAL PERSONAL FINANCE

If you don't know where you are going, you might wind up someplace else.

- Yogi Berra

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PRACTICAL ELEMENT OF PERSONAL FINANCE #1

- Discover your comparative advantage
COMPARATIVE ADVANTAGE

- Discover what you can produce of value at a lower cost than others. Think opportunity costs!
- Find out what others value and consider their willingness to pay you to produce your relatively low-cost good or service.
- Trade your specialized services and goods for income.
- Use that income to buy those goods and services that would be expensive for you to produce. Save to achieve other financial goals.
- Exchange is mutually advantageous! Consider the scenario presented in the next slide.
Farmer John vs. Nurse Amy: Can They Gain from Specialization and Trade?

What Do You Gain from Their Specialization and Trade?
What’s Your Comparative Advantage?

Think about what you are good at doing and enjoy. Is this something others’ value highly? Do you have a passion for it?

Is your educational training helping you develop a comparative advantage? Do others value your degree? How do you know?
Be entrepreneurial. In a market economy, people maximize their income by providing services and goods others value. They get ahead by discovering better ways of doing things in and outside their workplaces.
Entrepreneurs actively pursue discovering better ways of doing things.

They plan and this permits them to act quickly and strategically on new opportunities.

Entrepreneurs fuel economic growth and development!
Entrepreneurs’ Success Is Attributable To:

- Their ability to discover
  - New products that are highly valued relative to costs,
  - Cost-reducing production methods, and
  - Profitable opportunities that others overlook or pass by.
Entrepreneurial activity and self-employment are riskier than being employed by a proprietor, partnership or corporation. But greater risk can translate into higher income and more wealth.
Entrepreneurs Have High Savings Rates.

- Often they sacrifice consumption today in order to invest in their businesses, adding to their wealth.
Entrepreneurs Work Hard and Smart

- Entrepreneurs, business owners and independent contractors tend to work long hours and they work smart.

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PRACTICAL ELEMENT OF PERSONAL FINANCE #3

- Use budgeting to help you save regularly and spend your money more effectively.
“My other piece of advice, Copperfield,” said Mr. Micawber, “you know. Annual income twenty pounds, annual expenditure nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.”

-CHARLES DICKENS, DAVID COPPERFIELD
Why Is Budgeting and Saving Important?

- Most financial insecurity today is the consequence of poor saving, lack of budgeting, and other unwise financial habits.
- Consuming less of what you earn or produce today allows you to consume more in the future.
- Budgeting, consuming, saving and investing today helps you build wealth.

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Budgeting to Achieve Your Goals

- Budgeting in four simple steps...
Step 1. Start Today!

- Change your personal spending behavior and use savings to contribute to wealth building – one step at a time.
- If you do not start now, it is unlikely that you will do so later.
Step 2. Set Goals.

- Short-term goals (less than a year, immediate gratification)
- Medium-term goals (one to five years, gratification in the near future)
- Long-term goals (more than five years, gratification over your lifetime)
**Step 3. Devise a Plan of Action.**

- Create a personal budget with actual and proposed items to achieve your financial goals.
- See Supplemental Unit 10. Budgeting and Financial Fitness for Life

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**Step 4. Take The Plunge!**

- Begin consuming less of your discretionary income today and build a savings and investment program now to meet your financial goals. By doing so, you will
  - Increase your wealth,
  - Live a less stressful, a more financially free life,
  - Achieve high consumption levels in the future.

“An Afternoon Coffee Anyone?” An Example of the Power of Less Discretionary Spending or More Saving

Many people buy a premium cup of coffee, soda, bottle of water, caffeinated drink or some other type of liquid each day. Assume each drink costs $2.

- At the age of 22, stop buying a drink each day and place that $2 per day into an investment.
- At the age of 24 bump it up by $1 and save $3 a day. Your income will likely increase. So, it should be easy.
- At the age of 26, increase your daily savings to $4 a day.
- Do this until you are 30 years of age and you will have saved $9,490 plus interest. Pretty good.
- By the time you retire at age sixty-seven, that early start can easily add $153,305 to your wealth if invested wisely at about 7 percent a year. (More on this expected rate of return later.)
NEEDS VERSUS WANTS

- Really think about what you need versus what you want.
- Most of what you “need” is really only something you “want.”
- Think of creative ways to spend less on “wants” by using coupons, buying discounted products, etc.
- Avoid over-spending and excessive debt, get the most out of your money, invest strategically, and steer clear of unwise investment schemes. This advice will serve you well now and in the future.
Practical Element of Personal Finance #4

- Don’t finance anything for longer than its useful life.

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WHAT FINANCING DOES

- Financing makes it possible for you to buy now and pay later.
- Purchase on credit only when you are buying revenue generating assets in order to earn positive net returns.
- If what you finance will not generate future earnings, you are reducing your wealth and going deeper into debt.
GOOD DEBT. IS THERE SUCH A THING?

When goods and services financed now promise to yield a return greater than cost of borrowing (interest rate), taking on debt is strategic. Under certain circumstances, the following generate income and wealth over time. These “good debts” can help increase your net worth (assets less liabilities).

- Residential home
- Education
- Automobile
**STRAIGHTFORWARD RULE**

- **Do not** borrow funds to finance anything other than housing, automobiles, and education.
  - *Period!*
WHAT SHOULD NOT BE FINANCED?

- Nondurables – Goods that are consumed or items that depreciate in value quickly.
- Once consumed, food, clothing, nights-out-with-friends and concerts are gone. Payments (and interest on the debt) will linger if not paid for immediately.
PRACTICAL ELEMENT OF PERSONAL FINANCE #5

- Two ways to get more out of your money: Avoid creditcard debt and consider purchasing used items.
Prudent Use of a Credit Card

- Pay off the balance in full each month
- Do not buy the item if you cannot afford to pay for it immediately.
- If you are unable to discipline yourself in this area, cut up your credit card and use only cash.
CREDIT CARD CONVENIENCE ~ DON’T FALL PREY

- Paying with a credit card is **NOT** spending your own money, but borrowing someone else’s **IF** you do not pay right away.

- Interest rates on credit cards are high because they are unsecured. Interest charges will outstrip what you can earn on savings and investments.

- Think of your credit card as an extension of your checking account...Always pay your credit card bill in full.
IT TAKES HOW LONG?

- You buy new clothes, go to a once-in-a-life-time concert with friends and buy more and more until you gradually hit your credit limit of $3000 at 18%. You can only manage to pay the minimum of $50 each month.

- How many months will it take you to pay the credit card off?
  - 47, 80, 100 or 155 months?
  - 155 months!
You Paid How Much?

- You buy new clothes, go to a once-in-a-life-time concert with friends and buy more and more until you gradually hit your credit limit of $3000 at 18%. You can only manage to pay the minimum of $50 each month.

- How much does the $3000 end up costing you in interest?
  - $360, $720, $1300, or about $4700?
  - $4,745.35 in interest! And the items costing $3000 are gone, and it will take you 155 months (almost 13 years) to be rid of your debt.
Is buying new worth it?

Depreciation costs make new cars expensive. They depreciate substantially when driven off the lot and they depreciate rapidly in the first three years.

Used cars may have slightly higher maintenance costs but their depreciation costs are much lower.

Consider buying used! Visit Edmunds.com and compare.
Do Credit Card Companies Prey on the Financially Illiterate and Undisciplined?

- Advertisement of a credit card company: “You want it all, and you want it now! Our credit card will make it possible.”

- Is this a lie?
  - Are goods scarce? Can we have everything without sacrifice?
  - How will going deeper into debt affect your wealth and future consumption?
DO CREDIT CARD COMPANIES THINK YOU CAN BE DUPED?

- 0% introductory APR on all purchases and balance transfers for up to 6 months
- No annual fee
- Earn 2 miles per dollar on every purchase, every day
- Earn $100 Bonus Cash Back after you make $799 in purchases in your first three months
- 5% cash back when you spend at certain travel agencies, gas stations, grocery stores, restaurants, and other retailers

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WHAT YOU NEED TO KNOW ABOUT CREDIT CARDS

- Learn about the credit card offers – If they are too good to be true, stay away.
- Understand your credit card statement.
- Pay the credit card off in full.
- Keep abreast of key changes in credit card rules. Regularly visit: Federal Reserve Board: Consumers Guide to Credit Cards
PRACTICAL ELEMENT OF PERSONAL FINANCE #6

- Pay into a “real-world” savings account every month.

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Rainy Days and the Real World

Life is full of “surprises”, and they’re usually expensive!

- Cars break down.
- Computers crash and smart phones die.
- Heaters and air conditioners
- People get sick or injured.

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Plan for Your Rainy Days!

- The only “surprise” is the timing. So put a plan in place! Include this in your budget!
- You can purchase “peace of mind” by building a savings cushion.
- Make contributions into your “real world” savings account a mandatory part of your monthly budget!
Put the power of compound interest to work for you.
Compounding Interest ~ It’s a Miracle!!!

- Save and invest regularly. There is a huge payoff!
- Compound interest allows you to put your money to work and earn more and more interest on your interest plus the principal amount invested!

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The Rule of 70 ~ How Long Does It Take to Double Your Principal Investment?

- Place funds in a strategic investment vehicle and let them grow over time.
- Divide 70 by the expected rate of return (R) and see how long it takes to double in size.
  - The Number of Years It will Take X to Double = \( \frac{70}{R} \)
- When the rate of interest (R) = 7%, your investment will double in how many years?
  - 10 years (\( \approx \frac{70}{7} \))
Take A Closer Look: Rule of 70

- Save $2000 at the age of 16 and place it in an investment that promises a 10 percent return.
  - How long will it take you to generate $4000 in funds?
    - 7 years (70/10)
  - So at the age of 23 you will have $4000.
TAKE A CLOSER LOOK: RULE OF 70

- Save $2000 at the age of 16 and place it in an investment that promises a 10 percent return.
  - How much will you have at the age of 30 if you leave the funds invested at a 10 percent return?
    - $8,000 (Recall, the funds will double every 7 years.)
  - Age 37?
    - $16,000
  - Age 51?
    - $64,000 ($16,000 + $16,000 + $32,000)
Remember the Discretionary Spending Example Above?

- Rather than spend $2 per day on a drink, assume now that you spend $3.75 on a pack of cigarettes a day or $1370 a year.
- You can accumulate almost $600,000 in retirement benefits—and this figure is in dollars with today’s purchasing power at a 7 percent real rate of return!

![Exhibit 10: Don’t Smoke ~ Get Rich](http://commonsenseeconomics.com/)
Now add taxes, and the cost of a pack of cigarettes increases to $4.75 per pack. The value of your overall retirement increases by just over $100,000 to approximately $705,000!

<table>
<thead>
<tr>
<th>Age of Investor</th>
<th>Annual Amount Invested at $4.75 per pack daily</th>
<th>Value of Investment with Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td>16-26</td>
<td>$17,340</td>
<td>$23,958</td>
</tr>
<tr>
<td>26-36</td>
<td>$34,680</td>
<td>$71,086</td>
</tr>
<tr>
<td>36-46</td>
<td>$52,020</td>
<td>$163,795</td>
</tr>
<tr>
<td>46-56</td>
<td>$69,360</td>
<td>$346,167</td>
</tr>
<tr>
<td>56-67</td>
<td>$88,434</td>
<td>$704,921</td>
</tr>
</tbody>
</table>

Source: Authors' calculations
KEY LESSON

The best way to accumulate a million dollars or more at retirement is to begin saving early, make a few minor sacrifices, and take advantage of compound interest.
PRACTICAL ELEMENT OF PERSONAL FINANCE #8

- Diversify - don’t put all of your eggs in one basket.
ACCUMULATE WEALTH AND GAIN FINANCIAL SECURITY

- Investments involve risk, especially in the short-run.
- Manage this risk by building a broad portfolio based on diversification.
- Historically, long term returns on stocks have been attractive. But diversification is essential.
- Hold a large number of unrelated stocks for a lengthy period of time. Put the law of large numbers to work for you!

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PURCHASING A HOME

Buying a home you can afford, in an attractive community, and keeping it well-maintained can be a good investment. For many people, it is a huge investment and must be made with care, especially in today’s housing market. Enter the housing market purposefully.

- Have a 20 percent down payment.
- Avoid teaser rates on mortgages.
- Build up equity in your home and avoid borrowing against it.
- Diversify your overall portfolio of assets of which your home is only one!
THE LAW OF LARGE NUMBERS

- The law of large numbers states that while some of the investments in a diversified portfolio will do poorly, others will do well.
  - The performance of the latter will offset that of the former, and
  - The rate of return will converge toward the historic average.
QUESTION FOR DISCUSSION

If Microsoft constitutes a sizeable share of your current stock holdings, the purchase of which of the following stocks would provide you with the greatest increase in diversification and reduction in risk?

1. Lowe’s Home Improvement
2. Apple Computer
3. Google
4. Oracle

Answer: Lowe’s
Avoid Double Jeopardy

- Does your employer offer a company stock-based retirement program or agree to match any income used to purchase company stock if held for a period of time?
  - _If_ your company is well established and has solid growth potential, consider this investment opportunity.

- However, sell your company shares and diversify as soon as permitted.
  - Failure to do so puts you in _double jeopardy_ ... You are now beholden to your company both for current employment and retirement income. If your company fails, you lose both. Diversify!
Indexed equity funds can help you beat the experts without taking excessive risk.
THE RANDOM WALK THEORY

- No one person, group of experts, or company can predict future changes in the stock market.

The random walk theory suggests

- Current stock prices reflect the known information about the company.
- Unforeseeable events drive changes in stock prices.
- Since future changes are driven by unforeseen events, no one can persistently “pick the winners.”
Mutual Funds

- A mutual fund pools the savings of many individuals and channels them into alternative investments.
- There are many types of mutual funds (e.g. money market, bond, and equity funds.)
- A mutual fund that is indexed to a broad stock market indicator such as the S&P 500 will earn approximately the average stock market return for its shareholders.
What Is So Great About the Average Return on the Stock Market and Mutual Funds Indexed to Them?

- Historically, the stock market has yielded an average real rate of return of about 7 percent.
- That means that the real value, the value adjusted for inflation, of your stock holdings doubles approximately every ten years. Recall the Rule of 70.
TWO TYPES OF EQUITY FUNDS

- Managed equity funds are administered by professionals, seeking to pick and choose stocks. A large research staff is often involved.

- Indexed equity funds are invested to reflect the holdings of broad indexes such as the Dow Jones Industrials, S&P 500 Composite Stock Price Index, the Russell 2000 Index, or the Wilshire 5000 Total Market Index.

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INDEXED EQUITY FUNDS VS. MANAGED FUNDS

Because their holdings simply mirror a broad index, indexed equity funds do not require a lot of (i) market research or (ii) stock trading.

Consequently, the administrative costs of indexed equity funds are lower than those funds managed by professionals.

Thus, more of your funds indexed equity funds are channeled into investments.

Historically, the average long-term yield of indexed equity funds has been higher than that of managed funds.
Invest in stocks for long-run objectives but, as the need for money approaches, increase the proportion of bonds.
**Over time, relatively high and stable returns**

When held over a lengthy period of time, a diverse holding of stocks has historically yielded both a high and relatively stable rate of return.

**Exhibit 11: Stocks Are Less Risky When Held for a Lengthy Period of Time**

Source: Liqun Liu, Andrew J. Rettenmaier, and Zijun Wang, "Social Security and Market Risk," National Center for Policy Analysis Working Paper Number 244 (July 2001). The returns are based on the assumption that an individual invests a fixed amount for each year in the investment period. Data are updated through 2008.
As Exhibit 11 Shows

The “best returns” and “worst returns” on stocks converge as the length of the investment period increases.

- When a thirty-five-year period is considered, the compound annual return for the best thirty-five years between 1871 and 2009 was 9.5 percent, compared to 2.7 percent for the worst thirty-five years.
- Thus, the annual real return of stocks during the worst-case scenario was about the same as the real return for bonds.
- This high and relatively stable return, when held over a lengthy time period, makes stocks particularly attractive when saving for long-term for retirement.
Stocks Versus Bonds

- Historically, the real return from stocks (about 7%) has been higher than for bonds (about 3%).
- The stock market is volatile. Therefore, holding stocks is risky when you may need the funds in the near future.
- Most yields on bonds are set in nominal terms. When funds are needed in five years or less, they will be less risky than stocks.
- Nonetheless, bonds involve risk.
Bonds: Two Main Types of Risks

- **Inflation risk**: Unexpected inflation erodes the purchasing power of the face value of the bond and the earned interest.
  - Treasury Inflation Protected Securities (TIPS) help protect against this risk.

- **Interest rate risk**: Unexpected increases in the interest rate reduce the value of outstanding bonds.
  - This risk increases with the length of time to maturity.
**Bond Investment Strategies**

- Buy bonds that will mature when the funds are needed. If you need access to funds in five years, buy a five-year bond.
- Transfer funds in a diversified portfolio *gradually* from stocks to bonds as you approach retirement, thus reducing your vulnerability to volatile changes in the stock market.
RETIREMENT 101

- Taxes matter as evidenced in the example illustrating how taxes paid on cigarettes can be saved and used to help build retirement income if invested wisely.

- So, take advantage of one or more of the several retirement saving plans that provide favorable tax treatment.

- In consultation with a tax professional, explore your options with respect to
  - 401(k) plans, or the equivalent 403(b) plans for teachers;
  - Traditional Individual Retirement Accounts (IRAs);
  - Roth IRAs.
ALTERNATIVE IRA PLANS

- **Traditional IRAs:** Contributions to 401(k) plans, 403(b) plans and other traditional IRAs are deductible from your taxable income. So your take-home income is reduced by less than the full amount of your IRA contributions. You pay taxes on your accumulated savings eventually, but only when you retire and may be in a lower income-tax bracket.

- **Roth IRAs:** Payments to Roth IRAs are not tax deductible at time of contribution. So your take-home income is reduced by the full amount of your IRA contributions. However, your withdrawals on retirement are tax free. Thus, the value of your investment grows with this tax advantage when embodied in a Roth IRA.

- Seek impartial, professional advice when choosing these or other plans. Many factors influence which option is best for you.
PRACTICAL ELEMENT OF PERSONAL FINANCE #11

- Beware of investment schemes promising high returns with little or no risk.

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There’s No Such Thing as a Free Lunch!!!

- Beware of deals that sound too good to be true!

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THE PRINCIPAL-AGENT PROBLEM MAKES YOU VULNERABLE.

- A potential conflict of interest exists between the principal investor (you) and the agent selling investment products.
- The agent seeks to profit and has more information about the product than the principal investor. The investor is at a disadvantage and should be skeptical.
**TIPS FOR AVOIDING INVESTMENT FRAUD**

- If it looks too good to be true, it probably is.
- Deal only with parties that have a reputation to protect.
- Never purchase an investment solicited by telephone or email.
- Do not allow yourself to be forced into a quick decision.
- Do not allow friendship to influence an investment decision.
- If high-pressure marketing is involved, grab your checkbook or debit card and run!!!
PRACTICAL ELEMENT OF PERSONAL FINANCE #12

- Teach your children and others how to earn money and spend it wisely.

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TEACH YOUR CHILDREN FUNDAMENTAL TRUTHS ABOUT MONEY

Money is *earned* by providing services others’ value...

Money spent on one thing means less funds available for the purchase of other items or savings and investing.

Money both helps us get what we want, **AND** helps others get what they want.
SUCCESS IN GENERAL

Is realized by setting goals, budgeting monthly, saving regularly, using credit prudently, consuming wisely, investing strategically and working hard to accomplish all of this.

- This is important because everyone has to learn to strategically spend limited income and that spending more money on one thing means having less to spend on or save for something else.
- This is true for children, adults, households, businesses, governments and nations.