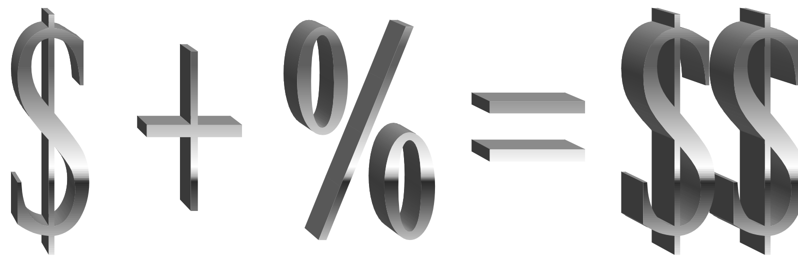
Money Fundamentals: The Rules of the Game

By Rick Baron

"If you give a person some money, you help them for a day. If you teach them how to manage their money, you help them for a lifetime."



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The purpose of this booklet

When it comes to personal money management, the vast majority of us spend our twenties making mistakes, our thirties trying to fix them, our forties wigging out because we realize we're nowhere near prepared for retirement, and the rest of our lives playing catch up. This booklet is intended to help you avoid many of the basic money mistakes that people make by giving you a simple, yet comprehensive idea of how American capitalism works, and how you can both take advantage of it and defend yourself from it. This information is designed first to show you how to become **financially self-sufficient**, and then point you in the right direction to eventually become **financially independent** on your own. It's by no means everything you will need to know, but it will give you a good start. With the recent contraction of the lending industry and credit requirements now tighter than they've been in decades, it's more important than ever for you to know how to proactively manage your finances and credit profile in order to survive and thrive financially.

In my opinion, the tried and true methods of creating, building, and managing income and wealth should be mandatory education for every person who lives in the United States. For whatever reason, the information we all need to "get" the basics of our financial system seems to be conspicuously hard to find. It's almost as if the system wants us to be ignorant of how it works so it can best take advantage of us. There are tons of books out there claiming to reveal "the secrets of getting rich," but more often than not, the only one getting rich are the ones selling the books. The basic, fundamental aspects of our financial system and the simple steps one can take to navigate it successfully are not broadly taught or advertised, but they should be. We all deserve to know the rules of the game.

My Experience

When I was a teenager, my parents were divorced and the only thing I really understood at the time about money was that if I wanted anything, I had to go out and earn the money for it myself. I had a good work ethic, plenty of ambition and a strong desire to become wealthy. But I also had very little direction or know-how about how to actually get there. The more people I asked, the more I realized that no one really knew the exact steps to take, and everyone had widely differing opinions about how to both establish credit and get ahead financially. It all seemed to be done by trial and error, and successful people just seemed lucky.

Then, in 1983 while I was in my early twenties, I stumbled into the mortgage business. All of a sudden I found myself analyzing other people's entire financial picture to determine if they could qualify for a loan to buy a home. This is where I began getting solid answers to the questions I had about how our financial system works. It turns out that there were (and are) very specific money management guidelines developed by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Corporation (Freddie Mac), the Federal Housing Administration (FHA), and the Veterans Administration (VA). The definitions of who qualified for a mortgage loan were developed by them over decades by analyzing millions of people's financial behavior and measuring what works and what doesn't. (Note: These guidelines were in place and worked just fine before the sub-prime and Alt-A loans became mainstream.)

Since that time, I've helped literally thousands of people obtain home loans, one at a time. Additionally, I've reviewed thousands more credit reports and financial profiles across the spectrum from broke to wealthy, and I've explained to all of them where their numbers and credit profiles needed to be before they could qualify for a home loan. Through that experience and my own personal experience with money, I feel I have learned the answers to the questions I had as a teenager, and I'm sharing the basics of what works here with you. The topics and concepts covered here address the foundation of what you need to be paying attention to in order for you to stand on your own financially.

Welcome to the real world: Basic money concepts you need to know

What is Money? – Money is simply a medium of exchange. It's a way to convert a product or service into something that can, in turn, be traded for other products or services. It doesn't have a mind of its own, and it doesn't care about you or me. It doesn't care what color or gender we are or where we come from. It's nothing to be afraid of, though, and it's certainly nothing you should love or hate. But it is something you need to pay attention to because our society uses money to function. You will need to know how to use it properly to function in our society as well.

What is Capitalism? – If you break down the word, "capital" is another name for money. The suffix "-ism" stands for "a system". So at its root capitalism is just a money system. When we engage in capitalism, we're making a financial exchange between two parties. One side trades a product or service in exchange for money from the other side. At the heart of this money system, the thing that makes it work, is the right and ability for private individuals and businesses to earn, and keep, a **profit**. It's also the right to invest those profits to earn even more profits. A profit is simply the difference between income and expenses. As long as the income exceeds the outgo, the difference is a profit. Profits are where wealth is created and where growth comes from. Rule number one of capitalism is that anyone who can consistently earn a profit can sustain themselves forever. On the other hand, anyone who consistently spends more than they bring is operating at a loss. The only way to do that is with borrowed money, and over time the debt payments will exceed their ability to pay or their creditors will cut them off. So rule number two of capitalism is that anyone who consistently spends more than they bring in will, at some point, be forced to stop.

Capitalism also involves the assessment of **risk of loss**, and the distinction between **good capitalism** and **bad capitalism**. Good capitalism is an exchange of fair value for a fair profit. Bad capitalism is an exchange where there's little or no value exchanged for profit.

In the U.S., We the People have the right to own private property, own our own businesses, and the right to create and build private, individual wealth. The U.S. is one of the few countries in the world where a person can start with absolutely nothing and become wealthy over time with enough hard work, discipline and smart money choices.

What Capitalism is not – Many people confuse **commercialism** with capitalism, but they are not the same thing. Commercialism is a part of capitalism, and the easiest way to think of it is as **"the art of parting you from your money"**. Every TV and radio commercial, newspaper ad, billboard, Google Ad, magazine advertisement, and junk mail piece is designed to persuade you to fork over your money for something. Companies spend billions of dollars figuring out how to make you feel you need or want to buy a particular product or service through advertising. Always be aware that businesses are competing with each other for your money, and they are extremely sophisticated in their methods of compelling you to spend it.

Consumerism, on the other hand, is the act of **spending money** for the products and services we consume. Roughly two-thirds of the U.S. economy is driven by the American consumer, and American businesses want you to spend all you can and they make it very easy to do so. The more you spend, the more they profit. Those businesses don't care if you're trying to save and invest your money. In fact, it could be said that many of them don't want you to save and invest because that's money they won't be able to get from you.

The difference between capitalism and **socialism** is most easily understood by an analogy: Under capitalism, if you go to school, attend all of your classes, study hard, do your homework, and earn an "A", then you get to keep the "A" grade you deserve. If someone else goes to school but skips some classes, doesn't study as hard, doesn't turn in all of their homework and gets a "C", then they get what they deserve as well. Under socialism, the government has the power to take away your "A" and give it to the person who made the "C" so that you both end up with "B's" to make it more fair. Capitalism rewards achievers, whereas socialism attempts to redistribute wealth through taxation to make the system seem more equal for everyone.

The profit motive vs. greed – What capitalism offers over and above what other economic systems offer is **motivation**. Most of us are motivated by the chance for a higher quality of life. In a capitalist financial system, the more money (profit) one makes, the higher quality of life one can afford, and the more one can help others as well. There is nothing wrong with being motivated to make a profit – that's **good capitalism**. Good capitalism always ends in a "**win/win**" result, where a buyer and seller, borrower and lender, and many other combinations all benefit from a mutual financial exchange. Greed, on the other hand, is the dark side of capitalism. Greed occurs when the profit motive becomes excessive, and is often accompanied by irresponsible, unethical and/or illegal behavior. Beware of greed. Greed likes to prey on people who don't know much about money, and it usually ends up with a "**win/lose**" result. That's **bad capitalism**. Do your best to avoid being greedy, and exercise caution in all of your financial dealings, for the world is full of trickery.

Our financial system is the game – The easiest way to understand how the financial world works is to think of it as a game. **The rules are exactly the same for everyone**. There are winners, losers, penalties, rewards, and a scoring system. It lasts your whole life. If you attempt not to play, the odds are you will lose anyway. But losing does not have to be a permanent condition. If you understand the basics and apply what you learn here, the odds are you will do well.

How businesses function – Businesses exist to sell a product or service for a **profit**. They track every penny of income coming in and every penny of expenses going out. They also keep a running tab of every penny of cash (**assets**) they have and every penny they owe (**liabilities**). By tracking income, expenses, assets, and liabilities, they always know where they've been, where they are now, where they're going, how much profit they are making, and their **net worth** (assets minus liabilities). They measure everything both in dollar terms and percentage terms, and it's always in writing. They do that to make sure they're headed in the right direction. They're making sure they're not just covering their cost of doing business, but that they're also making a **profit**. They know almost immediately if they are spending more than they're bringing in and take steps to correct it. If they don't, they will eventually lose track of everything and will be forced out of business.

If you see yourself as a business, then you've already won half the battle. If you focus on tracking your income and expenses, and always know how much you have and how much you owe, then you will be in an excellent position to control your own financial destiny.

The skills you need – If you can add, subtract, multiply and divide, then you already have the skills required to successfully manage your money. But you will also need both the self-discipline and the desire to make it happen.

Becoming financially self-sufficient

Three things you need to play the game – Income, Assets, & Credit

Income – Your first priority is to generate an income. In other words, **get a job**. There are several ways you can earn an income. You can earn money by working by the hour, or by a monthly or yearly salary, or commission sales, or by contract or "per job" basis, or by self-employment. Most employers will pay you on a weekly, bi-weekly (every other week), semi-monthly (twice a month) or monthly basis. It's important to know when you'll get paid when you're trying to budget and pay your bills.

Know the numbers exactly. It's not just your **right** to know how much you're making; it's your **responsibility** to know how much you're making. Also, be aware that how much you're getting paid isn't as much as you will actually receive. Income taxes, Social Security taxes, Medicare and Medicaid taxes, and possibly health insurance and retirement plan contributions will be deducted from your earnings before you get your paycheck. The amount you are getting paid before those deductions is called your **gross income**, and the amount you get after those deductions is called your **net income**. If you're getting paid without those deductions being taken out, it becomes your responsibility to pay them when it comes time to file your income taxes. There will be more on taxes later.

When creditors are looking at your employment history, they look for consistency and longevity. If you have gaps between jobs of a month or more, or if you change jobs frequently to unrelated fields, they see you as riskier and more unreliable. The more job stability you can show (e.g. one year or more) in the same line of work, the better your odds of getting what you need when applying for credit.

Assets – An asset is anything that holds or increases its value over time (including cash, stocks, bonds, real estate, precious metals, etc.). **Cash**, or paper and coin money, is considered a **liquid asset** because it can be instantly and easily used to make a transaction of any kind. Other assets are things of value that can be converted to cash, and depending on how quickly they can be converted to cash determines whether they are liquid, semi-liquid, or illiquid assets. Cash is where the majority of your profits should go in the beginning. Start with a savings account at a bank. Discipline yourself to add to it as much and as often as you can. While you're building up your cash, educate yourself about investments, but don't invest a penny until you have a very good understanding of the risks and rewards of any investment.

Assets can also be used as **collateral** against which you can borrow money from a lender. In other words, your asset can be pledged as a guarantee that you will repay a debt. If you don't repay it, the lender keeps the asset as payment. Assets can help you establish credit. They can also insulate you from hard times in an emergency. But most importantly, assets can be used to generate both income and profit. The more assets you have, the easier everything else gets.

When creditors and lenders are considering extending you credit, the more assets you can show you have the more likely they will work with you. When you have money in the bank as reserves, creditors can see that you will still be able to make monthly payments for a while if you lose your job. You're not as risky as someone who has no money saved.

Credit – Credit and debt are two sides of the same coin, but they are not the same thing. Credit is a track record of your financial character that dictates whether or not you can borrow money and at what cost. Credit is the ability to borrow money versus actually borrowing it. You can have good credit and no debt, but you can't have debt without credit. If you have a good track record of paying back your debts on time, then it will be relatively easy for you to borrow money in the future.

Credit is a tool just like fire is a tool. If you think about it, when you manage fire properly it can cook your food, heat your home, melt metals to make tools and many other useful things. But if you lose control of fire, it can burn you and destroy everything you have. Just like managing fire, if you manage credit properly it can do great things for you. Mismanage or lose control of it and you can lose everything.

Our society runs on credit. Businesses and governments use credit to obtain short term financing to fund many of their day-to-day operations like purchasing inventory and covering payroll expenses. Individuals use it to finance cars, homes, tuition, and many other things. It allows us to build a higher quality of life for ourselves much sooner in our lives. But it must be used sparingly and responsibly to avoid becoming over extended.

The credit bureaus – There are three major national credit bureaus: **Experian, TransUnion & Equifax**. They are companies that build and maintain a database on you and everyone else in the country that has credit of any kind whether you want them to or not. They identify you by your name, Social Security number, and your date of birth. The financial world works on a monthly basis, and the vast majority of creditors and lenders expect you to make a payment on your debts every month. If you get a credit card, car loan, student loan, signature loan, line of credit, mortgage, or any other kind of loan, the institutions and businesses you get the loans or credit from report to the credit bureaus **every single month** whether you make your payments on time or not. If you make your payment on time, they report each month that you made your payment on time. If you make a payment over 30 days past the due date, they report that, too. If you don't pay them back at all, they report that as well.

The credit bureaus collect your payment information so the financial world can see how reliably you repay your debts. Almost everyone you apply for credit from has the ability to request your credit history, called a **credit report**, from any or all of the three credit bureaus.

Your credit report is like a report card that contains information on who you are, where you've lived, who you've worked for, your credit scores, and whether you have any civil monetary liens or judgments like federal tax liens, bankruptcies, foreclosures, or that landlord who filed a legal judgment on you for skipping out on your rent. It also contains both a summary and a line by line description of every single credit account you have or have had. That includes when you opened the account, when it was last updated, the last activity date, the maximum amount of the loan or limit, the current balance, any amount past due, the payment amount, how many months are left to pay it off, and whether you've had any 30, 60, or 90 day (or more) late payments and the dates they were late. It also has a list of who else has checked your credit in the last couple of years. It's a comprehensive picture of your financial activity and behavior. The financial world uses it to judge your financial character.

It's important to know that there are several things you have to pay for each month that don't usually get reported to the credit bureaus. Things like your rent, electric and utility bills, phone/cell phone bills, cable and satellite TV bills or any other "pay as you go" items normally are never reported to the bureaus and won't help build your credit record. However, if you don't pay any of them for whatever reason, you can rest assured that they will report that fact to the credit bureaus and it will severely hurt your credit rating.

Credit scores – Decades ago, the credit bureaus began working on a scoring system that would accurately represent where people rank on a good credit/bad credit scale. Until the mid '90's, credit reports had to be reviewed on a case by case, line by line basis in order to make an assessment of whether someone was a good credit risk. A company called Fair Isaac was the first to develop an accurate and reliable scoring system, and it was adopted by Experian and aptly named the "**Fair Isaac Score**." With a few minor adjustments, TransUnion adopted it and named it the "**Classic Score**," and so did Equifax and they named theirs the "**Beacon Score**." Any time one of those three scoring systems is used, Fair Isaac makes money, so if you ever go online and pay for your credit score make sure it states one of those names or it may not be accurate. There are other scoring systems that have sprung up to sell credit scores and get around having to pay Fair Isaac, and most that I've seen show your scores to be higher than they actually are and higher than what the lending industry uses.

The scores work like this: There are about 45 different factors that are used, and each one has a numerical value – some are negative numbers and some are positive. These factors include things like how often you apply for credit, how many lines of credit (debts) you have, how long you've had them, how much you owe on each one, and whether they are installment loans (like car loans) or revolving credit (like credit cards). They also include late payments, collections, defaults, judgments, bankruptcies, foreclosures, and tax liens, which are all things that can happen if you don't pay someone. Exactly how many points each factor is worth is a trade secret.

The scores range from **350 to 850**. The higher the number is, the better your credit rating. If your scores are over **720**, you're considered to have excellent credit and manage your debts wisely. You're also the least risky for a creditor to do business with.

If your scores are between **680 and 720**, you probably pay everything on time, but you may have a late payment or two in the last few years and/ or you may be maxed out on some of your credit cards (charged to or near the limit) and you look a little risky and may have to pay slightly higher interest rates on credit cards and loans.

If your scores are between **620 and 680**, you may have gone bad on a few debts and made a few late payments recently, but you still pay most of your debts on time. You're a bit more risky to lenders, and you can expect to pay a fair amount more for credit of any kind.

If you're scores are between **580 and 620**, you probably struggle paying anyone on time and have defaulted on a few debts. Credit of any kind will be harder to get at all and it will be much more expensive. Creditors see you as mostly unreliable.

If your scores are between **520 and 580**, the credit industry sees you as a liar because you don't pay anyone as you promised, and you've likely gone bad on several debts.

If your scores are **below 520,** the credit industry sees you as both a liar and a thief because you don't pay anything as agreed and many debts you don't pay back at all.

Credit scores are not permanent fixed numbers. They fluctuate monthly based on your financial activity and behavior. People with the highest credit scores typically have three to five credit cards with the balances below 50% of their limits (you lose points when your balance goes over 50% of the limit). They also have a car loan and maybe a mortgage. They also have a history of properly paying other accounts off in the past. They use credit regularly, but they keep the level of debt pretty low, and in many cases pay credit cards off monthly.

Credit scores also factor in **time**, such as how long you've had good credit, how long it's been since you've made a late payment or had other negatives, or if you have any current negatives. The longer you maintain the positive items, the higher your score. The more recent your negative items, the lower your score. The longer it's been since any negatives, the more your score will rise.

When someone checks your credit, it's called an **inquiry**. Too many inquiries have a negative effect on your scores because the bureaus think you may be desperate for money. You don't want to have more than three or four inquiries per year. However, the bureaus can tell what type of an inquiry each one is, and they make some exceptions. If you're shopping for a car, for example, and you have several car dealers check your credit on the same day, it only counts as one inquiry. If you're shopping for a mortgage, several inquiries count as one if they're all in the same two week time frame. Also, it never counts as an inquiry if you're checking your own credit.

We are all legally entitled to one free credit report per year. You can get it online at www.annualcreditreport.com . Be sure to spell it correctly, because there are several phishing sites with similar spellings. Also, you can purchase your credit report directly from each of the bureaus through their websites at www.experian.com , www.transunion.com , and www.equifax.com for around $10 each. They also each offer a 3 in 1 report for about $30.

Establishing credit – Establishing credit may seem mysterious, but it's really fairly easy. With no credit history to go by, a bank or lender needs something to reduce their risk when considering lending you money or extending you credit. There is no better way to reduce the lender's risk than to give them money before you borrow any. In other words, save up some money, say $500 or $1000, then take it to a bank, ask to speak to a loan officer, explain to them that you want to establish credit, and give them $500 to use as collateral for a short term loan of $500. Or you can get what is called a "secured" credit card, which is a credit card with a spending limit equal to the amount you give them. In either case, make sure you can promptly pay back the amount you borrow or charge. If you take out a loan, the bank will give you your money back once you've paid the loan off. If you get the secured credit card, the bank will likely hold your money for a year or so until you've established a record of using the card responsibly and sparingly. This strategy works whether you're trying to establish credit for the first time or re-establishing new, good credit after having not so good credit in the past.

Debt – There are two kinds of debt – smart debt and stupid debt. Smart debt is debt incurred to establish credit. It's also debt used to buy a house or car, because it's difficult for most people to pay cash for those. It's also debt incurred to avoid using all of your cash in an emergency. Smart debt is paid off faster than required to avoid paying as much interest as possible.

Stupid debt is debt incurred for things that don't last or are not really needed. Going into debt for buying lunch, dinner, happy hour, groceries, gasoline, cigarettes, or anything else you consume simply doesn't make financial sense. You have to pay interest on these things, sometimes for years. Going into debt for things that are temporary or aren't necessary will undermine your financial progress. Avoid it the best you can.

Stupid debt is also debt that you agree to take on that you know beforehand is going to break your budget. Just because someone is willing to make you the loan or extend you the credit does not mean you can afford it. It's your decision and your responsibility to know what you can afford and what's best for you and your budget. You will need to learn how to say "no."

Credit card debt is the most dangerous type of debt, and it can be the most stupid and expensive. Try to use credit cards only for emergencies or for planned purchases. Always pay more than the minimum amount due each month because the minimum payment is almost all interest. If you only make the minimum required payment it can take you decades to pay them off.

Debt costs money. It's like paying rent for money you haven't even earned yet. Debt is other peoples' money, not yours, but you have to pay it back with money you earn plus interest. Carefully consider any debt you're thinking of incurring. You will find that if you only go into debt for things you really need, you will always be able to manage and control your debt (remember the fire analogy?).

Budgeting basics – the keys to success – Two clichés apply here: **If you fail to plan, you're planning to fail**. Also, **you cannot manage something you have not measured**. A budget is a financial plan, and it does not exist unless it is **in writing**. It is your record of both how much money you have coming in each month and how much money you have going out each month, and you're a fool if you think you can keep track of it all in your head. Write it down, and go over your budget at least once per month. It's the best way to keep score in your financial world. It's the only way to know for sure if you have enough money to pay your bills and debts each month, and it's the best way to see where you can make changes in your spending patterns to improve your situation. It's also the best way to avoid having some week left at the end of your paycheck. This is where your math skills come into play. Use them.

– Know this: **Everything costs money**. Food, clothing, shelter, and transportation are the big ones, but if you don't pay attention, the little things can sneak up on you as well. A budget starts with how much you earn. On a blank sheet of paper, write down both your **gross monthly income** and your take home pay (i.e. your **net monthly income**). You're doing this for two reasons – to be able to calculate percentages of both numbers, and to see how much of your hard-earned money is going for taxes and other withholding items. Next, write down every bill and payment you will need to pay and when the payment is due by. Then do the math. Subtract your expenses from your income to make sure you can pay what you owe and when you owe it. It's a timing thing, and if you are earning enough money each month to pay for your needs, and you're doing it consistently month after month, you, my friend, are playing the game right.

Here's a sample budget: Gross monthly income - **$3000** Net monthly income - **$2400** (paid $1200 twice per month)

Item	Amount	Date Due
Net Paycheck	+$1200	10/1
Rent	-600	10/1
Electric bill	-75	10/5
Groceries (2 weeks)	-250	
Fuel (2 weeks)	-100	
Credit card	-50	10/12
Total amount left	+$125	
Net Paycheck	+$1200	10/15
Car pmt	-300	10/20
Credit card	-40	10/22
Phone bill	-75	10/22
Cable bill	-50	10/25
Groceries (2 weeks)	-250	
Fuel	-100	
Total amount left	+$385	

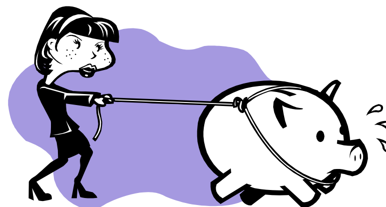
The above budget shows there should be $510 extra left over after expenses each month. It's totally up to each individual whether that money just gets spent, or if some or all of it gets put in the bank as profit.

Think One-third/One-third/One-third when budgeting- To make sure you're doing it right, use these rules of thumb for budgeting. They're proven to work. Divide your **gross monthly income** into **three equal amounts**. Make sure your single largest expense, your **housing expense**, is never more than between **one quarter to one third** of your **gross monthly income**. This includes your rent or mortgage payment and the utilities (i.e., electricity, gas, water, garbage, and cable/satellite bills). In other words, everything it costs to have a functioning home. Statistics show that most people struggle to meet their other expenses if this category takes a larger amount than one third of their income. Assuming you make $3,000 per month, this number should be under $1,000. If your housing expense exceeds one third of your income, you will need to either move to a less expensive place or find a roommate (who also has a job) to share this expense with you. For example, if your housing expense is half of your monthly income, splitting it with someone else makes it turn into a quarter of your monthly income.

The second portion of your income should be for everything else you have to pay for, and should be split into two parts. Monthly payments for car loans, credit cards, student loans, or any other debts you obtained through credit should never be over 15% of your gross monthly income. Food, gasoline or transportation, and non-essential items should never exceed 15% to 18% of your monthly income as well. In other words, if one third of your income is $1,000, your payments should stay under $500 per month and your purchases should stay under $500 per month. **Note**—under no circumstances should you allow your rent or mortgage plus all other monthly debt payments exceed half of your gross monthly income. You'll run into trouble.

The last third of your income is where your chance to make a profit lies. Most employers you will work for are required to withhold income taxes, Social Security, Medicare and Medicaid taxes out of your check. Whatever they don't take should be your profit. Bank it. A good rule of thumb is to shoot for between five and ten percent of your gross income. If your employer offers a retirement account, sign up for it as soon as you can. You can increase your profit here because it is deducted from your income before your income is taxed. Your employer will put some of your money into it each month, and you will pay a little less income tax as a result. Your net pay will stay close to the same, and you will have two accounts to funnel your profits into: savings and retirement.

Every individual is different and will have different priorities and spending needs. Use the above guidelines to make adjustments accordingly. If one area is too high, either change it or cut back in another area. It takes time, effort, and discipline, but the long term payoffs can be enormous. **Remember, one third housing, one third payments and purchases, and one third withholding and profit.** These numbers hold true whether you're making $1,500 per month or $15,000 per month.



Balancing your checkbook – If you have not yet opened a checking account, you need to do so as soon as you have some money together. Go in to a local bank or credit union that's convenient to your work or home, tell them you want to open a **checking account**, and they will lead you through the process. Once you have your money in the bank, they will issue you checks and probably a debit card that can be used just like a credit card. However, neither checks nor debit cards work like a credit card. With credit cards, you can charge up the balance and make monthly payments to pay it back down. It works just the opposite with a checking account. You have to put the balance in first, then you gradually draw down the balance as you write checks and use your debit card to pay for other things.

If you write checks for more than what you have in the bank, the consequences will be immediately severe and expensive. For example, if the balance in your checking account is down to $10, and you write a check to pay for a meal at a restaurant that costs $11, when that check gets to the bank it will "bounce" because you didn't have enough money in the account to cover the amount of the check. The bank sends the check back to the restaurant that you wrote the check to as unpaid, and the bank will also charge you $20 to $30 or more as a penalty for writing a check when you had insufficient funds to cover the amount of the check. Also, the restaurant has the right to demand you come in and pay the $11, and they will likely charge you a $20 or $30 fee as well for writing them a bad check. So because you didn't realize you were $1 short when you wrote the check, it ends up costing you an extra $40 to $60 big ones. And for many people, that amount could wreck their budget. Also, if you intentionally write a check knowing the money isn't in your account to cover it, that's a crime. It's called "theft by check," and you can go to jail for it.

The above example was used to drive home the point how important it is to know how much money you have at all times. The only way you can be sure of that is to keep your own record of your checking account activity, separate from the bank's records. Many people rely on the bank to keep track of everything, and check their balances online or at the ATM machine, but those are the ones that make the kinds of mistakes outlined above. That's because when you write a check or use your debit card, it can take a few days to a few weeks to be received and counted by the bank. If you write a check on Monday, check your balance with the bank on Tuesday, write another check by Wednesday thinking you had more money than you did, and both checks hit the bank by Friday, you're overdrawn again. The bank's records usually run a few days behind your financial activity.

When the bank first gives you your checks, they also give you a check register. Keep it handy to keep track of your money. It's a little booklet with lines on it for you to record every transaction you make. On each line you have a place to write the date, the type of transaction (i.e. ATM withdrawal, debit, or check number), to whom the money went or where it came in from, the dollar amount, and a place to check it off when you can verify the bank has processed the transaction. It's designed to give you a running daily total of your real-time account balance. At least once per month, use your check register to "reconcile", or sync up, your records with the bank's to make sure your numbers agree. The bank will send you a monthly statement, and on the back is a form that helps you figure it out. You will probably have online access to your

bank account information as well.

You will find once you begin tracking, measuring, and managing your money that it's very empowering. When you know how much you have and where you're headed, you begin to feel like you're in control of your own financial destiny. It's a great feeling, and it motivates you to keep doing it. Hence the term, "Profit Motive".

Plan for profits – Profits are the "seed corn" of your future. What that means is this: although money doesn't grow on trees, it does grow if you gather up some seeds and plant them. Those seeds are your financial future. People who manage their money successfully get control of their numbers and finances early on and discipline themselves to stick with it. They make sure they don't spend more than they earn, and they save their profits. They turn their profits into assets, and build them up over the years until they reach a point where they no longer have to work to sustain themselves.

Use your budget to make sure it costs you slightly less to cover your living expenses than you bring in each month, and start making a profit. Put your profits in a savings account at the bank and don't touch them. The bank will pay you interest for keeping your money with them, and your money will begin to grow. The seed corn profits you plant will begin to produce more seeds. Your money starts making money for you. If you keep adding your profits to it while it's growing, the effect is multiplied. Money that is earned by your profits will begin earning money. It's interest earning interest. That's called **compounding**. The goal here is to grow and compound your money over the years to a point to where it is earning enough money to pay for all of your monthly living expenses. You will then have the freedom to not work any more if you don't want to. You can retire and/or do something you love. If you start banking your profits early and often, that time will come sooner than later. If you make mistakes and lose it all, start over. It's never too late to start over. Financial freedom in the USA gives you more personal freedom than anywhere in the world. It's a freedom worth starting over for.

How the financial world measures everything

Risk – It measures you, & you should measure it. Understand that when you're considering doing anything with your money, **you're gambling**. You're taking a risk with your money whether you're buying a kitchen appliance or investing in the stock market. The risk you're taking is whether or not you stand to lose any of your money or make any money in any financial transaction. In most of your every day life, however, risk is low and you generally get the value you pay for. It's the larger transactions that carry the most risk of loss.

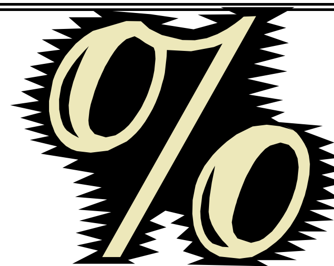
When you are attempting to borrow money or finance anything, any lender or creditor is going to analyze your financial profile to measure their risk and reward of doing business with you. Almost all will check your credit, and many will verify your income and your assets as well. The larger the transaction, the more information you can expect they will want to see. They'll want documented proof from you and possibly from third parties because they've been lied to before and will no longer take anyone's word. The more solid and reliable you look on paper, the lower risk you appear to the creditor and the better your odds of getting what you're asking for. If you appear slightly risky you can expect to pay a higher rate of interest. If you appear too risky, they probably won't do business with you.

The financial world measures everything as a **risk/reward ratio**. The lower the risk of losing money, the lower the reward (or profit) there is. The higher the potential reward there is the higher the risk of losing money. When you're trying to borrow money for any purpose, you are measured for risk by the system. When you're investing your money, it is up to you to determine how much risk of loss you're willing to take versus how much potential reward there will be. You must each decide if something is a safe bet or not, depending on your tolerance for risk.

To give you a brief idea, here's a list of places to put your money from low risk/low reward to high risk/high reward:

Savings account	- Lowest risk, lowest reward (interest earned)
Certificate of Deposit (CD)	- Low risk, low reward
Money market fund	- Low risk, low reward
Bonds	- Slightly higher risk, slightly higher reward
Real Estate	- Slightly higher risk, low reward short-term, higher long-term
Mutual funds & ETF's	- Medium risk, higher reward over time
Stocks	- Medium high risk, higher reward
Gambling casinos	- Extreme high risk, high reward (but heavily against the odds)

There are plenty of others, and it's up to you to learn about them. Low risk/low reward means that the odds of you losing money are small, but the amount of money your money can earn is small, too. If you put your money where it has a chance to earn more money, your risk of losing some or all of the money you put in goes up as well. The less you risk, the less you gain, and the more you're willing to risk, the more you have the potential to gain. The less money you have, the less you should put at risk, and the more money you have, the more you can typically afford to lose. The numbers will be different for everyone depending on each individual's situation. No matter what, though, **never risk more money than you can afford to lose**.



Percentages – Percentages are used to measure a particular part of a whole. Using them is the easiest way to measure financial progress, failure, gain and loss. The entire financial world uses percentages to measure everything. Get your mind around percentages and learn how to calculate the easy ones in your head. Knowing how to do that quickly will put you in much better position in your financial transactions throughout your life. You'll be able to more quickly identify if someone is simply making a fair profit for doing business with you or ripping you off. You'll also be able to more easily measure risk. Percentages are expressed as interest rates, fractions, ratios, rates of return, odds, etc.

When you borrow money or obtain credit, you will pay a certain rate of interest set by the creditor on the amount you owe. When you invest your money, you will be able to earn a certain rate of return on your money depending on where you invest it. The easiest percentage to remember, and the best one to know how to calculate quickly in your head, is **10%**. Ten percent is one tenth of something, or one out of ten. Ten percent of 100 is 10. Ten percent of 50 is 5. Ten percent of 10 is 1. It's an easy number to figure, and if you know how to calculate it, it makes it easier to calculate other percentages as well. For example, if you need to figure out 20% of something, find 10% first and double it. So, if 10% of 50 is 5, twenty percent is 10.

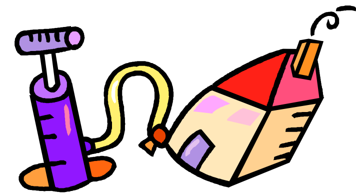
As a general rule, always try to **pay less than 10% on money you borrow**, and always **seek to make up to 10% on your investments**. Paying more than 10% on borrowed money tends to favor the lender over the borrower. Historically, most investments rarely earn more than 10% per year, and many earn less on average. Seeking a return of higher than 10% on your investments is usually very risky, and is more like gambling than investing.

Taxes, Government, the Economy, the Financial System, Interest rates, and Inflation – What you should know

Nothing that comes from the government is free. Whether it's the city, county, state, or federal government, everything the government does, and everyone who works for the government, is paid for by you and me. We pay for it all by paying taxes of many different kinds. **Taxes are everywhere.** We pay taxes on everything we earn, everything our money earns, everything we buy, and everything we sell. The government has no competition and no profit motive, so there is no mechanism in place or incentive for it to improve the quality of its services or lower its costs. When the government spends more money than it brings in from our taxes, it borrows money by selling IOU's to investors and foreign governments in the form of Treasury notes and bonds, and we taxpayers pay that money back plus interest. Currently, the federal government owes nearly **$11 Trillion in IOU's**. That's nearly $37,000 for every man, woman and child in the United States. We will have to pay it all back eventually with our taxes. If any of us or any of our businesses managed money the way our government does, we would have all gone bankrupt long ago. Try not to manage your money the way the government does, and vote for those who promise to try to be more responsible with our money.

The government is not the economy, nor does it directly control the economy. **We the People are the economy**. The money we earn, the money we spend, and the money we invest both as individuals and as businesses are collectively measured in many different ways, and those measurements constitute our economy. The government can only influence us (and the economy), but as of yet it still does not control us.

Our banking and financial system is not the economy, either. But without it, our economy would struggle to continue functioning. If you think of our economy as a house, then our financial system is the plumbing. When it is working well, our economy can function properly. If it breaks down or functions poorly, then our economy suffers as well. The financial system is everything that involves credit, lending, saving, investing, and the flow of money. It's the most efficient and sophisticated financial system in the world.



Inflation is a monetary phenomenon that we all have to pay attention to because it affects all of us. Inflation is a combination of the rising cost of goods and services and/or the declining value of money. When more money is created and pumped into the system, the value of money declines and prices for everything rise. We need a small amount of inflation in order to grow our economy, but if the economy grows too fast, it can overheat and cause runaway inflation. Because money can be created, in a sense, by borrowed money, one of the most effective tools to slow the economy down (or speed it up) is by adjusting interest rates. If the cost of borrowing money to expand and grow a business gets too expensive, then there will be less borrowing and less growth and expansion; inflation slows down as a result.

The United States Federal Reserve Bank, or the Fed for short, is the institution charged with controlling inflation in our economy. They set the **interest rate** for money they loan to the biggest banks in the country on an overnight basis, and it's called the Fed Funds Rate. They also set the rate the banks charge each other for loans made between them day-to-day as well. From there, the banks set their Prime Rate, which is the rate they charge to their biggest and best customers (borrowers). The Fed Funds Rate is the primary benchmark against which almost all interest rates of any kind are determined.

Most lending institutions are also in the business of borrowing. They borrow money at a lower rate and lend money out at a higher rate. The difference between the two is where they make a lot of their profit. When the Fed raises rates to fight inflation, everyone else raises their rates so they can continue making a profit. But because it causes the cost of borrowing to rise, businesses and individuals slow down the amount they borrow to save money, and the economy slows as a result. If inflation is in check but the economy is slowing, the Fed will lower rates to stimulate lending and growth. Interest rates are used as the brakes and gas pedal of our economy. (Taxes going up and down have the same effect as well.)

The Ultimate Goal – Becoming financially independent

If you have generated a consistent monthly income, constructed your budget to keep your expenses below your income, made a monthly profit, and turned your profits into assets, you have become financially self-sufficient. Now comes the fun part. To maximize your profit potential, minimize your risk of losing money, and begin building your path to financial independence, you will need to educate yourself as to the different types of investments available and understand their respective risks of loss. There is an enormous amount of information available on a wide variety of investments almost anywhere you look. Learn about them thoroughly before you invest any of your hard-earned money in them. Here's a brief overview of the kinds of investments available:

Stocks – Stocks are something just about everyone has heard of, but not everyone understands exactly what they are. When a business or corporation gets as big as it can on it's own but still wants to get larger, often it will need to raise money to grow. It may choose to "go public" by selling shares of ownership in the company. A single **stock** represents a single **share** or piece of ownership in the company. The company may sell thousands or millions of shares, depending on the size of the company. When people buy shares of stock in a company, they get a piece of ownership in the company and the company gets the cash. From there, the owners of the stock get to share in the profits of the company for as long as they own the stock.

There are two primary ways the owner of the stock can make money. The first is that as the company grows in profitability, the price of the stock grows as well. So a stock purchased at $10 per share can grow over time to be worth a much higher amount in the market place. This type of stock is normally called a **growth stock**. The second way is when a company chooses to pay out its profits to its shareholders on a regular basis during a given year, usually on a quarterly basis (once every 3 months). They calculate their profits, divide them by the number of shares, and pay an equal amount per share to all of the shareholders. This payment is called a **dividend**, and this type of stock is typically called an **income stock**.

Either way, there is no guarantee that the companies in which you own stock will always be profitable, so it's possible to lose some or all of the money you invest if the stock prices fall. That's the risk you have to assess on your own.

Bonds – Bonds are a type of **debt you can invest in**. Treasury notes and bonds, municipal bonds, corporate bonds, mortgage-backed securities, junk bonds, church bonds, and many other types of bonds are all used as a different way for those entities to raise money. But instead of selling shares of ownership, they are simply borrowing money. Any entity that sells bonds to raise money promises to pay back all of the investor's original investment plus a guaranteed rate of interest. Bonds are considered a safer investment than stocks because you are guaranteed the return of your original investment plus interest, but they typically don't earn as much as stocks, either. As investments, these are commonly referred to as **fixed income securities**, because they offer a fixed rate of return on the investment.

Mutual Funds and **Exchange Traded Funds** (ETF's)– Mutual funds are ways to invest in stocks and bonds with lower risk. The money you invest is pooled with thousands of other peoples' money into a giant fund, and a fund manager actively buys and sells many different stocks and/or bonds with the money. Since the fund invests in a variety of things, the risk is lower than investing in a single company. ETF's work the same way, but they are bought and sold as stocks, and the stocks own shares in a variety of other investments.

Real Estate – Investing in real estate in the U.S. has created more millionaires by far than any other type of investment in the history of our country. However, the days of buying real estate with no money out of your pocket were short lived and are now likely long gone (unless you're a military veteran). Lenders will want you to have some "skin in the game," because statistics clearly show that those who invest a good chunk of their own hard-earned money into a home are far less likely to default on their mortgage if times get tough than those who have little to no money invested. Buying real estate is typically the largest single financial transaction most of us will ever make. It will take a minimum of 3% to 5% of the sales price of a home for you to invest (as down payment and closing costs) and possibly much more before you can borrow the amount needed to buy a home to live in. Buying real estate as an investment will take a cash investment from you of at least 10% and up to 25% of the sales price.

What to expect and what to watch out for - The above descriptions barely scratch the surface of what you will need to know to invest and grow your money. Learn everything you can about investments…read, watch the financial news, and ask questions. Also, keep the following information in mind:

Since the stock market's inception over 200 years ago, the **average rate of return** (profit) on money invested has been **10%** per year. Many years it has been less, and many years it has been more, but the average over time has been 10% per year.

The **average rate of appreciation** (growth in value) of real estate in urban and suburban areas over the years has been between **3%** and **6%** per year. In some areas it has been more for a time, and in others it has been less for a time, but the overall average has been between 3% and 6% per year.

These averages are important to know so you will have a benchmark to tell if an investment is too good to be true or not. Although there are some investments that can earn higher returns than those above, history shows that those kinds of returns are rarely sustainable for more than a few years at best. Any investment that promises higher returns per year than the above are very likely to be part of a **speculative bubble**, a **pyramid scheme**, or a **Ponzi scheme**. A speculative bubble occurs when "everybody is doing it" which pushes prices and profits higher than their actual underlying value. This happens from time to time in both stock and real estate markets and typically ends in severe corrections in price and sometimes in outright crashes. Pyramid schemes and Ponzi schemes are fraudulent investment schemes that promise a very high rate of return on investments and are riskier than gambling. Look them up if you would like to know more. In any case, just about any attempt to "get rich quick" will likely end in the loss of your hard-earned assets.

If you start early, stay focused and disciplined, build and grow your assets and profits over time, maintain good credit, and minimize your debts, you will have positioned yourself to eventually become financially independent. **Financial independence** is the point where your money is earning enough money to pay your monthly living expenses each month, and you **no longer have to work** to support your lifestyle. This point will be different for just about everyone depending on each person's needs and desires, but it is a goal we all should strive for.

I genuinely hope you have found this information helpful, enlightening, and valuable. If you have, I'd like to invite you to go to the website www.moneyfundamentals.org and sign up for my blog that expands upon the information in this booklet. You also have my express permission and encouragement to give a copy of this booklet to any and every person you think may benefit from it. You're also welcome to visit the site frequently to see what new information we've posted and explore the links to other valuable resources. Good luck, God bless you, and may God bless America!