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Jonathan Clements

HUMBLEDOLLAR

Seven Ideas

WHAT DO YOU consider the important financial ideas? No doubt we'd all come up with a different list—sometimes radically different—and what we deem important likely says a lot about how we handle our money.

For my own list, I think less about practical financial concepts—things like indexing and asset location—and more about the big ideas that should guide our financial decision-making. Here are seven of those ideas, all of which heavily influence how I manage my own money:

1. Compounding. I love the notion of compounding and not because Albert Einstein described it as man's greatest invention, which he almost certainly didn't. Instead, I love it because it highlights that time can be as valuable as money—an inspiring notion for cash-strapped young adults who struggle to find $50 or $100 to invest. Time is the lever that can turn those modest sums into significant wealth.

Compounding works best when it isn't hampered by high investment costs or set back by large losses. That's why I'm a fan of building a globally diversified portfolio using low-cost index funds.

Compounding, of course, can also work against us. Imagine you racked up $5,000 in credit card debt during your college years. As I noted in a blog earlier this year, if you never paid down the balance and, indeed, the credit card company let you add the 20% annual interest to the account balance, you'd receive a credit card statement after 40 years showing more than $7.3 million owed.

2. Opportunity cost. Whenever we devote our dollars to one use, we're giving up something else. Yet, in countless impulsive shopping moments, we don't pause long enough to consider the tradeoff that's involved and the opportunities that are forgone.

It isn't simply that the shiny new iPhone can cost as much as a fun five-day road trip. If the choice is between consuming and saving, the $1,000 we spend today might mean giving up $4,000 or more in retirement spending.

3. Future self. Our lives are a constant tug-of-war between the demands of our often-whiny current self and the needs of our future self. All too often, our current self prevails, which is why we end up saving too little for retirement, the kids' college and other long-term goals.

How can we bolster our future self, so he or she has a fighting chance? We might try a host of tricks: Sign up for automatic investment plans, so money is snatched from our paycheck and our bank account before we get a chance to spend it. Tell family and friends about the commitments we've made to improve our financial life, so fear of their disapproval strengthens our resolve. Visualize our future self by, say, writing down in detail what we plan to do with our retirement years, so future spending seems as enticing as today's pleasures.

4. Human capital. Our income-earning ability is, I believe, the core notion around which we should organize our entire financial life. Those four decades of—we hope—fairly steady paychecks have four key financial implications.

First, they allow us to take on debt early in our adult life to buy homes, cars and college educations, knowing we have many years of income ahead of us to service those debts and get them paid off by retirement. Second, our paychecks provide us with the savings we need to sock away for retirement and other goals. Third, that steady income allows us to take the risk of investing heavily in stocks when we're younger.

Finally, our human capital drives our insurance needs. If we don't have significant savings to fall back on, we should protect our income-earning ability with disability insurance. If we have a family that depends on us financially, we likely also need life insurance.

5. Risk pooling. There are some financial risks that we simply can't afford to shoulder ourselves, including the risk that our house will burn down, we're sued, or we die prematurely and leave our family in the financial lurch. In these cases and others, the smart approach is to buy just enough insurance to ensure our family will be okay financially.

When we send off our premiums, they go into a pool of money that's overseen by an insurance company and which is used to pay claimants. We should then cross our fingers and hope to get nothing back, because that's a sign that life is good.

That said, there's one form of insurance where we should pray to get paid: longevity insurance. When we contribute to Social Security or purchase income annuities that pay lifetime income, we effectively buy financial protection against the risk that we'll live a surprisingly long time and outlast our assets. With these forms of insurance—unlike the other insurance policies we own—we should hope to collect vast sums in return for the "premiums" we paid.

6. Ownership. We live in a world where folks increasingly own nothing: Homes, cars, music, furniture, textbooks, movies and clothes can all be rented. And in many instances, this make ample sense.

Still, nobody ever got rich by renting. Instead, the road to wealth involves owning. If we can see staying put for at least five to seven years, we ought to buy a house, not rent. If we plan to keep a car for more than three or four years, we'll likely find it's cheaper to buy rather than lease. And if our investment goals are 10 years away, we should become a part owner of corporations by purchasing stocks, rather than renting out our money to sellers of bonds and cash investments.

7. Enough. We all get just one shot at making the journey from here to retirement—and we can't afford to fail.

What could cause us to come up short? One major risk: Not knowing what counts as enough. If our goal is simply to accumulate more and more, there's a danger we'll take reckless risks as we strive for the biggest financial pile possible. A smarter approach: Temper our risk taking—by having a firm idea of what constitutes enough.