Start cultivating healthy financial habits as early as possible

The habit of saving is as important as the actual amount…

Morningstar Investment Management South Africa

June 2023

Victoria Reuvers
Managing Director
Morningstar Investment Management
South Africa

For Financial Advisors and their Clients

South Africa commemorates Youth Day on 16 June 2023. With this in mind, we thought it prudent to tackle the importance of establishing good financial habits from an early age.

The Oxford Dictionary defines the word habit as "a settled or regular tendency or practice, especially one that is hard to give up". Good habits can have a lasting positive impact on the way we live our lives. Habits essentially become part of our routines and can even become so ingrained in what we do, that we almost forget whether we did them or not - for example shutting the garage door when leaving for work. Imagine if good financial habits could be on auto-pilot in your daily life.

Developing the right financial habits may help make decisions easier and improve our overall financial well-being. A successful investor is someone who understands the basics of saving and investing, some of the key habits that tend to lead to investment success and avoids some of the big mistakes and bad habits that investors can fall into.

Manage your money, instead of letting your money manage you

From an early age, allowances teach children the value of money. Giving children a budget to stick to can encourage smart decision-making. It forces kids to make their own cost-benefit decisions and prioritise what matters. If they spend all their pocket money immediately and forfeit having enough money for something more expensive later, they will be forced to learn the valuable lesson of saving, and not giving in to instant gratification.

As we get older, the spending habits we learnt with our pocket money can have a spillover effect on how we budget later in life. Whether you are earning weekly wages or an annual salary – the first step is to realise the worth of your income and to create a spending plan and budget with what you have.

Figuring out your budget at the outset and learning to stick with it will save you some pain down the road. If you're just starting out, don't wing it with your expenses. There are numerous budgeting templates available online to choose from. At the end of the day, the habit of creating and sticking to a budget and spending/savings plan is what is important. Morningstar's director of personal finance, Christine Benz wrote the following article "How to Assess Your Cash Flows and Create a Budget" which could be a good starting point.

Keep it simple with some basic rules of thumb

When it comes to building a habit, the more complex the desired behaviour is, the harder it can be. For our finances, using simple but effective rules of thumb can be a solution, for example:

- Don't spend more than what you earn

- Pay yourself first (by saving), and spend what is left (only after saving)
- Save up for big expenses instead of buying on credit
- If you have debt, make sure you pay it off as soon as possible
- Make sure you have an emergency fund

Start as early as possible – no matter how small the amount

People often assume that if they start very small, they don't have enough assets to invest. But the fact is, even if you have a very small sum, that you are able to save and invest in the market, thanks to compounding, over your longer time horizon you may be able to accumulate even more than the person who starts with a larger sum, but waits for a longer period of time to get started.

So, even if you're starting small, think about getting that money invested. In addition, even if you just start by saving your money in a bank account, you will be enforcing the habit of saving – which can become a very powerful habit over time.

The younger you are, the more time counts in your favour

The youngest investors have the longest time to benefit from compounding, and that benefit accrues even if they're only able to save small sums and the market gods serve up "meh" returns over their time horizons.

Starting from an early age, is more important than the amount you start with -

- The 22-year-old who starts saving R200 a month and earns a 5% return per year will have more than R362,000 at age 65.
- Meanwhile, an investor who waits until 35 to start investing yet socks away R300 a month and earns a 6% return will have a little more than R300,000 at age 65.

Those first 10 years of missed compounding swamp both higher returns and higher contributions later on, underscoring the virtue of getting started on retirement saving as soon as you can, even if it means starting small.

It really is worthwhile to save whatever you can afford to, even if it doesn't seem like much. Money invested in your 20s and 30s is extremely valuable – because these funds have several decades to compound, this money has incredible growth potential.

- R1 compounding at 6% per year will be worth R10.30 in 40 years.
- R1 compounding at 6% will only be worth a third of that, R3.20, after 20 years.

Put simply, the younger you are when you start investing, the more time your money has to grow and the less money you will need to save to reach your goal.

To make it even simpler – learn how to "double your money"

Getting kids to understand the time value of money from a young age can help them plan their careers, understand why they need to continuously get raises and increase the value of their labour over time. It can help them understand why investing a small amount of money in their 20s is so much more practical and valuable than a much larger amount in their 40s.

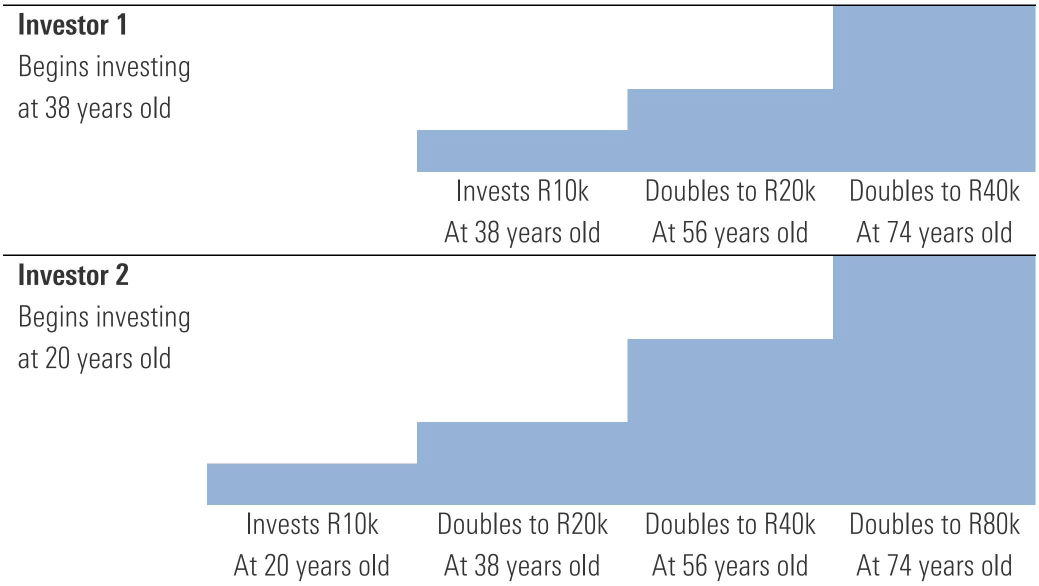
Enter the rule of 72. Divide 72 by the interest rate, and that tells you how many years it will take for your money to either double if it's invested or get cut in half if you're talking about paying interest or inflation.

For example –

$$\frac{72}{7\%} = 10 \text{ years}$$

→ Doubles if invested

→ Gets cut in half by interest or inflation



Source: Morningstar "How to teach your kinds about money". Data as at 18.09.2020. For illustrative purposes only.

Watch out for the infamous "lifestyle creep"

Now that we've written about some of the good habits to cultivate, let's talk about a bad habit that is best to avoid. The more income you earn, the more money you spend (usually). It's not strictly a bad thing; you work hard, and when you get rewarded with a raise, you might be able to afford a bigger apartment closer to work or a house in an area with a good school district, for example.

The more expensive your lifestyle becomes, the more you'll need to save to fund its continuation. But the more you're spending, the less money you'll have available to save.

Here's a more optimal situation: By staying conservative about spending and not taking on too much debt, you're not only able to save more while you're working, but you'll also be creating a less expensive lifestyle that doesn't require as much money to fund during retirement.

In conclusion

The key to being successful is to stay motivated throughout the process. Now and then you are going to have a setback. Setbacks are o.k. - as long as you keep doing your best and get back on track as soon as possible.

Share your goals with your family to keep yourself accountable, break down your goals into smaller steps, and reward yourself when you hit major milestones. With patience and commitment, you can improve your financial habits and rest easier about your future.

+ t: (0)21 201 4645 + e: MIMSouthAfrica@morningstar.com + 5th Floor, 20 Vineyard Road, Claremont, 7708.