Financial fallacies we follow

To earn more you need to work harder or be a financial wizard, right? Wrong! **Manoj Arora** busts some common misconceptions about wealth creation

Manoj Arora *is an electrical engineer turned financial expert and author. After graduating from AMU Aligarh as a gold medalist, he spent two decades working for many Fortune 500 companies. Now, he pursues his passion as an author and seeks to uplift society.*

Compound Interest generates *some* extra money

There is hardly anyone who has not heard about compound interest. But perhaps the biggest tragedy of our financial life is the extent to which we underestimate it. Compounding works with time and has the potential to create such wealth, that you just cannot foresee. Let me illustrate: imagine holding a paper sheet. Try folding it in half, so as to double its thickness. Fold it once again to double its thickness further. Do this 50 times. Just assume that you can physically fold it 50 times. Now, guess what the approximate thickness of the paper would be after 50 folds. A few centimetres? Maybe a few metres? No! It is stunningly higher. The approximate thickness of a normal paper after 50 folds would be more than 112 million kilometres! Yes, it's true. Now imagine what would happen if we allowed just one more fold. We would achieve in the next one fold, what we achieved in the last 50 folds.

This is how powerful compounding is, provided you give it enough time to create an impact. The only reason most people are unable to realise its true power is because compounding works on the concept of *delayed gratification*. You do not really see its impact for the major part of the tenure. But the magic happens in the last part of the tenure, wherein, it just explodes exponentially. To the common man, compounding has always been just some extra interest over interest. But for a smart investor, it is, as Albert Einstein described, the eighth wonder of the world.

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Handling finances is complex

Warren Buffet, arguably one of the most successful investors of all times, says that managing wealth and investing money does not require more than a fundamental school education. On the other hand, most of us shy away from this subject with the consideration that we may not be qualified financial planners. The fact is that we don't need to be.

Financial planning is not at all complex, provided you can clearly differentiate between your financial need versus greed, and possess some fundamental sense about numbers [which you should have acquired by standard 10].

You do not need any financial degrees, you do not need to inherit great wealth and you don't have to be lucky to create wealth. What you really need to get wealthy is only rudimentary financial knowledge. But on top of that, you need planning, discipline and commitment. And this is where most of us struggle. While we might not lack knowledge or the ability to acquire knowledge, we lack the commitment to get the results. It is easier said than done. It is not a cinch to stay disciplined and committed for, say, 30 years at a stretch. Your goals and dreams in life are the key to drive your discipline and commitment. If you have a clear mission of your life, everything else will fall in place.

Increased income is the only way to increase wealth

When people think about getting wealthy, what they usually focus on is increasing their income. Well, increasing your income is definitely one way to get wealthy, but is definitely not the only way. And is certainly not worth it—if it makes you busier and takes away your family time, peace and happiness. Increasing your income has the potential to increase your savings by the same proportion. If you increase your income by 30 per cent in a year, you can potentially save and invest a large portion of that increase.

However, quite conversely, it has been observed that an increase in income generally leads to a proportionate increase in expenses, rather than an increase in savings or investments. While a higher income is desirable, there are two other smarter and more efficient modes to get wealthier, and these are often overlooked for lack of our own appreciation of the impact these can have on our financial portfolio.

1. **Reducing your expenses:** A penny adds up to a dollar earned. Sounds old fashioned, but this wealth management principle is time-tested and proven.
2. **Increasing your returns on investments:** As your wealth grows bigger, even a small percentage of increase in your returns on investments can have a more significant impact on your wealth than a substantial increase in your income. In this case, you are letting money work for you here, rather than you working for money—again, a time-tested principle for financial freedom.

I don't need to track my monthly expenses

I overlooked expense tracking for 10 years of my earning life, and am still paying a heavy price. Tracking your daily expenses under various heads like grocery, fuel, entertainment, eating out, travel and kids' education and the like is not only important, but making it a family routine can actually help you reduce your monthly expenses by as much as 20 per cent. Yes, it's proven through multiple scientific studies that just the act of tracking your expenses consistently can reduce your expenses significantly.

Do not underestimate the power of tracking your expenses and writing them down

20 per cent of money saved is as good as 100 per cent more money earned, because you usually save only 20 per cent of your income. Do not underestimate the power of tracking your expenses and writing them down every night before your family goes off to bed. Make it a family exercise every night and you will nurture good money management practices in your children too, without having to specifically teach them. Increased family bonding and new money saving ideas from your kids—are just some of the by-products of this activity.

Wealth has nothing to do with a written plan

How much money do you want, by when do you want it and why do you want it? These are some of the questions that must be answered in a 'written' format via a proper financial plan. If you are more of the 'thinker and intellectual' type, then my advice to you would be to 'think on paper'. Do not make the mistake of having the goals and targets in your head. Your head is not a database, it is a computing and decision-making engine. Use it for the right purpose, to get the most out of it.

Nothing worthwhile in the world has ever been achieved without a concrete documented plan. Your plan should have your financial goals, monthly targets to achieve the goals, and a mechanism to track your actual portfolio against those targets. If you are failing to plan, then you are planning for failure.