

January 2010 Issue

In This Issue...

- [Calculating Your Financial Ratios](#)
- [Pursuing Your Resolutions](#)
- [Teaching Important Financial Lessons](#)
- [Take Another Look at Home-Equity Loans](#)
- [Do You Have a Budget?](#)



Calculating Your Financial Ratios

When reviewing the financial health of a company, it's common to look at financial ratios, such as earnings per share, price/earnings ratios, book value, and total return. The reason financial ratios are so popular is they give you a means to evaluate financial information, while allowing you to track changes over time.

Consider using the same concept to assess and track your personal financial situation. At least annually, prepare a net worth statement and then calculate various financial ratios. Comparing those ratios over time will help you assess whether you are making progress toward your financial goals.

You should start by preparing a net worth statement, which lists all your assets and liabilities, with the excess representing your net worth. Assets should be valued at the price you would obtain if you sold them now, not the amount you paid for them. You'll also want to list your annual income for ease in calculating some of the ratios.

Now, ask yourself the following questions about your finances:

- **Has your net worth grown by more than the inflation rate?** Calculate the percentage growth in your net worth over the past year and compare that to the inflation rate. To make progress toward achieving your financial goals, your net worth should increase by more than the inflation rate. With recent declines in the stock and housing markets, you may see short-term declines, but make sure you are making progress over the long term.

- **What is your ratio of assets to liabilities?** A ratio of less than 1 indicates you have more liabilities than assets - a negative net worth. If that is the case, take active steps to reduce your liabilities. This ratio should increase over time, which indicates you are reducing debts.
- **What is the trend in your liabilities?** Review the amounts and types of debts outstanding. Mortgages are typically used to purchase a house or other items that may appreciate in value, so they are considered "good" debt, as long as the amounts aren't excessive. Credit card balances and auto loans are used to finance items that typically don't appreciate in value and should be kept to a minimum.
- **What percentages of your assets are liquid and nonliquid?** Nonliquid assets include items like your home, other real estate, jewelry, and works of art. Although they may increase in value over time, they can be difficult to sell quickly at full market value. Liquid assets, such as bank accounts and stocks, are more easily converted to cash. You want sufficient liquid assets to cover financial emergencies.
- **What is your savings-to-income ratio?** For this ratio, your savings equals all assets designated to help fund your retirement. It typically won't include your home, since you will probably live there after retirement. First, you need to decide what this ratio should equal at retirement. It is basically the amount of savings you want at retirement age, preferably determined after a careful analysis of all appropriate factors, divided by your annual income. For instance, if you want retirement assets equal to \$2,000,000 when you retire and you currently earn \$100,000, you would need a savings-to-income ratio of 20 when you retire. You might then develop benchmarks over your working years to help you gauge whether you are on track to achieving that goal.
- **What is your savings rate?** Calculate what percentage of your income you are saving on an annual basis. Typically, you'll want to save a minimum of 10% a year. This would include 401(k) contributions and individual retirement account contributions. If your employer matches your 401(k) contributions, you can include those contributions as part of your annual savings.
- **How have your investments performed?** Now may also be a good time to thoroughly analyze your portfolio's performance over the past year. Measure the performance of each investment, comparing it to an appropriate benchmark. Also calculate your overall rate of return and compare it to your targeted return.

[Back to topics.](#)



Pursuing Your Resolutions

How often have you drawn up an ambitious list of new year's resolutions, only to find you've given up on them after a few weeks? Don't let that happen to you in 2010. If you want to make significant strides toward achieving your financial goals, determine why your resolutions have failed in the past and find ways to overcome those obstacles.

We make resolutions because we really want to change some aspect of our lives. However, the reason we have to make resolutions is because it is difficult to get these changes accomplished. Thus, if you want to achieve your resolutions, follow these tips:

- **Put your resolutions in writing.** Doing so will go a long way in helping you achieve those resolutions.
- **Make your resolutions specific and achievable.** Rather than making vague or very broad resolutions, set smaller goals you know you can reach. Once you achieve these smaller goals, you may find it easier to pursue more substantial goals.
- **Don't expect perfection.** Changing any behavior is tough, and you should expect that you might slip along the way. Don't use that as an excuse to abandon your goals. Shake it off and keep pursuing your goals.

If you're looking to shape up your finances, consider these resolutions:

- **Spend less than you earn.** The amount of money left over for saving is a direct result of your lifestyle. Since you will typically want to continue the same lifestyle after retirement, your lifestyle decisions will impact you now and in the future. To get a grip on your spending, take time to analyze your expenses and to set a budget. Try reducing nonessential expenditures to find ways to spend less money on the same things.
- **Save the money before you see it.** If you have to find money every month to save, you'll probably find there isn't much left after paying all the bills. Typically, a better strategy is to set up an automatic savings program where money is automatically deduced from your bank account every month and directly deposited in an investment account. Another good alternative is to sign up for your company's 401(k) plan, having funds withdrawn every paycheck. *(Remember that an automatic investing program, such as dollar cost averaging, does not assure a profit or protect against a loss in declining markets. Since such a strategy involves periodic investment, consider your financial ability and willingness to continue purchases through periods of low price levels.)*
- **Don't let debt sabotage your goals.** If a significant portion of your income is going to pay interest on loans, you'll have less available for saving. Strive to eliminate all debt except your mortgage. Pay cash for all purchases so you don't incur additional debt. Pay down your existing debts by using additional funds to pay off the debt with the highest interest

- rate. Once that debt is paid in full, start paying down the debt with the next highest interest rate, continuing until all your debt is paid in full.
- **Invest, don't just save.** The ultimate value of your investment portfolio is a function of two factors - how much you save and how much you earn on those savings. Become comfortable with various investment alternatives, so you'll feel more comfortable investing in alternatives that offer potentially higher rates of return. Even small differences in your long-term rate of return can significantly impact the ultimate size of your savings.

[Back to topics.](#)



Teaching Important Financial Lessons

Even though it seems like money and financial topics are discussed everywhere, these are not concepts your children will learn automatically. Some of the most valuable lessons you can teach your children involve basic money concepts, such as the value of saving and investing. Some strategies you can use to help teach these concepts include:

- **Impart money concepts along with the children's allowance.** You must decide whether to tie your children's allowance to the performance of chores. Some people feel that doing so instills the concept of working for pay, while others feel chores should be performed without pay as part of children's family responsibilities. When setting the allowance, make sure your children understand what expenses must be paid with it. The allowance should increase as your children grow older and should be large enough so children have money left over to make their own purchasing decisions.
- **Provide opportunities to earn extra money.** Offer to pay your children for additional chores around the house, so they learn the connection between effort and pay. If your children want part-time jobs, first make sure they understand that their primary responsibility is to do well in school.
- **Allow your children to make their own financial decisions.** You may not agree with the choices your children make, but it is important for them to learn from their mistakes. That doesn't mean you can't discuss options with them, but the financial decisions should be theirs.
- **Encourage your child to save money.** Saving for tomorrow rather than spending today is a difficult concept for both adults and children. Thus,

- you may need to offer incentives to encourage saving. You may require your children to set aside a certain percentage of their allowance for long-term goals. Or you can match your children's savings, perhaps contributing 50 cents or a dollar for every dollar your children save.
- **Explain the basics of investing.** At an early age, open a bank account for your children, explaining concepts like saving and compound interest. Around age eight or so, explain how businesses operate and how investors buy and sell stocks. As their interest grows, help them purchase stocks with their savings. Since minors can't own stocks, you will need to purchase the stock as custodian for your children. Teach your children how to research a stock, follow its price, review its annual report, and decide when to sell it. Exposing your children to these concepts at a young age will hopefully make them comfortable with investing when they become adults.
 - **Encourage your child to take finance courses.** Many high schools and colleges offer courses that teach stock basics and personal finance. Encourage your children to take at least one of these courses.
 - **Be conscious of the money messages you send to your children.** Your children watch your actions closely, so how you treat money will be a significant influence on their views. If you make large purchases only after careful research and price comparisons, your children will learn to be careful before making a purchase. If you use your credit cards cautiously and explain how to select a card, what items to charge, and how to pay off the balance every month, your children will learn not to abuse credit cards.

[Back to topics.](#)



Take Another Look at Home-Equity Loans

When home prices were increasing, home-equity loans were a convenient way to finance numerous types of expenditures. While the loan is secured by the home's equity, the proceeds can be used for anything, including expenditures that have nothing to do with the home. In addition, home-equity loans have a significant

advantage over other forms of consumer debt - interest paid on up to \$100,000 of home-equity loan proceeds can be deducted on your tax return if you itemize deductions. Home-equity loans typically offer competitive interest rates, usually no more than prime rate or 1% or 2% over prime. Competitive interest rates combined with tax deductibility can add up to very attractive after-tax rates.

With all these advantages, it's no wonder home-equity loans became popular with homeowners. Until recently, lenders were often willing to offer home-equity loans on up to 100% of your home's value, with a simple application process and a quick check of home prices in your area.

But with declining home values and increasing numbers of foreclosures, lenders are not as anxious to approve home-equity loans. While the loan is secured by the home, it is a second lien that is subordinate to the mortgage. Thus, following a sale, the home-equity loan won't be paid until the mortgage is paid in full.

Many homeowners are being notified by lenders that their home-equity line of credit is reduced or frozen. Most contracts contain a provision allowing the lender to reduce or suspend the line if home values fall significantly or the homeowner's ability to repay the loan decreases. Signs to the lender of a decreased ability to repay include a poor credit rating, a small down payment with no private mortgage insurance, or late payments noted on your credit report. If you receive such a notice but still need the line, call and discuss your situation with your lender.

If you are trying to obtain a home-equity loan, be aware of these likely changes:

- **The loan-to-value ratio will probably be lower.** In the past, it was not uncommon for a mortgage and home-equity loan to total 100% or more of the home's market value. Now, anything over 90% is rare, and that percentage may be much lower in markets with declining home values. Some areas have limits as low as 65% of the home's value.
- **Your credit score is more important.** In the past, it was fairly easy to obtain a home-equity loan. Now, lenders are more concerned with your ability to repay the loan, using your credit rating as an indication. If your credit score is less than 680, it will be difficult to find a lender willing to approve the loan. The higher your score, the more options available and typically, the lower the interest rate you will have to pay.
- **You'll need a full appraisal of your home.** In the past, a simple review of home values in your area was often enough for a home-equity loan. Now, you'll probably need a full appraisal, including a walk through of your home.

[Back to topics.](#)



Do You Have a Budget?

A budget serves as a road map for your spending, helping you find ways to save more money for your financial goals. For a one-month period, keep track of every dollar you spend, whether by cash, check, or credit card. Break down those expenditures by category and total them for the month. Are you surprised by how much small expenditures add up over a month? Did you realize how much you were spending on things like dining out, clothing, and impulse purchases?

To make sure you get the maximum benefit from the budgeting process, keep these points in mind:

- Use spending categories that make sense for your spending patterns. If there are areas with good potential for spending reductions, even if the amounts are relatively small, set them up in their own categories.
- Set up enough categories to give you a good feel for your spending patterns, but not so many that it becomes difficult and time consuming to monitor your progress.
- Include nonrecurring items in your budget, such as gifts, tuition, insurance premiums, property taxes, etc.
- Periodically compare your actual expenditures to your budgeted expenditures to find out where you are having problems.
- While everyone in the family should have some cash that can be spent without accounting for it, don't make the amount so large that it detracts from your savings efforts.
- Include savings in your budget and make sure you actually save that amount every month.
- While at times a budget may not seem worth the effort, remember that it is a tool to help you accomplish your financial goals. Remain committed and stick with it.