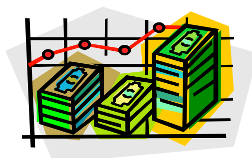
Common Sense Economics:
What Everyone Should Know About Wealth and Prosperity

(Gwartney, Stroup, Lee, and Ferrarini - St. Martin's Press, © 2010)

Reading Guide

Part IV. Twelve Key Elements of Practical Personal Finance



Introduction

1. Is making money the key to happiness? Is there anything wrong in taking steps that will help you earn more money? If you make more money, will you have more resources with which to pursue objectives that you think are important?

Discover Your Comparative Advantage.

2. Why is it important for individuals to specialize in those areas where they have a comparative advantage?
3. What are the major factors that determine whether you have a comparative advantage in a specific area?
4. Is it important to specialize in an area that you find interesting and fulfilling? Why or why not?

Be Entrepreneurial. In a Market Economy, People Get Ahead by Helping Others and Discovering Better Ways of Doing Things.

5. What are the four factors mentioned by the authors that underpin the success of self-employed entrepreneurs?
6. If you want to make a lot of money, why is it important for you to figure out how you can help others a great deal?

7. “Successful entrepreneurs must be good at discovering and acting upon opportunities that are often overlooked by others.” Is this statement true?

8. Is it important for employees to “think like an entrepreneur?” If employees can figure out how to make their services more valuable to employers, how will their promotion and earnings be affected? Can employees adopt many of the attributes that underlie the financial success of business entrepreneurs? Give examples.

9. If entrepreneurial activity were not rewarded financially, do you think that innovations and technological changes that improve the welfare of people would occur as rapidly? Why or why not?

Use Budgeting to Help You Save Regularly and Spend Your Money More Effectively.

10. What is the primary source of financial insecurity? Why are so many people with middle or even high levels of income financially insecure?

11. What is a budget? Will budgeting help you make better financial decisions and develop a strategy to achieve personal objectives? Explain how.

12. Is it important to save regularly? Why or why not?

13. Think about your current spending habits, what expenses can you either eliminate or reduce in order to save more?

14. Why is it important to start saving and investing at a young age? If you allocate 10 percent of your income each year into an investment program, how much would you have 20 years later? How much would you have 35 years later?

15. Why is delaying a savings plan until you earn more income or have more discretionary income a bad idea? What are the advantages of saving even small amounts of your income now?

Don't Finance Anything for Longer Than Its Useful Life.

16. Does it ever make sense to buy things on credit? If so, what type of items might the prudent person purchase on credit?

17. If you finance an asset such as a car or a machine, why is it important to pay off the debt before the asset is worn out?

18. If you pay for items that are consumed immediately or wear out quickly by placing them on your credit card, what is happening to your wealth?

Two Ways to Get More Out of Your Money: Avoid Credit-Card Debt and Consider Purchasing Used Items.

19. Why is it important to avoid using credit card debt as a method to purchase normal consumer goods?

20. If you have several outstanding debts, which ones should you pay off first? Why?

21. Can you think of some items that are "bargains" when purchased used? What are the characteristics of used items that can be purchased at attractive prices?

22. Why is it expensive to purchase a new car every year? Do you think most millionaires purchase a new car every year?

Begin Paying Into a "Real-World" Savings Account Every Month.

23. What is a "real world" savings account? Can it help you purchase some "peace of mind"?

24. List some expenses that you can expect to incur at various times in the future even though you may not know precisely when you will incur them.

25. How much should you set aside monthly in order to have sufficient funding for surprise expenditures?

26. How can you determine if your "real world" savings are adequate?

Put the Power of Compound Interest to Work for You.

27. What is compound interest? How does compound interest affect the importance of starting a saving and investment program at an early age? Explain.

28. Describe the "miracle of compound interest". Why is the analogy to a snowball so useful?

29. If a pack of cigarettes costs $4 and a person starts smoking one pack per day at age 16, how much retirement wealth would they be giving up if they smoked until

age 66? Assume they could earn a real return of 7 percent if they allocated the funds into an investment account.

Diversify – Don't Put All Your Eggs in One Basket.

30. What is "diversification" and how does it "put the law of large numbers to work for you"?

31. Is it attractive to invest in a home? What are some of the pitfalls to avoid when purchasing a home?

32. What is volatility? What are the two ways that diversification can help to reduce volatility?

33. When the authors state that the stock market has yielded an average real rate of return of approximately 7 percent over the last 150 years, what does this mean?

34. Historically, stocks have earned a higher rate of return than bonds. What is the primary reason why this has been the case?

35. Why do the authors recommend selling off your employer's stock (as part of a company investment plan) as soon as you are permitted to do so? How does the term "double jeopardy" influence your answer to this question?

36. What is a stock mutual fund? Explain how it can help even small investors maintain diversity in their holdings of stock.

Indexed Equity Funds Can Help You Beat the Experts Without Taking Excessive Risk.

37. What is an indexed equity mutual fund? What is a managed equity mutual fund? How will the administrative costs of the two differ?

38. What is the random walk theory of stock prices? What does it indicate about the ability of "experts" to forecast accurately the future direction of stock prices?

39. When considered over lengthy time periods, such as a decade, how has the rate of return of actively managed equity funds compared with the return derived from indexed funds? Is this surprising?

40. If a mutual fund has earned a high rate of return during the last five years, is this solid evidence that it can also be expected to earn an attractive return during the next five years?

41. During the last two centuries, what has been the best method for a long-term investor to earn an attractive return and build funds for their retirement years?

Invest in Stocks for Long-Run Objectives, but As the Need for Money Approaches, Increase the Proportion of Bonds.

42. Suppose an investor pays a fixed amount each month into a mutual fund indexed to a broad set of stocks such as the S & P 500. When this strategy is followed over a lengthy time period, 35 years for example, historically has the annual rate of return been attractive? Has the variability of that return been relatively stable? How does this affect the attractiveness of this strategy for a younger person paying into a retirement investment fund?

43. What is the difference in the tax treatment of a traditional Individual Retirement Account (IRA) and a Roth IRA? If you are currently in a high tax bracket and expect to confront a lower marginal tax rate during your retirement years, which of these two options would be most attractive? Explain.

44. As a person approaches retirement or anticipates that they will want access to their funds some time during the next few years, why does it make sense for them to switch out of stocks and into bonds?

45. Over a relatively short time period, such as five years, are stocks likely to have more variability in rate of return than bonds? Why?

46. What is the major risk of investing in long-term bonds? How do changing interest rates affect bond values?

47. If the inflation rate increases sharply in the near future, what will happen to the market value of a bond you are currently holding?

48. What is a Treasury Inflation-Protected Security (TIPS)? How do TIPS differ from ordinary bonds? Which investors will find TIPS most attractive?

Beware of Investment Schemes Promising High Returns with Little or No Risk.

49. What is the principal-agent problem? Is this problem often present when an agent is trying to get you to invest in stocks, insurance, or a business proposition? Why should this cause you to be cautious?

50. Will it be attractive for entrepreneurs to contact and raise funds from a large number of relatively small investors? Under what circumstances are they likely to do so?

51. How can you avoid making investment decisions that, even though they sound good, may well result in the loss of all or most of your funds? What are some of the things that should cause you to be highly cautious?

52. Can you think of examples, either from someone you know or from the news, where someone lost money on an investment because they failed to recognize the risk involved? Would any of the six guidelines mentioned in the book have helped avoid a poor investment decision?

Teach Your Children How to Earn Money and Spend It Wisely.

53. What can parents do to help their children learn how to make wise financial decisions?

54. People tend to appreciate things they earn more than things that are given to them. Do you think this is true? How might this impact how you deal with your children?

55. Rather than simply purchasing items for a child, why will it often be better to provide the child with a fixed amount of money, allow choices about which items to purchase, and keep any funds that are not spent? How will this influence their incentive to economize?