Maximizing your Economic Happiness

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26 April 2010
What is Wealth?

What is wealth? How is wealth measured?
(also called net worth)
_patches

Wealth = Assets - Liabilities

Example: you have $10,000 in cash.
You owe $9,900 on credit cards.
Net worth is $10,000 - $9,900 = $100.

Economic Net Worth

Conventional Net Worth = A - L

What about human capital (HC)?

Human Capital is your asset which throws off labor income each year.

Economic Net Worth = CNW + HC

We can value Human Capital using the time value of money.
A Simple Example

Joe Blow, age 22
No assets, not married, no kids.
Joe earns $42,000 per year
Joe will work until age 66, then drop dead.
(No taxes, no transfers.)

A millionaire at age 22!
**Standard of Living**

- A measure of consumption of goods and services (per individual, household).

**Economics says you should maximize your sustainable standard of living, given your labor supply.**

**Earnings:** $42,000  
**Consumption:** $42,000  
**Savings:** $0  
(Live to age 66)
Another Example

Joe Blow, age 22

No assets, not married, no kids.

Joe earns $42,000 per year

Joe will work until age 66, and then live until age 85. How will he eat?

(No taxes, no transfers.)

Earnings: $42,000
Consumption: $36,380
Savings: $5,620 (live to age 85)
What is Savings?

Savings the process by which one converts human capital to financial capital.

- Human capital throws off income
- Savings = Income - Consumption

Financial capital = accumulated savings

Earnings: $42,000
Consumption: $36,380
Savings: $5,620  (Live to age 85)
Example, continued…

Joe Blow, age 22
No assets, not married, no kids.
Joe earns $42,000 per year
Joe will work until age 66, and then live until age 100.
(No taxes, no transfers.)
What are some of Joe’s possible consumption paths?

![Lifetime Consumption Profile]

**Earnings: $42,000**
**Consumption: $34,204**
**Savings: $7,796** (Live to age 100)
Standard of Living
Decreasing Annually

Lifetime Consumption Profile

- Earnings
- Consumption Spending

Standard of Living
Increasing Annually

Lifetime Consumption Profile

- Earnings
- Consumption Spending
How to Save?

“It’s so hard to have money left over at the end of the month. Usually I have month left over at the end of the money!”

Saving money is incredibly hard!
It requires delayed gratification!
(once upon a time frugality was a virtue)

Pay Yourself First

- The surest path to successful saving.
- Have a portion of your paycheck set aside for savings BEFORE it goes to your bank account.
- Spend the remainder after saving first.
The 3 Kinds of Savings

Everyone needs:

- An emergency fund
- Retirement fund
- Savings for Major Purchases

Set up your Emergency/Go to Hell Fund

- You need to save up a minimum of 6 months of expenses in an emergency fund.
- Start saving toward this on day 1 of your first job.
- Put the money into a bank CD or I-Bonds
Uncle Barack wants you to be rich!

**Series I Savings Bonds**
- Risk-free, inflation-protected
- Invest after-tax money
- No state or local taxes ever
- May defer taxes for up to 30 years
- No federal tax if used for education

**IRA, 401k/403b (Retirement Accounts)**
- Save *pre-tax* dollars now, tax deferred until you retire, pay taxes upon withdrawal

**Roth IRA/401k/403k**
- Save *after-tax* dollars now, no tax when you withdraw at retirement
How To Invest for Retirement

2 schools of thought:
Jeremy Siegal: “stocks for the long run”
Zvi Bodie: “you can’t handle the truth about stocks” -- buy TIPS

What you should do:
- invest in the market index
- Use mutual funds with the lowest expenses

Save for Major Purchases

- Save up in advance for major purchases (cars, vacations, down payment on house).
- Borrowing involves reducing future standard of living to pay for past consumption.
- When you borrow, you pay interest; when you save, you earn interest.
Everything costs more when borrowing.
Don’t Trust Anyone!

Be ware of Broker/Dealers, Financial Planners, Insurance Salespeople, etc.

- Most are looking to sell you products, but do not have your best interest at heart.
- Salesmen are “coin operated”
- Trust no-one; you alone are responsible for your financial security.
- Read everything and ask questions!

What If I need Some Help?

The National Association of Personal Financial Advisors (www.napfa.org) is an association of strictly fee-only advisors.

- Members take a fiduciary oath to act in your interest only
- Do not take commissions
- You get what you don’t pay for
What Can I do?

- Maximize your spending power
- Smooth your consumption
- Protect your living standard
- Price your passions

It’s the Living Standard, Stupid!

How should you maximize your economic happiness?

- Maximize your spending power
- Smooth your consumption
- Protect your living standard
- Price your passions
What About...

- going to college
- paying for college/grad school
- choosing your career
- choosing a job
- where to live
- whether to buy or rent
- paying taxes
- insuring
- getting married
- having kids
- investing
- retiring
- taking social security
- spending down your assets?

How can you maximize your standard of living?

EC 171: Personal Lifecycle Economics

EC 171 counts for CAS Social Science distribution credit.

Offered Summer and Fall 2010

See you then...
Want to Learn More?

- www.esplanner.com/basic - software which uses the lifecycle model to do financial planning
- “Spend 'til the end” by Laurence Kotlikoff and Scott Burns
- “The Only Investment Guide You’ll Ever Need” by Andrew Tobias
- “The Millionaire next Door” by Thomas Stanley and William Danko

And Now...

The Most Powerful Force in The Universe
What is Interest?

Interest is the rental fee for money.

The basic rule for loans and interest is if you use someone else's money, you pay interest.

The amount of the interest depends on the amount borrowed, the length of the loan (in years), and the interest rate.

The reverse works when you deposit money into a bank or buy an investment.

If they use your money, they pay you interest.

Interest and Future Value

Deposit $1000 at the bank, earn 10%

Future Value answers the question: What will some amount today be worth in the future?

Interest = 10% * $1000 = $100

FV = $1000 * (1 + 10%) = $1,100

Interest is the rental fee for money
Compound Interest

Interest year 1 = 10% * $1000 = $100

FV year 1 = $1000 + $100 = $1,100

If you redeposit the $1100 for another year?

Interest year 2 = 10% * $1100 = $110

Simple interest = $100

Compound interest = $10

FV year 2 = $1100 * (1 + 10%) = $1,210

Compound Interest

Interest (year 3) = 10% * $1210 = $121

Simple interest = $100

Compound interest = $21

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"The most powerful force in the universe is compound interest"