Top 10 lessons in personal finance

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Johanna Gornitzki

What do you think of when you hear the word 'ISA'? While most would know immediately that it's a tax-free savings account, an astonishing 15% of 18-to-24-year-olds think it's an iPod accessory, while 10% believe it's an energy drink, according to a recent survey by Scottish Widows.

Given this lack of financial awareness, it's not surprising that many young people find it hard to make the right decisions when it comes to their finances. But it's not just youngsters who are guilty of making mistakes with their money. Most of us, at some point in our lives, have squandered money on a pointless insurance policy, made a dud investment or been hit with a surprisingly large tax bill.

So, in the interests of better financial education, and to help you protect yourself from making some of the most common money mistakes, *Moneywise* takes your finances back to school with its top 10 lessons in personal finance.

Lesson one: Learn to live within your means

According to uSwitch, a mind-boggling 4.8 million adults in Britain currently spend more than they earn, and another nine million only just break even at the end of each month. While it's nice to treat yourself to a weekend away or a new car, living beyond your means is not sustainable - and this will become even more apparent in the coming months as household bills continue to rise.

"We're about to go through a recession, so people will have to start saving and pay off their debts. If they don't do that, they'll be in for a shock," warns Mark Dampier, head of research at IFA Hargreaves Lansdown.

If you find yourself going overdrawn every month or your credit card bill is growing bloated, it's time to go back to basics and write a budget. Once you know how much you have coming in every month and how much you need to shell out on regular expenses like food, mortgage or rent, and bills, you'll have a better idea of how much you can afford to spend on enjoying yourself. And if you're tempted to borrow, stop and think first about how and when you'll pay it back.

Lesson two: Don't save when you have debts

Saving money can make you feel good. But if you've got a big credit card bill hanging round your neck, pumping all your spare cash into a savings account is unlikely to be the best use of your money. Even if you're earning 5% or 6% on your savings, with interest rates on credit cards typically around 15% to 20% (or 30% if you have a store card) it doesn't take a mathematician to see that you would be better off clearing your debts first as they'll be growing at a faster rate.

Take a typical credit card balance of £1,812. According to uSwitch, if you just paid the minimum balance of 2% each month, with an APR of 18.33%, it would take you 29 years to clear the bill and cost you £2,857.55 in interest. So it makes sense pay off as much as you can every month. Even by stepping up your repayments to just 3% you would cut the repayment time and your total interest cost almost by half.

Of course, it's sensible to have a small emergency fund, but once you've put that away, you should concentrate on paying off your debts.

Lesson three: Financial advice isn't as expensive as you might think

There are many areas of financial planning that are easy to do yourself, but there will always be some areas, such as tax, pensions and mortgages, where professional advice can be incredibly useful. But while a lot of consumers assume they can't afford to see an IFA, this needn't be the case.

All IFAs offer a choice of payment options. This will either be a fee or they will earn a commission based on the products they sell, so you don't have to pay a penny. The rules regulating IFAs mean they do have to justify every product they offer you, nonetheless many consumers are more comfortable paying a fee as it guarantees that their IFA won't factor his or her commission into the advice.

Even if you do pay a fee for your IFA, you could still save money in the long run. Peter Chadborn, principal of IFA CBK Colchester, says that nine out of 10 of his new clients come to him having bought the wrong product. "I had a couple who came in with two life and critical illness insurance policies, for example. Only one was a guaranteed policy [if you have a reviewable policy your premium is likely to increase with time] and both of them only covered 13 critical illnesses. The monthly premium for both was £45. We found them a new policy, which offered a guaranteed premium and covered over 30 illnesses, for a total of £28.74 per month - a saving of 36%."

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Lesson four: Tax planning isn't just for the rich

UK adults will pay more than £9.3 billion in unnecessary taxes this year, according to IFA Promotion's latest Tax Action report. Given how much we all hate paying taxes, Alan Phillips, divisional director for financial planning at Brewin Dolphin, says, "it's surprising how many people don't look at what they can do to mitigate their tax burden".

While tax planning may sound daunting, there are plenty of things the average person can do to reduce the amount of tax they pay. If you have savings, you should make sure you use your ISA allowance as all interest will be paid tax-free. If you're a couple, remember that you have two allowances that you could use.

If you aren't a taxpayer, double-check that you aren't paying tax on your savings. If you discover that you are, HM Revenue and Customs or your bank can provide you with a form (R85) to complete to rectify the situation. It's also worth checking that your tax code is correct and you're receiving all the tax credits you're entitled to, as well as making sure your home is in the right council tax band.

If you suspect you might be above the inheritance tax threshold - that is, if you have assets, including your property, worth more than £312,000 (married couples and those in civil partnerships have a combined total of £624,000), it's worth speaking to an IFA about what you can do to prevent your beneficiaries being hit with a whopping tax bill. This might include re-drafting your will or taking advantage of the annual gift allowance - each year you can give away £3,000 to any individual tax-free.

It also pays to make sure that any life insurance policies are placed in trust so that death benefits don't form part of your estate.

Alan Phillips adds: "Everyone should tax-plan to ensure they make best use of any allowances, and their estate is best positioned to reduce any potential IHT liability."

Lesson five: Is a savings account the safest home for your money?

A savings account is safe in so far as you won't physically lose any money, but it doesn't necessarily follow that it's the best home for your cash. Not only is its growth potential limited, making it tougher to achieve your financial goals, but you could find that its value is eroded over time as inflation continues to rise.

Whether or not a savings account is the best option for you depends on what you're saving for - and for how long, says Annabel Brodie-Smith, communications director at the Association of Investment Companies. If you expect to need your money in the next five to 10 years, a traditional savings account will usually be the best place for it. However, if you have more time to play with, equities could be a better option.

While many savers see equities as high-risk, if you have time to ride out short-term market wobbles, your money should grow much faster than it will in a savings account. Brodie-Smith says: "Over the 10-year period ending June this year, a £1,000 investment in equities in the average investment company would have seen a return of £1,980. With a UK high-interest savings account, a £1,000 investment would only have given you £1,118."

If you have more than 10 years before you need to get your hands on your money, the gap between cash and equities is even wider. During an 18-year period, a UK savings account with £1,000 would have given you a return of £1,650, while money invested in equities would have risen to £4,456.

Of course, investing is never risk-free and you could end up losing some money, but if you choose your investments wisely (see lesson six) and build up a broad mix of funds, you can get better returns without taking too much of a gamble.

Lesson six: Don't follow fashion when investing

Scanning the Sunday papers you might well see an article recommending a great new fund, and wonder if should you invest in it. No, warns Paul Dickson, head of financial planning and wealth management at the accountancy firm Armstrong Watson.

"You shouldn't follow fashion when it comes to investing, because by the time an investment becomes popular it's usually time to sell," he explains. "Look at the property market, for example. Many UK investors followed the trend of thinking 'bricks and mortar' was the perfect investment, and they carried on investing in residential property even as the real returns from this kind of investment fell."

The best way to invest is to first work out your goals, how long you want to invest for, and your attitude to risk. You also need to make sure your portfolio is as diversified as possible - put all your eggs in one basket and you'll take a much bigger hit if that particular investment falters.

It's also important to be committed to your investments and to take a long-term view. When the market falls many private investors tend to panic and cash in their investments. But this is one of the most costly mistakes you could make as you could be cutting your losses at the worst possible time.

Peter Hicks, executive director UK retail at Fidelity, explains: "It can be tempting during times of stockmarket uncertainty to delay making investment decisions or to sell existing holdings in the hope of buying back in when values are lower. In theory, this is an attractive idea, but it seldom works in practice."

According to Fidelity, for example, if you had invested a £1,000 stake in the UK stockmarket in June 1993, it would have been worth £3,260.58 at the end of June this year. But if you had dipped in and out of the market and missed the best 10 days during this period, your investment would only have been worth £2,147.09. And if you had been unlucky enough to miss the 40 best days, your investment would be worth just £885.32- leaving you with a loss of £114.68.

Lesson seven: Ignore pensions at your peril

According to Met Life, a whopping 2.8 million homeowners are risking their retirement income by treating their property as their pension. Whether you have a buy-to-let or are planning to downsize, falling house prices could mean you get much less than you bargained for when you come to sell. Or if you were considering releasing some of the equity in your home, you might not be able to release as much money as you thought you would.

In the worst-case scenario, you could even find yourself unable to sell your property, leaving you with a house that no longer suits your needs and with no income to support you in retirement.

While pensions have had a bad press in recent years, Matt Pitcher, a wealth manager at IFA Towry Law, says: "A pension is still the most tax-efficient way of saving for retirement, as the government tops up your contribution by 20% or 40% depending on your tax rate. No other type of retirement saving gets this kind of overnight growth." If you're a part of a company scheme, you also have the added benefit that your employer may make monthly contributions on your behalf.

Lesson eight: It could happen to you

One in four women and one in five men will suffer a serious illness, such as cancer or heart attack, before they retire. Yet, despite these worrying statistics, few of us even stop to think about how we'd cope in that situation.

"Imagine the emotional state you would be in if you lost a loved one," says Peter Chadborn. "Then imagine on top of this that you could face financial ruin. Obviously, you can't prevent the former from happening, but you can prevent the latter."

Worryingly, half of the population would not be able to survive financially for more than 17 days after the loss of an income, according to research by Combined Insurance. And with household bills and personal debts continuing their upward march, people will find it even harder to cope. Policies like critical illness, income protection and life cover might not be the sexiest types of financial products, but they could offer you lifeline if disaster strikes.

It's worth protecting your mortgage and your income from the risk of death or illness - a good financial adviser will be able to recommend the right cover for you. Fully comprehensive protection may be expensive, but in this case something is definitely better than nothing.

Lesson nine: Loyalty doesn't pay

When it comes to personal finance, if you stick with the same products over the years, all the evidence shows you'll end up paying for it. Take savings accounts: Halifax, for example, is currently welcoming new savers with a tempting 6% on its Web Saver account, but those with older Halifax accounts don't get nearly such a good deal. If you have money in Halifax's Liquid Gold account, for example, you will be earning just 0.5% on a balance over £50.

The same goes for mortgages - stick with your current lender after your fixed or discounted rate runs out and you could see your interest rate rise by up to 2%. Likewise, the cost of your home and car insurance will go up each year whether you've made a claim or not. The key is to review all your financial services on a yearly basis, and switch if you're no longer getting a good deal.

Lesson 10: Read the small print

Reading the small print on any of the financial services you buy is unlikely to be the most enjoyable use of your time, but it could be the most valuable. Chadborn warns: "The consequences of not reading the small print could be greater than you could handle. What would you do if your insurance policy didn't pay out or your monthly mortgage payments turned out to be more expensive than you originally thought?"

Even with more straightforward products it's still important to know what you're signing up for. Some of the highest-rate savings accounts, for example, are likely to have strings attached, such as penalties for withdrawing your cash.

And while it's great that you can use your mobile phone while you're abroad, unless you read the small print and check the charges before you jet off, you could be hit with a surprisingly large bill when you get home.