3 Ways You May Be Throwing Money Away Without Realizing It

By Geoff Williams | U.S.News & World Report LP – Fri, Sep 27, 2013

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You aren't a dimwit. You're just stressed.

According to a recent study published in Science magazine, if you're poor and mismanage your money, you may be very capable of making good financial decisions. But you're trapped in a vicious circle: The inevitable problems that come with being poor are likely affecting your judgment, which means you're making bad decisions, which end up making you even more poor.

With that in mind, if you're financially struggling - or know someone who is - here are three ways people end up throwing money away when making common financial decisions: buying a house, buying a car and investing in a retirement plan. They're all generally good ideas, of course, but just because you're doing something smart doesn't mean you're doing it right.

Stretching to take out a mortgage. Few personal finance experts will say it's stupid to buy a house - but they will tell you that you can buy one too early in life, before you're financially ready. Many people also buy too big of a house.

"I can't tell you how many people I've seen get swept up in the romantic notion that they need to own a home or that they need to own a more expensive home, only to later regret it when they end up with a beautiful place but no money," says Scott Halliwell, a certified financial planner with USAA, a national financial services company based in San Antonio that mostly serves military members and their families.

Halliwell says too many people try to buy a house before they've learned to budget. These red flags, he says, should alert you that you aren't financially ready: if you don't yet have an emergency fund, you can't save up for a sizable down payment (20 percent is standard) or you're trying to find another way to buy a house, such as taking on a high interest rate in place of having that down payment.

He has a point, especially considering that a house comes not only with a monthly mortgage that you'll likely be paying for the next 30 years - but also homeowners insurance, yard maintenance, appliances and furniture to buy and the inevitable home repairs. Most lenders say your house payment shouldn't be more than 30 percent of your income, so if you're searching for a way to buy a house that is going to be, say, 40 or 50 percent of your income, you might want to do some serious reconsidering.

Halliwell adds: "We always talk about how much money someone can save if they just stop drinking fancy coffee. The truth is, coffee doesn't do anywhere near the damage this move can."

Buying a too-expensive car. If you're not paying attention, the car you're buying may not seem all that expensive. The auto finance manager may suggest that instead of three years, you pay for six, and that $531

monthly payment for an $18,000 car decreases to $282, obscuring the fact that you'll end up paying far more in the long run, especially if you aren't getting a good interest rate.

For instance, if your car's interest rate is around 4 percent, which is average these days, paying the loan over six years instead of three means you'll pay $1,145 more just in interest. That might be worth it for the lower payments. But let's say you have bad credit and you're paying a high interest rate. Buying an $18,000 car at 18 percent (a typical interest rate if your credit score is, say, 550 and you're buying a used car) and paying it over three years means you'll shell out approximately $5,000 just in interest. Spreading the loan over six years means your interest alone will climb to $11,000. Your $18,000 car is actually a $29,000 car.

Of course, it can be easy to rush into buying a car, especially if your current vehicle is on life support. But not only should you make use of the many monthly loan payment calculators for car-buying on the Web, remember to research how a new or new-to-you car will affect your insurance and your auto's gas mileage.

"We're certainly a nation in love with automobiles, and I'm right there with the crowd," Halliwell says. "Even so, I'm forever amazed at the number of $40,000 to $50,000 cars and trucks I see on the road every day. The payments on those loans are huge by average financial standards, and the cars are often worth thousands less than the purchase price within days of buying them."

Many experts suggest ensuring that the car you buy is no more than 1/10th of your gross annual income. So if you make $70,000 a year, you shouldn't buy more than a $7,000 car. Even if that doesn't seem realistic, it's a good blueprint to try to follow. After all, six years is a long time to lock yourself into paying for a car, which depreciates the moment it is driven off the lot.

"I regularly get questions from people about what they can do to fix their auto loan situation when only three years into their six-year loan term, their circumstances change and they can no longer afford the payment," Halliwell says. "Unfortunately, in many cases, they owe thousands more on the loan than the vehicle is worth, so they're often stuck."

Withdrawing money from your retirement plan for anything other than retirement. Yes, times are still tough for some people, but short of dredging up money to save your house from going into foreclosure or raising ransom money for a kidnapper, most financial gurus will tell you to stay away from your 401(k) or individual retirement account.

"Too many people take money out of a qualified plan or IRA to pay for everyday expenses. The Department of Labor has a word for this: 'leakage,'" says Kenn Tacchino, professor of taxation and financial planning at Widener University in Chester, Penn.

How devastating can it be? Tacchino says that when he is in the classroom, he offers his students this example:

"A 25-year-old is getting married and he wants to buy a $5,000 engagement ring. He is in the 28 percent marginal bracket and he will pay a 10 percent penalty to take the money from his IRA. He will need to take out $8,064 to buy the ring and pay the taxes. He throws caution to the wind and takes out the $8,064. Five thousand goes to buy the ring, and $3,064 goes to taxes. Had he kept the money and earned an 8 percent rate of return, he would have had over $195,000 at 65 for retirement. That's quite a ring!"

5 Financial Decisions That Sound Smart But Are Really Dumb

From budgeting mishaps to bad purchases, these money mistakes may haunt you

By GEOFF WILLIAMS

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Norma Yaeger, 83, of Encino, Calif., thought she was making a smart financial decision last fall, when, after pulling into a Ralph's supermarket, she impulsively hired two men to fix her car.

"Two nice gentlemen came over to me and look at my fender, which was badly scratched. They said that they had a compound that will remove the scratches and restore the paint," Yaeger says.

They would fix it, for just $50.

Yaeger isn't a rube – she was, in fact, the first female stockbroker to work at the New York Stock Exchange (and recently wrote an autobiography, "Breaking Down the Walls"). She also served as president of two stock brokerage firms. The men who approached her seemed honest, and Yaeger was self-conscious about her fender. She paid the $50, a snap decision that seemed perfectly reasonable.

Instead – and you knew this was coming – when she returned from grocery shopping, her car fender hadn't improved. In fact, it looked far worse. Yaeger drove to a mechanic and was told that it would take several days and $1,000 to fix her car. “The worst part was that I had to tell my husband about this embarrassing story," Yaeger says.

Most people have made a financial mistake that seemed sensible at the time, but in hindsight turned out to be pretty stupid. With that in mind, here are some thoughts from a slew of personal finance experts on five financial decisions that sound smart but are likely a waste of money.

The mistake: Buying something because it is interest-free for awhile.

Why it can seem smart. It's tempting to buy something with a zero-interest window, such as a "90-day, same-as-cash" offer, in which you're charged no interest if you pay for the product within 90 days.

Why it may be stupid. Many people don't end up saving the money or putting it aside when they get it, "and they end up paying accumulated interest at a high rate plus compounding interest on the balance going forward," says Kelley Long, a Chicago-based certified public accountant.

She says consumers make such mistakes when they open a store credit card to get a 15 percent discount, for example, but then carry a 22 percent balance. Paying for things with a rewards credit card to earn frequent flier miles can also be a mistake if you're not paying off the card in full each month. "The interest expenses end up far outweighing the price of an airline ticket," Long says.

The mistake: Buying long-term care insurance when you're broke.

Why it can seem smart. Who wouldn't want long-term care insurance? It helps pay for basic activities that people need to do on a daily basis, like getting dressed, bathing and preparing food.

Why it may be stupid. Senior citizens who are worried about their long-term prospects but don't have money to spare buy it but shouldn't, says Sonja Kobrin, a geriatric care manager in Palm Beach, Fla., and owner of V.I.P. Care Management. Kobrin says many seniors buy it when "their economic status is so low that they would qualify for Medicaid programs, which would pay for care and facility costs at no charge to them."

The mistake: Buying life insurance for a child.

Why it can seem smart. If you bought it, you were probably convinced by an aggressive insurance salesperson that you need insurance for burial purposes, in case the worst happens. Or you may have bought it just to be on the safe side – no matter what, your child will have life insurance.

Why it may be stupid. Your reasoning may be correct, but generally, parents take out life insurance because their child depends on them for financial support. "Unless your kid is Justin Bieber, it is probably unlikely that you need to consider taking out a life insurance policy for him," says Marvin Feldman, CEO of the LIFE Foundation, a nonprofit that educates the public about life insurance. Feldman adds that if there is a history of significant health problems in your family, you may want to consider life insurance so your child doesn't have trouble getting it as an adult. But all in all, you're probably better off putting that money into your child's college account.

The mistake: Not having a credit card.

Why it can seem smart. If you've ever had mountains of credit card debt, it seems like the smartest decision in the world. Who wants to be beholden to a credit card company?

Why it may be stupid. "Many people believe they are helping themselves by not having a credit card at all when, in fact, you can be hurting your credit score," says Priya Haji, CEO and co-founder of SaveUp, a free rewards program that helps people save and get out of debt.

Haji is correct – at least to a point. If you cannot trust yourself with a credit card, you're probably better off without one. But like it or not, lenders consider whether you have a credit card when deciding whether to offer you credit. If you want a home or a car someday, and you don't have enough money saved to buy either outright, showing that you can peacefully coexist with your credit card may mean you'll get a much better loan than if you don't have a credit card.

If you're really credit-card averse, Haji suggests getting one with no annual fees and making purchases semi-regularly – then paying them off within the month.

The mistake: Not allotting space in your weekly or monthly budget for fun.

Why it can seem smart. You're budgeting, which is serious work. It seems much wiser to budget for things you know you need, like food and rent, than something you don't, like going to the movies.

Why it is stupid. "Just as it's important for people trying to lose weight to allow themselves some 'treats,' it's important for those on a budget to be realistic and include some allocation for fun," says Kevin Gallegos, vice president of Phoenix operations for Freedom Financial Network, a national company that aims to help consumers get out of deep debt. "Depending on income, it might be something as simple as a new bike helmet to enjoy more cycling time, or a small amount for a dinner out each month."

In other words, you're only human. You'll likely do something financially unnecessary or impulsive every month, whether you plan to or not. If you're shrewd, you'll plan for that in your budget, too.