Financial Pitfalls

& Where to Find Them

by Justin O'Gorman

Justin O'Gorman looks at the Financial Pitfalls that exist and how to avoid them.

Avid JK Rowling fans may notice the reference to her post Harry Potter book, "Fantastic Beasts and Where to Find Them" in the title of this article. There is a reason for this. The wizarding world created by Ms. Rowling exists side by side with the world inhabited by "Muggles", non-wizarding humans, but is hidden from view by the use of magic. In effect, her wizarding world exists quite openly but cannot be seen because Muggles are not allowed to see it. Occasionally, a blip occurs and the two worlds interact with each other. When this does occur, the minds of those Muggles who have witnessed the wizarding world are "Oblivated", wiped clean, so that they don't remember what they have seen.

This is the same in the world of Finances, without the wizards and the mind wiping obviously, insofar as despite the enormous amounts of evidence available, people still end up making the same mistakes when it comes to their finances. It's as if the lessons learned and passed on by others lose their potency over time to such a degree that they no know longer exist to the real world. The purpose of this article therefore is to point out the Financial Pitfalls that do exist and in the process, help you avoid them.

Having no Financial Plan:

It is extraordinary the amount of people who have no financial plan. For these people, their existence from a financial perspective exists from payday to payday. Yes, they may make short term financial decisions such as how to fund next year's holiday but in essence, their sole purpose is to get to their next pay cheque. They may still have some money from their previous week's/ month's pay cheque left over but that is more by accident than design or they have had to forego the smashed avocado on toast for a couple of mornings.

For people like these, an unexpected financial outlay is a disaster. These people also tend to end up as the fodder for Payday Loan companies. While these companies make the process of borrowing a sum of money as easy as possible, the interest rates they charge would make a Money Shark blush and in too many cases, the person ends up in an ever-deepening pit of debt. As The Eagles sing in Hotel California, "you can check out any time but you can never leave".

Leaving your financial wellbeing to chance is a high-risk strategy and is one that tends to come back to haunt you when you least expect it.

Therefore, Financial Pitfall No. 1 to avoid is not having a Financial Plan.

Having a Financial Plan that is too short term:

Ok, maybe scenario no. 1 has made you feel uncomfortable and you decide to draw up your financial

plan. However, your financial plan only takes into consideration the next 5 years of your life. For "younger readers", the next five years probably represents the "saving for a house" period of their lives and that is where 100% of their focus is. And, taking into consideration the malfunctioning nature of our housing market at the moment, it would seem to be a reasonable action to focus on.

The difficulty with a plan with a short-term focus on one specific issue is that it ignores other areas that should also be included in a financial plan but that may be of a longer-term nature such as children's education and retirement planning. It may also ignore the "what if" scenarios or fail to take into consideration the consequences of an unexpected illness or a premature death which can throw a plan off course.

Your plan should consist of short, medium and long-term goals. While there may be a greater focus on one particular goal within the plan, it should not be to the detriment of the other goals within the plan.

Finally, there must be an allowance in every financial plan for things going wrong.

Therefore, Financial Pitfall No. 2 to avoid is having a Financial Plan with too narrow a focus and no flexibility.

"Oooh, it's shiny and sparkly and I want it"!

I'll freely admit that I have a weakness for cars. I spend too much time on car websites and have visited various car dealerships to sit in new and nearly new cars – for research purposes only of course! The problem with sitting in a car in a dealership is that the new car smell tends to permeate the brain and switches off its rational side. The internal calculator tries to convince you that "yes, of course you can afford the monthly repayment and really you'll end up saving money because it's cheaper to run etc." With the myriad of finance options available as well, it can often seem like a no brainer.

While my weakness is cars, yours may be Technology, Jewellery, Holidays, Clothes etc.

Whatever your weakness is, sometimes we can end up justifying the purchase of said item because we convince ourselves that we deserve it. However (and this feeds back into Financial Pitfall No. 1), if we find ourselves having to justify the purchase to ourselves and others, it means that the purchase may have been spontaneous and we're not actually sure what the impact will be on our finances in the medium term or, (Financial Pitfall No. 2), we didn't allow for a what if scenario and our financial plan was too narrow in its focus.

Now, I'm not saying that purchasing the item is not allowed. What I am intimating is that spontaneous purchases of "sparkly" items can lead to longer term difficulties with finances as monies that should have been used as part of your financial planning could have ended up being side-tracked into instant gratification items.

Therefore, Financial Pitfall No 3 to avoid is making purchases that you struggle to justify at a later stage.

Credit Cards, Personal Debt, Borrowing in General:

Ok, so it is unrealistic to say that some form of borrowing won't occur in our lifetimes. The most obvious debt most of us will end up with is mortgage related. Even with a well laid out financial plan, it is still nigh on impossible to purchase a house without some form of borrowing. Of course, having had a financial plan may mean that the end amount borrowed is less than may have been the case without the plan.

It is also possible to justify taking on other debt from time to time. For example, borrowing to retrofit your home with insulation, a boiler upgrade, better windows and doors may well pay in the long term as the reduced cost of heating your home should fall, thus providing you with savings on your energy costs. However, before taking on such a borrowing, it would be important to see how long it may actually take to claw back the costs as sometimes the examples used may not apply to your circumstances.

The previous examples are quite obvious examples of borrowing. What I mean by this is that there is a process that needs to be gone through in order to access the funds borrowed.

Credit Cards, Overdrafts and smaller personal loans are not in the same category, as through the advent of online banking, these borrowings can be secured with minimal effort. And because they are nearly treated as a convenience transaction, the long-term implications of these borrowings may not be appreciated. Also, as the application process is so straightforward, you could be fooled into thinking that the fact that you qualify for the loan must mean that your bank believes you can afford to repay it.

Of all the short-term debt that can lead to the greatest long-term issues, Credit Card debt is probably the guiltiest. Credit Card usage these days is now second nature and we don't even think twice about it when we use our cards for purchases. However, it's when the clearance of the monthly outstanding balance begins to slip that these issues come sharply into focus. Credit Cards still charge very high interest rates and when combined with the very low minimal repayments accepted, can lead you to paying substantial amounts of interest over the period that the balance is outstanding. You also need to take into consideration that the bank/credit card company is not your friend but a business only interested in its bottom line.

Therefore, Financial Pitfall No 4 to avoid is taking on unnecessary debt.

Finally, after avoiding the pitfalls outlined above, you discover that you are accumulating cash reserves that have ended up sitting on deposit with your bank or Credit Union. While you can justifiably feel good about yourself as the cash balance increases, the poor rate of interest that the banks will pay you (yes, the same banks charging you such high rates on your credit cards and personal loans) actually mean that in real terms you are losing money as your cash sits on deposit.

The alternatives to holding cash on deposit that offer capital guarantees are few and far between and so you may need to look at some of the longer-term investment options that offer potentially higher returns but come with a capital risk as well.

The first thing to understand in relation to investing is that while it is possible to make a large return in a short investment term, it is not the norm and so you need to look at investing as a long-term strategy. By long term I would certainly suggest 7 years plus. The reason for suggesting this investment term is that it should allow you to ignore the "noise" that comes with investing and allow your investment to ride out any market volatility that may occur during this time period.

A second issue with investing that needs to be avoided if possible is the tendency to have kneejerk reactions to market events. While this may make sense, often times in the heat of an extended period of market volatility, it can be difficult to stay focused on the task in hand. Investment decisions made during these periods of volatility can end up doing more damage to the investment than the actual volatility itself.

Finally, if an investment appears too good to be true, then it probably is. However, the temptation to get involved in this type of investment is greater if you keep reading about how much money other investors are making. The "green eyed monster" can cloud your judgement at times like this. Even Sir Isaac Newton fell victim to this curse during the South Seas Bubble. After investing and getting out with a profit, he went back in again because others were still making money on the investment. Unfortunately, the second time around he was not so fortunate and ended up losing a fortune when the South Sea bubble burst

Therefore, Financial Pitfall No. 5 to avoid is following someone else's investment plan rather than your own.

Of course, there are many other financial pitfalls that one can fall into but this article would need to be a lot longer to cover them all. The soundest piece of advice I can give you is to commit to putting in place a Financial Plan and sticking with it. Every financial decision you make thereafter should then be made in the context of how it relates to your plan.

Lastly, it would be remiss of me not to say that those individuals/couples who work with a Financial Adviser to put together a Financial Plan are better off in the long run than those who do not seek advice.

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Justin O'Gorman is the Director of Financial Services, JDM Insurance Services. He holds the QFA and RPA qualifications as well as being an APA in both Personal & Commercial Insurance