

# On Financial Success

## FOUR STEPS TO FINANCIAL SUCCESS

*by Aaron Stroud*

A lot of people think financial success is complicated or difficult to achieve.

**It isn't.**

Just as the recipe for staying healthy is simple—eat less, exercise more—the recipe for financial success is straightforward.

**Spend less, & save more.**

Few people find this fun or even pleasant, but it is a natural law as reliable as gravity. When we deviate from this path, achieving success takes longer and becomes more complicated.

Other hurdles like a low salary, unrealistic expectations, or inconsistent behavior further lowers one's chances.

This pamphlet provides four steps, designed to minimize chance's role. The steps provide a framework for financial security and freedom. Although the steps are straightforward, some people may find a professional planner helpful.

A good fee-only financial planner will craft a personalized plan that addresses your unique situation. The planner can also help you navigate the complex tax issues that stand between you and financial success.

But, whether or not you seek additional counsel, the basic steps remain:

1. *start now*
2. *save enough*
3. *minimize expenses*
4. *own everything*

## **1** *start now*

This step is essential; it is **hands down** the most important, for this reason:

*For every decade delayed, one must save twice as much.*

This means if \$1,000/month was enough in your twenties, you'll need \$2,000 monthly if you're in your thirties. For those of you starting in your forties, \$4,000 might be in order.

Once you pick yourself off of the floor, we'll move on.

The numbers are broken down in greater detail on the next page, but the rule is simple. The power of compounding interest can either work for you or against you. That's why it is so important to get started *right now*.

If your mind is running through excuses—you are procrastinating. Starting doesn't mean investing. If you are in debt, create and follow a plan to get out of debt. If you aren't, start investing or increase your contributions if necessary.

## **2** *save enough*

People often set money aside for retirement, but underestimate how much they need to save. Fortunately, figuring out how much to save isn't too difficult.

### **How much will I need at retirement?**

Experts generally agree that you can safely spend 2-3% annually of your nest egg. Anymore, and you significantly increase the risk of outliving your savings. However, bigger withdraws are an option if you do not intend to leave your nest egg to heirs.

How does 2-3% translate? Well, a million dollar nest egg would provide \$20-30,000 annually. If you have a pension, or expect to collect social security, that might be plenty. If your nest egg will be your only source of income, you might need more or a plan to work part-time.

The number will also vary wildly based on your hobbies and how often you travel. Some advisers suggest you plan on generating 70% of your working income; however, expenses will vary. Don't forget that you shouldn't have

any debt when you retire and you won't be contributing to retirement accounts anymore!

### How much will I need to save?

Lots. The market won't turn small contributions into a pot of gold.

People often claim the stock market returns 10-12% over the long term. But this number isn't as big as it sounds. When you take ½ % off for investing fees (the expense ratio) and another 3-4% for inflation, your real gain is closer to 6-8%.

Also, you will only be earning 6-8% *on a portion* of your nest egg. You'll want to protect a percentage of your savings in bonds. Bonds are far less likely to rapidly drop 10, 20, even 30% in value like stocks can.

But with this reduced volatility (think of it as security) also comes much lower expectations for growth.

### How can I get the best return on my money?

In the end, the market dictates how much we earn. Unfortunately, there is no way to game the system or to super-size our returns **consistently**.

**However, we can take some steps to earn more than the majority of investors.** Steps 3 and 4 cover how.

The table below provides *rough estimates* on how much to save. The figures are based on a flat 6% return, year after year.

| <i>Desired income</i> | <i>You'll need to save ——— every year, starting at</i> |               |               |               |
|-----------------------|--|---------------|---------------|---------------|
|                       | <i>age 20</i>  | <i>age 30</i> | <i>age 40</i> | <i>age 50</i> |
| <i>20-30,000</i>      | <i>4 k</i>   | <i>8 k</i>    | <i>16 k</i>   | <i>37 k</i>   |
| <i>40-60,000</i>      | <i>8 k</i>   | <i>16 k</i>   | <i>32 k</i>   | <i>74 k</i>   |
| <i>60-80,000</i>      | <i>12 k</i>  | <i>24 k</i>   | <i>48 k</i>   | <i>111 k</i>  |
| <i>80-100,000</i>     | <i>16 k</i>  | <i>32 k</i>   | <i>64 k</i>   | <i>148 k</i>  |

## 3 *minimize expenses*

Most investors skip this step and **billions are made** thanks to their oversight.

Investors spend countless hours trying to find an angle to give their investments a boost. This hope persists because the financial industry invests millions spreading **the myth** that you can beat the market.

Unfortunately, beating the market *is highly unlikely, especially over the long term.*

### **Focus on what you can control**

If investors cannot control what their investments' return, what can you control? *You control how much money you give to your investment company.*

This *gift* (the expense ratio) is really a fee for managing your investments. Most investors pay tens of thousands more for the same, but often sub-par, performance.

### **The cost of doing business**

The expense ratio is charged annually, *even when you lose money (returns are negative)*

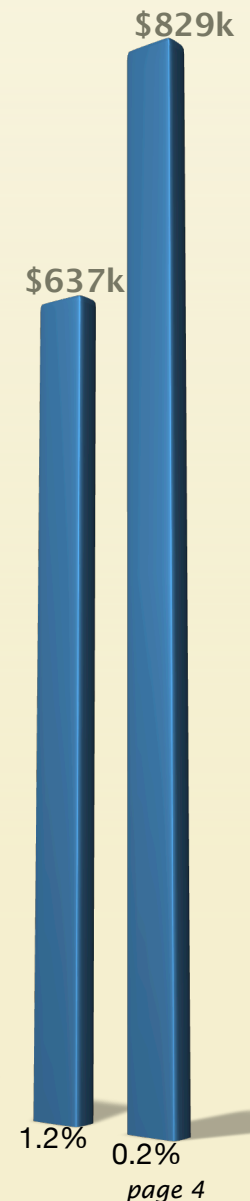
and is expressed as a percentage of your total investment. Because large amounts are involved, the percentage is measured in basis points, one hundredth of one percent (0.01%). However, even small differences in fees add up over time.

Some investors are pretty generous, giving up two, three, four, even ten times as much *for the same performance.*

This generosity is not repaid. Over forty years, an investor simply paying 1% more (for the same 6% return) will lose over \$192,000 compared to a more cost savvy investor.

To get the best deal, compare your current costs to [this list](#) of Vanguard's funds. Vanguard pioneered low-cost mutual funds. Their expenses are generally the lowest in the industry because they are a non-profit, member-owned organization.

The impact of higher costs over a 40 year investment horizon.



## **own <sup>4</sup>everything**

If we can't beat the market, what's left? Well, we can cross our fingers, selecting individual stocks and fund managers in hopes that we're making the right decision.

Or we can approximate the market's returns by *owning everything*. There are several benefits to this approach:

- You'll beat approximately 85% of managed funds
- When the market goes up, you *will know for sure* that your investments are going up too
- You'll be insulated from spectacular Enron-like bankruptcies

### **So, how does one go about owning everything?**

*Low-cost index mutual funds.*

**They match the market's return**, minus small annual fees (the expense ratio).

**They beat the majority** of actively managed funds every year.

**They beat an even higher percentage** of actively managed funds if you consider consecutive years.

**They don't change**—you don't have to worry about a new manager changing the way the fund invests.

**They are more efficient** because there are far fewer transaction costs from the manager's trades into and out of stocks.

### **So owning a little of every stock will be enough to ensure success?**

Hardly. Stocks are still risky, especially over the short term. **Diversifying** will bring a level of stability to your nest egg that would be impossible if you only invested in a handful of places.

There are four main types of **diversification**:

1. Holding index funds instead of individual stocks
2. Investing in multiple industries instead of a single sector (owning different types of companies instead of owning, say just internet-based companies)
3. Investing in foreign stock markets instead of only owning your nation's stocks
4. Investing in a combination of stocks, bonds, and cash instead of putting all of your money into one type of asset

While everyone should diversify, your *personal tolerance for risk* will help you decide on the exact percentages of stocks, bonds, and cash. A good, common rule of thumb is to hold your age in bonds.

As you age, your bond holdings take up a bigger percentage of your nest egg and your stock holdings decrease, protecting you from a catastrophic setback *at an age when you won't be able to replace your losses*.

### What's next?

That's it. These key steps lead to financial success *if you start now*. Of course, there is still more to learn if you want to:

- be more comfortable making financial decisions
- avoid personal finance and investing pitfalls
- better craft a plan for your unique situation

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Aaron Stroud writes from his wooded retreat in Seabeck, Washington. He maintains On Financial Success, a growing collection of articles, introducing financial concepts in plain english. You can learn more about his financial awakening [here](#).

