

9 money rules to live by

Americans young and old are flunking their finances, but money mastery isn't really that hard. Here are 9 simple keys you need to know.

By [Liz Pulliam Weston](#)

Most surveys that measure financial literacy focus on teenagers, and the results are always grim.

In the latest research by Jumpstart Coalition, a nonprofit that promotes personal finance education, the average high school student correctly answered just 52.4% of the questions covering money basics. That's down from 57.3% in the 1998 survey and up from 50.2% in 2002, but it hardly matters. Anything less than 60% counts as an F.

Now a poll by Harris Interactive for the National Council on Economic Education shows that adults aren't that much savvy.

While teens on average scored a 53 (another F) on a quiz testing knowledge of basic economic and personal-finance concepts, the grownups' average score was just 70 (a C).

In addition:

- More than one-quarter of adults failed the quiz.

- Women were far more likely to fail than men: 42% scored an F compared with 15% of men.

- Men were much more likely than women to get an A or B on the test (51% compared with 17%).

If it makes you female readers feel any better, there are also lots of studies out there showing that we're better investors than men -- once we get around to investing.

But the fact remains that there's a heck of a lot of financial ignorance going around, and financial ignorance is costly. Women may have even more to lose than men, since we tend to earn less, are more likely to have interrupted careers and live longer, which means we have more time to suffer from our mistakes.

My e-mail box and the [Your Money message board](#) bear testimony to the daily cost of financial illiteracy: men and women who are overwhelmed by debt, or have no savings, or don't invest for retirement, or fall for investment scams, or think we can drive gas prices down by not buying fuel for a day.

Understanding economics and personal finance doesn't mean you won't make mistakes or face financial disasters. But you can lessen the odds and repair the damage faster if you know the rules of the game. (You'll also be treated a bit more kindly by the denizens of the Your Money board, many of whom believe there *is* such a thing as a stupid question.)

Here are the economic and financial concepts I wish everybody knew:

The difference between needs and wants

Our actual needs are pretty limited: food, shelter, clothing, companionship. Just about everything else is a "want," and our wants are essentially endless. Because our resources are limited (see "scarcity," below), we have to make choices about which wants to fulfill.

Also, the way we fulfill our *needs* involves a lot of choice. Shelter, for example, can be a bed at a mission for the homeless or a \$125 million mansion. Our food choices offer a similar range, from beans and tap water consumed at home to steak and Dom Perignon at an exclusive restaurant.

I've discovered many people believe they *have* to spend money in certain ways or in certain amounts, when in reality their spending is a choice -- or is at least based on choices they made earlier. If you're facing a monster mortgage payment, for example, it's because you *chose* to buy that home and selected that particular mortgage.

[Taking responsibility for our choices](#) can be scary, but it should also be empowering. After all, if you have choices, you're not just a victim of circumstance.

Scarcity makes your choices for you

It's lovely to believe in a world of endless abundance, but the reality is that at any given point in time, our resources have limits. Whether it's oil in the ground, our time here on Earth or the cash in our pockets,

there's only so much available to be spent.

People who ignore this reality are the ones who run out of paycheck before they run out of month, or who extend their unsustainable spending by relying on credit cards, home equity loans and other reckless borrowing. Their refusal to make the sometimes-hard choices needed to responsibly manage money means that they will have even fewer choices in the future. The money they spend on stuff and on interest can't be invested in other goals, like retirement, so odds are pretty good they'll wind up old and broke.

The pointlessness of the hedonic treadmill

This isn't the latest workout device at your gym. The hedonic treadmill means that we quickly adjust to improved circumstances. A raise at work or a new possession may make us happy for a little while, but we soon take our situation for granted. Our expectations continue to rise: if only I could get another raise, or a better car, or a bigger house. Should those expectations be satisfied, again we'd adjust and quickly want more.

This has a lot of implications for personal finance and the economy, but here's something to consider: Maybe we need to look beyond our wallets for true happiness.

Don't let excuses keep you down

Solving your money problems doesn't have to be difficult. Liz Pulliam Weston gives you a few simple steps that can start you on the road to financial security.

Every money decision has a cost of its own

"Opportunity cost," very simply, means what we give up to get something else. In every choice, there's an opportunity cost. If you decide to go to college, for example, you're giving up the income you could have earned by working full-time during those years plus whatever you could have purchased with the money used to attend school. You also may take on loans to pay for school, which will have to be paid back with future income that could have gone for other purposes.

The good news, of course, is that even with opportunity costs, [college is a slam-dunk](#) for most people. The average graduate makes 70% more over his or her lifetime than someone who stops with a high school diploma.

If, however, you train for a career that has little demand and wind up making the same amount as a high school grad or trailing huge amounts of student loan debt you can never repay, you may regret the money spent on school and the foregone income.

Understanding that our choices have opportunity costs, and examining what those costs are, should help us make better economic decisions.

Why supply and demand rule

For the most part, prices are set by the interaction between supply and demand. If demand for something suddenly shoots up and the available supply of that something doesn't change, then prices will increase. If demand drops or supply increases, prices typically fall.

Here's an example. Say rock star Brittany Amber Tiffany is photographed wearing a cap with the brand name of a Midwestern seed company. Suddenly, all her fans and half the people reading *Us* magazine decide they, too, need the Midwestern seed company's hat. The farm supply companies that stock these hats figure out a good thing when they see it, and double, then triple, the price. The hat actually worn by Brittany sells for a mint on eBay, earning a notice in mainstream newspapers and furthering the craze.

The Midwestern seed company wants a piece of this action and starts cranking out hats by the ton. Suddenly you can find one in every Target and Wal-Mart. The retailers can no longer command a premium for having a rare item, thanks to the increase in supply. In fact, the hats start seeming a heck of a lot less cool, lowering demand; Target and Wal-Mart slash the price still further to get rid of their unwanted supply.

The interplay of supply and demand is also why one-day gas boycotts don't work. Even if a lot of people participated, overall demand wouldn't change; the boycotters would likely gas up before or after the selected day. Only a big increase in supply or a *sustained* decline in demand is likely to affect prices.

Supply and demand have a lot to do with our incomes as well. If we have rare skills that are in high demand by employers, we can negotiate higher pay. If, on the other hand, a lot of people can do what we do or the employer need for what we do is limited, our incomes are likely to be stunted.

Throw no good money after bad

"Sunk costs" are expenses that have already been incurred and can't be recovered to any appreciable extent. "Sunk cost fallacy" means an irrational belief that a further investment of time, money or effort will somehow resurrect the value that's already disappeared.

A classic example is the investor whose stock has plunged because the prospects of the company have worsened. The investor wouldn't buy the same stock today, yet continues to hang on to the shares rather than sell them and take the loss. The investor may offer the excuse that he or she wants to at least "break even" before selling, but of course the stock market doesn't care about the investor getting the money back, and all the wishing in the world won't bring the stock price back up.

By hanging on to the shares, the investor is giving up the opportunity to invest elsewhere at a profit -- an opportunity cost.

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The role risk plays

Every human endeavor carries some risk, and investments are no exception. What differs is the amount and type of risk and how you're compensated for taking it.

The 30-day Treasury bill, for example, is one of the "safest" investments around if you're solely concerned with getting back your original investment. The T-bill is backed by the full faith and credit of the U.S. government. But the average return on a 30-day T-bill over the past 80 years is just 3.7%, according to Ibbotson Associates. That's just above the historical 3% inflation rate for the same period;

if you factor in taxes, you probably lost money.

Large-company stocks, by contrast, returned an average 10.4% annually during the same period. That handily beats inflation, but as everyone who has invested in the past decade knows, stocks aren't a sure thing. There were plenty of years along the way that the market for large-company stocks dived, and if you invested all your money in a single stock -- say, Enron -- you could be wiped out. That's called market risk.

Here's what you should take away: You'll almost certainly need to take some market risk if you want to grow your wealth and beat inflation over time. But you should also be wary of anyone who "guarantees" a high return on an investment. If you're earning much more than the going rate on a T-bill, you're taking some risk, and you should understand that risk before proceeding.

The time value of money

This boils down to a relatively simple proposition: that the dollar I get today is worth more than a dollar I'm promised sometime in the future.

There are several reasons for this. One is the "bird in the hand" reality: the dollar I get today is real, but the dollar I'm promised in the future likely will be worth less (because of inflation), or I might not get it at all (you might renege on your promise to give it to me, or die, or cease operations if you're an employer or business). Also, the dollar I get today can be invested to create more dollars in the future.

Turn this around, and you'll see why lenders charge interest for loaning money -- and why the interest rate depends on your creditworthiness. Lenders want to be compensated for the erosion in their dollars due to inflation, and for the risk of lending money to you. The higher the perceived rate of future inflation and the more lenders doubt your promise to pay the money back, the more interest they'll charge to compensate for the risk.

The miracle of compound interest

This is a concept best illustrated by example. Let's say I give you a penny today, and promise to double the amount every day for a full month. How much money would I be giving you on the 31st day?

The answer: \$10.7 million. Check it out:

It all adds up

Day 1	\$0.01
Day 2	\$0.02
Day 3	\$0.04
Day 4	\$0.08
Day 5	\$0.16
Day 6	\$0.32
Day 7	\$0.64
Day 8	\$1.28
Day 9	\$2.56
Day 10	\$5.12
Day 11	\$10.24
Day 12	\$20.48
Day 13	\$40.96
Day 14	\$81.92
Day 15	\$163.84
Day 16	\$327.68
Day 17	\$655.36
Day 18	\$1,310.72
Day 19	\$2,621.44
Day 20	\$5,242.88
Day 21	\$10,485.76
Day 22	\$20,971.52
Day 23	\$41,943.04
Day 24	\$83,886.08
Day 25	\$167,772.16
Day 26	\$335,544.32
Day 27	\$671,088.64
Day 28	\$1,342,177.28
Day 29	\$2,684,354.56

Day 30	\$5,368,709.12
Day 31	\$10,737,418.24

Each day, the "interest" I paid you the previous day earns more interest. At the beginning, the amounts are nominal, but by the end we're talking big bucks.

Of course, no one's going to double your money every day. But this concept explains how people who save relatively small amounts over the years can build rather substantial nest eggs. After a few decades, their actual contributions represent only a small part of their burgeoning wealth -- it's mostly their returns that are earning returns. But this also illustrates how debts can quickly balloon out of control. If you're paying interest, rather than incurring it, and you're not diligent about paying off the finance charges in full every month, the unpaid amount will incur additional interest charges, increasing the total amount that you owe. This is why so many families who incur credit card debt eventually find themselves in trouble as the amounts they owe explode past their ability to pay.