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"The Seven Simple Secrets of Financial Independence"

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In this article, I will show you the Seven Simple Secrets of Financial Independence. Next year, 1996, will mark my 25th anniversary as a personal financial advisor. My idea of an advisor is to be a guide, or teacher. And I believe to be a good teacher, one must always continue being a student. Over this 25 years, I have been an avid student -- I've done a lot of reading, taken over 1000 hours of continuing education, observed what works and what doesn't work. And I have tried out many of my theories myself. I think one reason I am such a good advisor is that I've systematically gone through life and made most of the mistakes myself!

Over this time I've mostly learned from my clients - I've seen some clients become incredibly wealthy; others I've seen slide downhill financially. Most clients however at some point in our relationship make a dramatic shift that enables them to somehow break free from the anxiety of financial failure and achieve peace of mind. Peace of mind comes from knowing that you have enough, or will have enough, to provide for yourself and be financially independent.

Recently I've decided to try to distill from my experiences in working with clients the seven key concepts that successful clients have in common. Before detailing these here, I want to review with you what I call the Cambridge Life-Cycle. We introduced this concept to our clients in the 1995 newsletter. But for those of you who may not have read it I will review it briefly now so you will have some context to see how these principles apply to you at your stage of life.

Cambridge's 10 Stages of the Financial Life-Cycle

The Cambridge Life-Cycle divides our life into ten typical financial stages that most of us go through. There are specific strategies that apply to each stage and definite markers that delineate the end of one stage and the beginning of the next. While I will refer to general age ranges, there is a wide variance in ages at which individuals pass through these stages, so don't start thinking that you are hopeless if you re not in the stage that others are in at an earlier age. Also, don't start gloating if you are in a more advanced stage for your age because frequently individuals who are more advanced at one stage end up falling behind later. "Pride cometh before the fall..."

Life-Cycle Stages #1 & 2: Infancy and Early Childhood

We start at infancy then Early Childhood. During this stage we generally believe that money is to eat - and we learn that it is not a sound financial strategy (or a healthy habit) to eat money. From about 6 years old to about 12, we usually learn the relative value of money, for example that dimes are worth more than nickels even though they are littler, and that a quarter buys more than a dime. If we have financially functional parents, we will also start learning at this stage the rudiments of financial accumulation -- that it is good to save money in a piggy bank. It is worth noting that our basic belief systems about money are usually formed during this period, which we will refer to later.

Life-Cycle Stage #3: Teen Years

From about 12 to 19, the Teen years, we start learning how money makes money - that is how money earns interest, how to make money by buying something and then reselling it for a profit, and how work is rewarded with money. Often at this age, children can get sidetracked with the idea of earning their own way. Because they are not sophisticated enough to understand the cost of supporting oneself, they may think they can just go to work at McDonalds and make enough money to live happily ever after.

Life-Cycle Stage #4: Laying the Foundation

From about 20 to 30, we enter the stage we refer to as Laying the Foundation, when we start being completely self-supporting. During this stage it is key to accomplish the Five Fundamentals of Fiscal Fitness -- like buying a house, saving 10%, etc., some of which we will cover later. It is not all that unusual for some people to never really get past this stage because they basically haven't grasped the concept of what it is to be financially independent, and what it takes to get there.

There are three basic ways to get money: the first is by affiliation - you marry it, inherit it, or are given it. It's common to think that this is the easy way to wealth, but in my experience it seldom is, and money obtained this way seldom lasts because the recipient hasn't learned the basic concept of how to invest money. Thus a fool and his money are soon parted. The second way to get money is to earn it by the sweat of your brow. While this is honorable, most people yearn to get to a point in their life where they can do what they want to do, what is self-actualizing for them, without having to worry about how much money they make. This brings us to the third way to make money, which is what financial independence is all about, which is to let your money make money for you. This requires saving and investing enough so that at some point you have enough money so that the money your money makes will enable you to do whatever you want to do. Understanding this goal of financial independence is crucial for clients to get beyond this stage.

Life-Cycle Stage 5: Early Accumulation

At the point, usually between 30 and 40, that our net worth exceeds our annual income, we move into the Early Accumulation stage. This is where basic investment begins and we teach clients how to diversify their assets.

Life-Cycle Stage 6: Rapid Accumulation

At some point, usually between 40 and 50, when our net worth is 3 times our annual income, we reach the point at which the income from our investments exceeds our annual savings. At this point we move into the Rapid Accumulation stage and our net worth tends to increase exponentially.

Life-Cycle Stage 7: Financial Independence

Once our net worth has grown to between seven and ten times our annual income we pass on to the stage of Financial independence, usually between ages 50 and 60. At this stage we have options - the option to change jobs, or semi-retire, or have a mid-life crisis. We can use part of the income from our investments to subsidize our living expenses so that we don't have to work full-time at a job we don't really like.

Life-Cycle Stage 8: Conservation

When our net worth is ten to fifteen times our living expenses, the earnings from pensions are usually adequate so that we don't have to work at all - we call this retirement stage the Conservation stage.

Life-Cycle Stage 9: Distribution

If we continue saving, we eventually reach the point where our net worth exceeds 15 times our annual expenses. At this juncture we are faced with the reality that we have more money than we could possible spend in our lifetime and enter the Distribution stage -- this is where we start gifting money to charities, set up endowments, and start giving it to our children.

Life-Cycle Stage 10: Terminal

The Terminal stage comes when we have less than 12 months to live, and we try to provide for the orderly distribution of the bulk of our assets.

The Seven Secrets of Financial Independence

Understanding these ten basic stages of the financial lifecycle is useful in applying the seven secrets of financial independence -- are we ready?

Simple Secret #1: Fund Your Future First!

1. Fund your Future First! What this means, in a nutshell, is to always save 10% of your earned income. Indeed the most important thing you can teach your child, after they understand that they should not eat money, is to put aside 10% - a dime on every dollar - of everything they earn. Funding your future first also means reinvesting your investment earnings until you are financially independent. A corollary of this secret is that the money you save when you are young is worth much more than money saved at a later age. This is because of the miracle of compounding.

For example, let's say Jane saves $2000 per year for five years starting at 25, and leaves the money invested at 10% until she is 65. John starts saving $2000 per year at age 35, but keeps on saving for thirty years, leaving it invested at 10% also, until he's 65. At age 65, Jane will have more money than John. Keep in mind that if Jane had continued to save $2000 per year, she would end up with over a million dollars! That is the miracle of compounding.

But there is another reason for always saving 10% of your income, even after you have retired. The number one reason that people get into financial difficulty is this: they have established a pattern of living beyond their means. Occasionally someone gets into financial trouble because of medical bills or legal expenses, but even then often these events have the effect of pushing them over the edge because they have been consuming more than they produce. And one of the terrific benefits of always saving 10% is that you are then, by definition, always living within your means.

Continuing this practice after retirement means that you will never run out of money and the resulting growth in your nest egg helps offset inflation.

Simple Secret #2: Don't Mortgage your "later" to pay for your "now."

2. Don't mortgage your "later" to pay for your "now." About 15 or 20% of new clients who come to us are over their heads in debt. I'm not talking about the mortgage on your house, because your house will outlast your mortgage. Taking out a 20 year education loan is OK, because your education will last a lifetime. Even taking out a 3 year car loan, if that's the only way you can afford to buy a car, is reasonable.

But running credit card balances month after month is not only devastatingly expensive, it is also a sure sign that you are living beyond your means. Using credit to finance a vacation or clothing or groceries means that you are in truth buying something you can't afford. You are trying to be someone you're not. You are not living in integrity with yourself.

Interestingly, I often hear the excuse that "I'm not really spending too much money. I can't afford to save because I have too many bills!" It's as if the bills appeared by spontaneous creation. If you have too many bills, it's because you are spending more than you make. And the only solution is to get rid of the credit cards for at least 6 months.

A corollary of this principle is to never pay more in interest than you are earning on your investments. We usually recommend that clients don't pay off their mortgages at an accelerated rate, because their mortgage interest is deductible and unless they are in a very low bracket with very conservative investments, the after tax return on their investments is more than the after-tax cost of their mortgage.

This however does not apply to credit card debt. We always insist that clients start saving 10% instead of using the money to pay off their credit cards sooner. This is not logical, I admit. But as either Teddy Roosevelt or Gloria Steinem said (I can't remember which, but it was one or the other): "If this was a logical world, men would ride side-saddle!" If you are loaded down with credit card debt, the reason you have so much of it is that you are so good at paying it back. The reason you have no savings is that you're not good at saving. The only way to break this cycle is to start saving while you pay off the debt.

Simple Secret #3: Money is a Mind Matter

3. Money is a mind matter. Living within your means does not necessarily mean spending less. That balance is usually more easily achieved by earning more. Most people here I think would agree that it is easier to earn an extra hundred dollars a month than it is to cut a hundred a month in expenses. Most of us don't live up to our earning potential because of dysfunctional money belief systems.

These are some of the most common dysfunctional money beliefs. These beliefs are usually formed in childhood, and are strong subconscious barriers to charging others what we are worth. One key concept, for example, that is foreign to many self-employed people in the helping professions, is that money is how we value things in this society. In childhood some of us, for various reasons, concluded that if I make money, I am taking it away from someone else and thus making them poor. If you believe this, you will always feel guilty about charging higher fees, and will forever be trying to decide what is the "fair" rate for you to charge. Trust me on this: the fair rate for your services is the highest rate you can possibly charge that enough people will pay to keep you as busy as you want to be. (Repeat.)

Moreover, if you charge less than that, i.e. less than the market will bear, your services will be discounted by your clients and they will not get the full value you have to offer. Anyone who has done pro bono work for indigents knows how often this is true. When others are not charged what a service is worth, they show up late or skip appointments, do not follow through on your advice, and never really get the benefit of your professional advice.

It is not about taking their money away from poor people; it's about them spending their money on what is important to them. Poverty is a state of mind. The lack of money does not cause poverty; it is the poverty mentality that causes or results in a lack of money. Surely our government programs have amply demonstrated over the last 30 years that giving poor people money does not reduce poverty. If you give a poor person $10,000 or $100,000 today, in a year they will likely be poor again because their values are based on a poverty mentality and they spend their money on those things they value. This may be cigarettes or booze or drugs or flashy cars - but the basic dysfunctional belief system of poor people is that money is to spend. With that belief system it is impossible to save money or defer immediate gratification and spend it on things that have a long term payoff, like education.

The other side of this coin is that wealth is also a state of mind. Real wealth is not about how much money your have. Rich people with dysfunctional beliefs think their value is measured by the bottom line of their balance sheet. I have clients worth 2 or 3 times what I'm worth who think of themselves as poor, because there is always someone richer than they are; others with a fraction of my net worth are at least as wealthy as I. Wealth is the result of being properly valued in your society, and being paid accordingly, and then living within your means and saving enough to provide for your future. The key to financial independence is knowing how much is enough.

Simple Secret #4: Money is Money

4. Money is Money. When we were children, most of us learned some variation of the envelope system of budgeting money. This envelope is your lunch money, this one is for holiday presents, this one is for a new bike or vacation. This is very comforting psychologically since we know that we have planned for our needs. And this may still be useful for some people when budgeting for short term needs, but it is not a useful tactic for investments, which are by definition long term.

I am convinced the idea of setting up separate investments for college planning, retirement planning, nursing home expenses, estate taxes, and other long term objectives was devised by life insurance agents as a way to make people feel guilty about not having enough permanent life insurance. The plain simple reality is that, when you are investing money you should invest it in the most efficient vehicle; when you need money you take it from the most efficient source. It does not make any sense to buy a life insurance policy or a mutual fund for your child, and not be fully funding your 401(k) or TSA. Or to be making extra principal payments on your house and not funding your SEP or Keogh plan to the max. When your kids go to college, you may be able to pay for it out of current earnings, they may get a scholarship, you might borrow against your 401(k), take out a home equity loan, or gift them stock to sell at a lower capital gains rate.

Similarly, retired people frequently become preoccupied with the adamant belief that their investments must produce income. Generally it is much more advantageous to structure a portfolio to include investments that provide growth and are tax efficient, like mutual funds, even if they don't provide income. It is easy enough to periodically sell off enough to provide for the desired amount of cash flow, and your portfolio will be more productive and you may be able to cut your taxes substantially.

Simple Secret #5: Be an Investor, Not a Trader

5. Be an investor not a trader. The difference between an investor and a trader is this: the investor invests for the long term; the trader seeks profits by exploiting short-term swings. Traders are full time professionals; they spend all day everyday buying and selling. You cannot win in that game.

Trying to time the market is the worst mistake an investor can make because you give up the biggest advantage the investor has: time. The most frustrating question I get asked is "where do you think the market is headed?" I usually reply "I don't know which way the next 20% move will be, but I do know which direction the next 100% move will go!"

Most of us are aware of the massive restructuring process sweeping across America today. Fundamental changes are being made in how cars are made, medicine is practiced, in banking services. These have diverse causes ranging from foreign competition to government intervention to computerization. Our industry is also undergoing a complete restructuring. I believe this was set in motion about 20 years ago with the change in the way pensions are funded.

Employees used to depend on defined benefit pensions - you work for ABC company for 30 or 40 years and you get X amount of pension. Because of the prohibitive cost of these pensions, and the increasing disenfranchizing of a mobile work force who don't stay employed at one company for a lifetime, there has been a massive shift to defined contribution pensions. This means it is largely up to you to fund your own pension, so tax deferred 401(k), TSA's, SEP's and Keoghs have mushroomed. Along with this there has been a corresponding explosion in awareness and involvement in investments by the average citizen. Because you have to make your own decisions on how your pension is invested, you have learned how mutual funds work, how rates of return are measured, etc.

This has led on the one hand to a marked decline in the traditional commissioned based advisor, because now people understand how much commissions they are paying. On the other hand there has been a whole new self-help industry spawned to advise the layman about investments through newsletters, magazines and TV programs. Unfortunately, these sources have a built in bias to emphasizing the short-term activities of the financial markets. A wise investor knows that these short-term moves in the market are only relevant to traders, not to investors.

Of course investors take into account market trends. For an investor to insist he never times the market is like the guy who insists he only reads Playboy for the serious articles. If you try to make a killing in the market, I can assure you: you will lose. The best thing that can happen is that you lose your money on the first trade. The worst thing that can happen is you make money the first time, because then you will think you know what you are doing. As Confucius said, the Gambler is born of his first win. So what if you've made a bundle this year on the market: everyone did! Don't confuse genius with a bull market.

Simple Secret #6: Cover Your Backside -- Diversify.

6. Cover your backside -- diversify! We have all learned the wisdom of the old adage "Don't put all your eggs in one basket!" It's just that we have a real problem with the practical and inevitable results of that approach in our investments. A well diversified portfolio means you will always have something going up in value, but it means you will also always have an investment going down.

The investor who believes that bonds are the best and only investment for a portfolio, or one who believes that bonds are foolish and only stocks make sense, are both courting very high risk exposure. It is diversification among stocks, bond and real estate, long and short term, US and foreign that lowers the risk of the total portfolio and enables investors to take risks on individual investments which would be too risky by themselves.

Last year, in 1994, we were all shocked at how badly our bond investments got hammered, and were so proud to have had the foresight to have those great international holdings. This year our international holdings, even though they did better than last year, look like dogs compared to our blue chip holdings.

They key is to stay the course. We all have a tendency to shoot where the rabbit was. To try to move everything now into blue chips, or into technology stocks (the darling of '95) is folly. Diversification is the best strategy you have to reduce your risks in volatile financial markets. Your asset allocation should be determined by your stage in the financial life cycle, your risk tolerance, and your tax situation, not by whatever asset class was hot last year.

Simple Secret #7: Build on Your Successes

7. Build on your successes. The final secret I have to share with you is to build on your successes. The most critical points in your journey to financial independence come at the transition points - when we move from one stage to another. Sometimes this transition comes as a part of the natural growth process, but often it is the result of some life trauma: a death, divorce, disability or job loss. When beginning each new stage, our goals have to be reevaluated; our belief systems need to be re-examined; our strategies must change.

I personally think that it is at these transition points that we, as personal financial advisors, add the most value. Indeed, most new clients come to us when they are in the midst of a transition, or want to be able to move forward.

Frequently for clients, these transition points are marked with anxiety and confusion. They are not sure what they really want, or what they can realistically expect, or how to go about achieving it. I believe that a formal goal setting session is central to this process.

It is easy to think that we can rearrange our lives to eliminate all the awful problems we have to deal with. In truth, I have never known this to occur, except perhaps after death. The temptation is to completely break with our past, and start a new business. Or, for the successful entrepreneur, to start another business. We tend to believe that if we are good at one thing we can be good at anything. Or that if we were only our own boss, we would solve all our problems.

What is more likely to happen, however, is that we trade one set of problems for another and discover too late that we were better equipped to deal with our old familiar problems than with our new ones. Or in the case of the person who retires too young, we get rid of our big problems but end up feeling useless and irrelevant and so we make our little problems into big problems.

The key I have found is to build on your past successes, rather than start all over. Look at the strengths you have developed and the knowledge you have acquired and find new ways to utilize those in a new environment. If you want to start a new business that you have never been in before, take 6 months or a year and work for someone else first in that business. At least then you will find out if you even like it, and you can make your mistakes at their expense, plus perhaps learn something form their mistakes - and their strengths.

Most of all, it is important to see these transitions as growth, as whole new opportunities rather than with a sense of foreboding. It is not change that causes the pain, it is the resistance to change that causes pain.

Over my 25 years, I have seen clients devastated by these transitions; as a matter of fact I have personally botched a few of them myself. But I have also seen new lives take root, blossom with new possibilities and produce tremendous rewards when these transitions are made constructively. And as some of you who know me well can confirm, I have experienced the upside of this growth.

These seven secrets delineate the path to facilitate our growth, not to become unbelievably rich, but to have real wealth.

The Seven Secrets again are:
1. Fund Your Future First!
2. Don't Mortgage your "later" to pay for your "now."
3. Money is a Mind Matter
4. Money is Money
5. Be an Investor, Not a Trader
6. Cover Your Backside -- Diversify.
7. Build on Your Successes

I hope that this sharing of these secrets will help you navigate the transitions in your life. If you would like more information on how a Cambridge Advisor in your area can help you on this journey, please see our information page.