

Money Matters

by Suze Orman

The 12 Biggest Money Mistakes

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Avoiding costly money mistakes is one of the best ways to make more money -- each penny you avoid throwing away on a senseless move is a penny available for reaching your financial goals.

So if you do nothing else this year, please avoid making any of the following financial blunders.

1. Don't borrow from your 401(k) or 403(b).

It's a horrible deal. For starters, your 401(k) contributions are pre-tax. Your money will get taxed later on, when you withdraw the money from the plan.

But if you take out a loan, you're pulling out pre-tax dollars that you will then have to repay -- with money that has already been taxed. Then when you eventually retire and start making withdrawals, the money is going to be taxed again. So your loan gets taxed twice.



The payback period can also be a problem. You'll have to repay the entire loan in just a few months if you're laid off or take a new job. And if you don't have the money for repayment -- and you're not 55 or older -- the loan will then be treated as a withdrawal. That means a 10 percent early withdrawal penalty and income tax on all the money. Ouch.

Moreover, you're shortchanging your retirement savings. Reducing the money you have growing tax-deferred in a retirement plan is going to translate into having less money when you need it.

2. Don't use a home equity line of credit to pay off your credit-card debt.

This is a move that can end up costing you your home. Your credit-card debt is what's known as unsecured debt: There's no collateral the credit-card issuer can force you to sell to collect on your debt. A HELOC-like a mortgage and a home-equity loan is what's known as secured debt. Your home -- or more specifically, your home equity -- is the collateral. If you fall far enough behind on your HELOC payments, the lender can require you to sell the home to recoup the money you borrowed.

Besides, many people wipe out their credit-card debt by rolling it over into a HELOC -- and then run up new credit-card balances again. This puts them in a big fix: They have credit-card and HELOC debt.

You also need to be doubly careful with HELOCs in today's rising-interest-rate environment. In 2005 the average HELOC rate jumped from 5.62 percent to 7.25 percent. On a \$25,000 HELOC balance with a 15 year payback period, the monthly payment would have jumped from \$206 to \$228. That's an extra \$250 for the year.

3. Don't fall behind on paying your taxes, student loans, or child support.

Even if you're in dire financial straits and file for bankruptcy, these obligations won't be forgiven. You could even have your wages garnished if you fall behind on either your tax or student-loan payments.

4. Don't flake on paying your library fines or parking tickets.

Be a model citizen -- with a model credit score. More and more municipalities in search of revenue are turning over unpaid tickets and bills to collection agencies. If you don't cover the payments, the collection agency is likely to report the outstanding bill to the credit bureaus. A dented credit score from an unpaid \$25 parking ticket or library fine could cost you the lowest possible interest rate on a mortgage or car loan.

5. Don't buy a variable annuity, especially for your retirement account.

A variable annuity is basically a contract with an insurance company, and the money you invest is used to buy mutual funds within the annuity. The sales pitch is that you can buy and sell the funds inside the annuity as much as you heart delights and have no tax bill while the money is invested. But what you probably aren't told is that you will pay ordinary income tax on withdrawals and that if you take money out before you're 59 ½, you will also be hit with a 10 percent penalty.

Then there's the cost. The annual fees buried in a variable annuity can easily run to 2.5 percent or more a year. Compare that with many mutual funds that charge 0.5 percent or less, and you're talking about quite a big cost to own a variable annuity.

It can make a lot more sense to go with a low-cost mutual fund, rather than a variable annuity.

Sure, you're exposed to the annual tax distributions mutual funds make. But plenty of funds, especially large-cap ones, are very tax-efficient, meaning they make no or very small annual tax distributions.

And the tax bill when you sell your mutual fund can be a lot better than the deal on your variable annuity. If you hold a mutual fund for at least one year, all the gains when you sell are eligible for the long-term capital gains rate rather than being taxed at your ordinary income-tax rate. For most people, the long-term capital gains rate is 15 percent. That's a lot better than the top income tax rate of 35 percent.

And the absolute worst thing you can do is to follow any advice to buy a variable annuity for your IRA. A variable annuity is a tax-deferred investment, and so is an IRA. So don't waste your IRA by stuffing it with an investment that's already tax-deferred.

6. Don't finance a home purchase with a variable interest-only loan.

If the only way you can buy a home is to take out an interest-only loan with a low initial teaser rate, then you can't afford that home.

And the ultimate bad housing move is to use an Option Adjustable Rate Mortgage that allows you to set a very low payment during the start of the loan that might not even cover your interest costs. If you fall for that trap, you will have a "negative amortization loan." Instead of your loan balance becoming incrementally smaller with each monthly payment, it's actually rising because the lender just shovels the "unpaid" interest onto the balance of the loan.

Paying just the interest initially on the mortgage only means that you will need to eventually repay the principal at an accelerated pace. If you have a 30-year loan and you don't pay principal for 10 years, you will then have to repay the entire principal in the final 20 years of the mortgage.

And don't fall for the lender's pitch that you will have more income to handle the increase once the principal is due, or that you can refinance. If your career takes an unexpected dip, perhaps your income won't grow as fast as you need it to. And refinancing isn't easy if interest rates increase, or property gains have slowed so you don't have much equity built up. There's no guarantee that you'll be able to handle the higher payments.

7. Don't miss out on your employer's offer of an annual bonus.

I'm talking about the matching contribution on your 401(k) or 403(b). One recent study found that more than 20 percent of 401(k) participants aren't contributing enough to get the maximum annual match. These people are turning down free money.

8. Don't purchase life insurance on your kids.

Life insurance has one purpose: To replace the income of the deceased if anyone is dependent on that income. While losing a child is a tragedy, your child doesn't have an income that you

depend on. So it makes no sense to purchase a life insurance in their name.

But you sure need to have a life insurance policy in your name because your kids -- and possibly your partner -- are dependent on your income.

9. Don't purchase life insurance as an investment.

Policies that include an investment component are quite possibly the worst financial deal you can make. The cost of these "cash-value" policies (they come in a variety of flavors including universal life, variable life, and whole life) can be 10 times the cost of a standard term-life insurance policy. That's why insurance agents love to sell them: In the first year of your policy, the agent's commission can be as much as 90 percent of your premium.

Please stick with term insurance. It provides all of the insurance coverage you need to protect your loved ones -- at a fraction of the cost.

10. Don't let any single stock account for more than 10 percent of your investment portfolio.

It's pretty irresponsible for corporations to offer their matching 401(k) contributions in company stock and then have it offered as an investment option in the 401(k). All this leads to employees who have way too much of their retirement banking on the company stock. Just ask an Enron or WorldCom worker.

And you don't need a total company meltdown to hurt you. A disappointing stretch for the company -- be it a failed product launch, regulatory problems, or stiff competition -- can send a stock down 20 percent or more.

11. Don't pass up a Roth IRA.

The Roth is an absolute slam dunk. Yes, it's true there is no initial tax break: You invest money that you've already paid tax on, unlike a 401(k) where you get an upfront tax break because your contribution is pre-tax.

But the Roth pays off later. Your money grows tax-deferred while it's invested, and when you withdraw the funds in retirement -- assuming you're at least 59 ½ and have had the account at least five years -- you won't pay one penny in tax. Meanwhile, all your 401(k) or 403(b) withdrawals will be taxed at your ordinary income tax rate.

I also like the great flexibility you get with a Roth: The money you contribute can be withdrawn at any time, without having any tax or penalty to pay. It's only the earnings in your Roth that need to stay put until you're 59 ½ to avoid any tax or penalty. While you should avoid needlessly raiding your retirement account, easy access to your Roth contributions is a nice emergency safety cushion for you.

So if you're eligible for a Roth IRA, you're crazy to pass it up. If you're single and have modified adjusted gross income below \$95,000, or are married and file a joint tax return with MAGI below \$150,000 you're able to invest the full \$4,000 annual limit in a Roth this year. If

you happen to be at least 50-years old, your limit is \$5,000. Invest \$4,000 a year for the next 30 years, earn an average 8 percent annual return, and you'll have nearly \$500,000.

12. Don't opt for low home- or auto-insurance deductibles.

The odds are relatively low that you will need to make a claim in any given year, so it makes sense to reduce your premium, not your deductible. Boost your deductible to \$1,000 or more, and you can shave 10 percent or more off of your premium costs.

It's also smart to stick with a higher deductible because you won't be tempted to make small claims. And that's a good way to stay in your insurer's good graces. If you make a lot of claims, you're bound to see your premium rise, or even be turned down when it is time to renew your coverage.

This strategy works only if you have the resources to cover the higher deductible. My hope is that you have an emergency cash fund. Or that you have a credit card with a very low interest rate that you can tap in an emergency.

O.K., that's enough mistakes for now. But I plan to devote an upcoming column to some additional pitfalls I want you know about. Meanwhile, e-mail me at moneymistakes@yahoo.com and tell me your biggest financial blunder. I won't share any of your personal information, but it would be great if in my follow-up column other people could learn from your mistakes, too!

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