Learning to live on what you make

ROSE,' CALLS JOHN REID TOWARD THE BRIGHT kitchen of his six-bedroom, antiques-filled post-Victorian home, 'have I spent any money on you lately?'

'No!' his wife shouts triumphantly. She enters the dining room, beaming. 'You've got to see this hole in the kitchen floor.' she tells a visitor proudly. 'We put duct tape over it instead of repairing it.'

Hold the phone. This couple brags about not spending money? Don't they know that, for all too many people these days, the new American dream is to spend, spend, spend until you drop, no matter the unpaid bills? Well, maybe once upon a time, but not anymore. Americans are slowly learning they'll have to cut back. For the Reids, who allowed MONEY to chronicle a yearlong effort, getting a grip on their finances proved to be painful and instructive. The couple's successes and failures, indulgences and frustrations hold lessons for every American family trying to take control of their finances. For one, kicking the spending habit turns out to be every bit as tough as giving up addictions or losing weight. Here's their story:

Two short years ago, John and Rose Reid's finances were headed toward disaster. Savings? Zilch. Investments? None at all. The charming turn-of-the-century house? A money pit that had sucked up some $20,000 since they bought it for $247,000. Rose readily characterized their spending habits as 'Live for today. When we see something we want, we buy it.' The result: a whopping $16,670 of credit-card debt at interest rates ranging from 13.9% to 19.8%. Even with John's $71,200 salary, the couple could barely meet their minimum payments each month. In keeping with their cavalier attitude, the Reids had neither valid wills nor adequate insurance.

Since their wedding, the couple hadn't stopped to do much financial planning. Energetic and joke-a-minute John, 35, jumped among four jobs, including his current position as a business manager with a multinational chemical company. Sunny Rose, 32, put a budding career with State Farm Insurance on hold in '86 to become a full-time mother to (eventually) four kids: Andrew, 9; Rebecca, 7; Adam, 5; and William, 2. Plus, the Reids bought and sold four houses, ending with their beloved but demanding 1905 home in a historic area of Merchantville, N.J., 15 minutes' drive east of Philadelphia.

Fact is, the Reids are all too typical. For too many of the 53.2 million American families headed by married couples, living the good life today is license to buy whatever they want whenever they want it. U.S. installment debt, according to the Federal Reserve, surged to an unprecedented $911.2 billion last December, 15% higher than the previous year. And the cost of instant gratification keeps going up. Nowadays, only 27% of married couples with kids under 18 have stay-at-home moms, according to the Bureau of Labor Statistics, compared with 51% in 1969. Even two-income families are feeling the pinch (see 'Here Comes the Four-Income Family,' MONEY, February).

By the summer, John and Rose Reid finally figured out they were overdue for belt tightening. That September, with MONEY cataloguing their progress, they embarked on their 12-month plan. First, they tracked every dollar they earned and spent for two months. Then, under the guidance of two local fee-only financial planners selected by the magazine--Carole Phillips, vice president of the Wescott Financial Planning Group in Philadelphia, and Harry Scheyer, who is also a C.P.A., in Cherry Hill, N.J.-the Reids at last put themselves on a budget. They continued to record all incoming and outgoing money for 10 months, meeting with the planners two more times. Six months later, the couple summed up their experience and their balance sheet one last time.

Digging the 10-year hole

When the Reids married two weeks after Rose's graduation from the University of Maryland, their only debt was $14,000 in student loans, paid off five years later. The newlyweds gave little thought to saving until the house bug bit. Then, eager to own a two-bedroom home in Haddonfield, N.J., Rose remembers saving $5,000 'real fast' for the down payment. Three years later, the $7,500 net proceeds from the sale of their third home were all they could put down against the $247,000 Merchantville house. That's when their credit-card debt, until then a manageable $5,000, went up like a rocket.

'We went wild on credit cards,' Rose cheerily admitted. 'Our house needed a ton of work and we wanted it done yesterday.'

It didn't help that they had depended on the word of an inept home inspector. 'He didn't tell us anything,' complained Rose. Almost immediately, the burner on their oil heater died; the water heater burst; the garage roof was caving in; and the place needed rewiring. Rose and John kept costs down by doing work themselves, but the tab for repairs and renovations, replastering and repapering quickly neared $20,000.

Then, of course, all those spiffy rooms beckoned. Passionate about late 1800s and post-Victorian antiques; the couple spent $1,500 on turn-of-the-century oak dining furniture. They haunted yard sales to unearth antiques for the kids' rooms. Said John: 'We always justified it by saying, 'That's a good piece of furniture at a good price. We need it, so let's buy it.''

The inevitable result: Within a year, balances on their seven credit cards, including five department-store cards with interest rates averaging 20%, had ballooned to about $15,000.

Despite the debt, the Reids treated themselves to a weeklong vacation in Bermuda for their 10th wedding anniversary while family and friends minded the kids. Price tag: $2,200. 'We deserved it,' says an unrepentant John with a grin. Putting the trip on plastic just about maxed out their charge limits, saddling them with minimum payments of roughly $500 a month.

The lesson: 'People think so long as they can meet the minimums on their credit cards, they're doing okay.' observes Durant Abernethy, president of the nonprofit National Foundation for Consumer Credit in Silver Spring, Md. 'But they're teetering on the brink of big trouble.' The danger point, says Abernethy, is when your nonmortgage debt load hits 20% of your take-home pay. By the summer, including the $12,000 car loan, the Reids' percentage had hit a towering 56%.

Seeing the light

'Once you're so far behind, it's easy to think there's no way back,' an unusually downcast John told MONEY. With their credit-card interest rates averaging nearly 15%, the couple were paying about $2,400 a year in interest charges alone, or $200 a month, simply to stay even.

'It would be great if we could learn to live within our means,' Rose chimed in. 'I would like to have a retirement plan. And I want to send the kids to college.'

The Reids' first task was to figure out where their money was going. While still spending as usual, they wrote down all their expenditures from September through October. Early in November, when planners Phillips and Scheyer met the Reids for the first time, the couple were aghast at some of the totals:

* Food, $1,956 for two months. ‘Look at how much we're eating,' gasped Rose, who along with John had previously estimated their monthly bills at $400. Rose's once- or twice-weekly trips to McDonald's, kids in tow, didn't help. 'John's out of town so much for work. I'm alone with the kids, and I'm like, 'Let's get out of here,'' she said apologetically.

* Clothing, $1,000. 'I didn't realize how much it costs to clothe six people,' said Rose, who quickly pointed out that back-to-school shopping made this figure unusually high.

* Extras for two months, $1,050. That included such expenditures as $250 for gifts, $219 for party and holiday decorations and $120 for cable TV.

Other outlays came as little surprise:

* Doctor bills and prescriptions, $280. John paid $75 every month for HMO coverage, under which doctor visits and prescription drugs cost just $15 each. But because baby William was severely asthmatic, 'even the co-payments add up quickly,' sighed Rose. Much of his necessary equipment wasn't covered, such as a $200 nebulizer machine that vaporizes medication into the lungs.

* Commuting, $220. John usually drove to work, paying $2 in tolls plus $9 in parking each day.

* Phone, $168. 'It's often higher than that,' confessed Rose. 'My problem is if I want to talk to somebody, I don't want to wait until the more data gets loaded.'

In all, counting the $1,257 they spent on credit-card payments, the couple's spending totaled $14.145--or 27% more than their income for September and October.

The lesson: The Reids' primary challenge, according to planner Scheyer, was to keep their eyes on the distant prize. 'Unless they can say a strong yes to long-term goals like college and retirement, they won't be able to say no to new furniture and vacations. They can't even begin to invest for the future until they spend more effectively, pay off credit-card debt, protect what they have and build a cash emergency fund.'

Feeling the pain

According to planner Scheyer, couples with ages, income levels and the number of kids comparable to the Reids should spend 22% of their income on housing-related costs. But the Reids were shelling out a hefty 43%. Food and household supplies should account for about 9% of their spending, but the Reids were up to 14%. And while they should be saving at least 9% of their income, John and Rose were saving nothing at all. The solution was to set up a realistic budget and track it each week--a first for the Reids (see page 156). 'They have to learn to live with limits,' concluded Scheyer.

Scheyer and fellow financial planner Carole Phillips agreed there wasn't much to do about the family's fixed expenses, including:

* $1,173 a month for their 30-year mortgage (interest rate: 4.25%), plus $320 a month for property taxes, $55 in mortgage insurance and $40 in homeowners insurance
* $344 a month for their $22,000, 5%-interest loan on Rose's Ford Escape SUV (John's Chevy pickup was paid off)
* $15 every two weeks for John's employer-sponsored long-term disability insurance, which would pay 55% of his salary after six months
* $500 a year for State Farm (mostly term) life insurance: $250,000 on John, $70,000 on Rose and $5,000 on each of the kids. John also had $50,000 worth of employer-provided coverage.

Everything else, however, was fair game. At Phillips' and Scheyer's prodding, the Reids agreed to cut back on their accustomed treats. For example, the final budget limited expenditures on food and household supplies to $700 a month; clothes to $250; home maintenance and repair to $130; and phone calls to $50 (limited data). Farewell to their summer vacation, typically a $2,000 weeklong family romp at a rented North Carolina beach house. 'Change is not going to be easy,' cautioned Harry. 'You're going to feel some pain.'

But, Phillips pointed out, the Reids should allow for some pleasures. 'A budget shouldn't feel punitive,' she said. 'If you go on a starvation diet, you feel deprived, and you become resentful. Then you wolf down the first box of chocolates you see.'

Accordingly, when John suggested scuttling their $125-a-month basic cable-TV subscription, Rose balked: 'The kids watch a lot of the Family Channel and Nickelodeon, and they're better than most other channels.' Nor was she willing to sacrifice her aerobics classes, which run $42 per month, plus the $40 more each month for babysitting while she's high-stepping. 'I need that for my sanity,' she said.

The Lesson: For the 10 months to follow, the Reids agreed to the novelty of spending less than they earn--fully $8,190--something they'd never done before. The advisers recommended using the entire sum--$819 a month--to pay down credit-card debt: $6,000 on one Visa card at 13.9% interest; $5,750 on another Visa at 14%; $3,970 on the AT&T Universal MasterCard at 15.9%; and $780 on a Strawbridge & Clothiers department-store card at 19.8%. To ensure their remaining balances compounded as slowly as possible, they should attack the highest-rate cards first. And one more thing, said Scheyer sternly: 'Don't add to your balances. If you must charge, pay off the new charges each month.'

Getting smarter

Phillips and Scheyer were worried about another pressing problem: inadequate insurance coverage. They advised the Reids to immediately:

* Buy more life insurance, To adequately protect his family from the loss of his income should he die young, John ought to increase his total coverage from $300,000 to $800,000. Phillips recommended a $500,000, 10-year level term policy from AA+ rated insurance company First Colony, which would cost a reasonable $450 a year.

* Buy more disability insurance. Scheyer calculated that John's current long-term disability coverage, purchased through his employer, would provide a skimpy $39,000 a year after six months of disability. John needed at least $10,000 a year of additional coverage (estimated annual cost: $300 to $500).

* Buy an umbrella liability policy. Such a plan would protect them from lawsuits--say, from someone injured on their property. Cost for an adequate $1 million policy: about $125 a year.

Moreover, the pair should enlist an attorney to write valid wills, powers of attorney, health-care powers of attorney and living wills for each of them (cost: about $400 total).

The Lesson: If the Reids had to rework their new budget to make room for these costs, stressed Scheyer, that was okay: 'Protect what you have,' he advised.

Catching the fever

Like most self-improvement converts, the Reids began in a burst of enthusiasm. Rose shunned the Golden Arches; John hopped the train to work for $2.50 a day instead of the $11 to drive; Rose laundered and ironed John's shirts herself. John even rewired an accountant friend's thermostat in exchange for getting their taxes done. 'We both feel great!' Rose crowed in April, also buoyed by an 18-pound weight loss since November. 'I've never felt like we could pay off our debts before. Now I think we can.'

In May, despite the Reids' fears of a spotty credit record, a credit union John joined through his employer permitted the couple to refinance the car loan at 3.8% interest--or falmost 2 percentage points lower than the old one. Like magic, their $344 monthly payment dropped to $210 every two weeks, which came right out of John's paycheck. 'The Reids should rely on payroll deductions for as many expenses as possible,' approved Phillips. 'Out of sight, out of mind.'

In perhaps their biggest coup, also in May, the reborn Reids persuaded the credit union to grant a five-year, $10,000 personal loan at 5.9%. Once they got the proceeds, they dutifully wrote a check for $3,740 to pay off the remaining Universal card balance; $3,400 to pay off the 14% Visa; and $560 to pay off the Strawbridge & Clothiers card. They put $1,000 toward the last remaining card, the 13.9%-rate Visa, bringing its balance down to $5,000. The remaining $1,300 went toward other bills. Their loan payments? Only $30 every two weeks.

Succumbing to temptation

As the spring faded, though, the Reids slipped into old habits. They virtuously banned gifts for their 11th wedding anniversary in June, then indulged in a $110 dinner to celebrate. John gave Rose a $100 gold necklace for her birthday in August, and rationalized it by getting a 50% discount. And when a French colleague of John's mentioned that his 19-year-old daughter Estelle would love to see the States, the couple agreed to engage her as an au pair from mid-June through mid-August. Although they paid no salary, they covered her food and living expenses during her stay--and the price of painting and furnishing a spare room for her. After it was over, Rose admitted, 'Having Estelle here cost us about $400 more than we figured.'

The softhearted Reids also couldn't adjust to disappointing their kids. Mindful that the usual vacation in North Carolina was off, Rose and John joined a club with a pool for the summer ($1.000, plus annual dues of $450 after the first year). 'We could have not joined a pool and stuck to the budget, but what kind of life is that?' argued John. 'Your kids are only seven years old once. Saving money is important, but life is important to us too.'

Lack of discipline wasn't entirely to blame. As in any family, John and Rose encountered inevitable budget-busters: The cars broke down three times over the 10 months (repairs: $1,000). Two-year-old William fell off a wagon and broke his two front teeth (unreimbursed costs for the bonding and capping job: $1500). The paint peeling off the house finally became intolerable ($1,000 for 30 gallons of khaki green paint and other supplies). 'It would have cost us $5,000 if we hadn't done the work ourselves,' John pointed out.

As recommended, the Reids did set about securing estate planning documents (an associate of Phillips, attorney John King, then of Duane Morris & Heckscher in Philadelphia and now with a Syracuse, N.Y. firm, drew them up at no charge). But when it came to buying more insurance, the couple were in perfect agreement: No way. 'Getting the debt down is more important to us,' said John. 'We'll just roll the dice for another year or two.'

Getting the report card

As the next August waned, so did the Reids' 12 long months of meticulous planning, tracking and budgeting. How did they do? On the income side, the figures looked great. The Reids earned significantly more than they'd counted on for that period: a promotion and an annual raise brought John's income to $80,500. He also collected a $6,800 bonus. And a business Rose began in a few years earlier that researched home deeds brought in an extra $359. On the other side of the ledger, however, they were woefully over budget just about everywhere. 'The budget was too tight,' analyzed John. The worst offenders:

* Housing: 35% over budget
* Clothing: 48% over budget
* Gifts and contributions: 93% over budget
* Entertainment: a whopping 124% over budget--largely owing to the pool membership and kids' birthday parties.

All in all, the Reids managed to put a slim $3,944 toward their burdensome credit-card debt (including the late-year personal loan), 63% less than the $8,190 they'd budgeted. Because much of that $3,044 went to pay interest charges, their total balances dropped only from $16.500 to $14,500: $5,000 on their Visa and $9,500 on the personal loan from the credit union. Had they stuck to the plan, the increased income would have let them pay off nearly all their plastic debt.

Such what-ifs didn't bother the Reids. 'We feel we've made great strides,' said Rose. 'We would have been 10 times worse without the budget.'

'The reality,' added John, 'is that we have four kids. And we don't want to shortchange them.'

The Lesson: Phillips and Scheyer were pleased that the couple succeeded in controlling some indulgent spending, but they felt the couple should have tried harder. 'One of the two had to be the bad guy.' observed Scheyer, 'and say, 'We can't afford this.' Neither one seemed willing to do that.'

Facing reality

According to the advisers, the Reids must now:

* Reconsider their insurance coverage, 'They have to ask themselves the hard questions, What happens to our kids if we get sick? What

happens if John loses his job?' asks Scheyer.

* Continue paying down credit-card debt as fast as possible.

* Build a cash emergency fund after the debt is paid. That amount should equal three months' worth of expenses, or about $15,000. Phillips recommends they put the cash into the safe Vanguard Money Market Reserves/Prime fund (800-851-4999; $3,000 minimum initial investment: recent yield: 6%).

* Invest for retirement, The best idea: John's employer-provided 401(k) savings plan, which allows for tax-free contributions as well as tax-deferred growth of the plan's contents. Phillips recommends John contribute at least 4%, the maximum amount his employer will match. The company match varies with annual performance. Because he's young, John should put it all in the plan's growth fund option.

* Invest for college, If all four Reid children attend New Jersey state school Rutgers University (current annual tuition for in-state students: $9,640), tuition alone will total a stiff $154,240, even assuming only a modest tuition inflation rate of 5% a year. If the family wants to meet tuition costs in full, Scheyer calculates that the Reids must save $4,215 a year starting this next year and earn a 3% after-tax return on the money. Phillips recommends they put the dough into a growth fund such as Kaufmann (800-237-0132; up 20.5% on average over the past five years), moving into a more conservative fund such as Scudder Short-Term Bond (800-225-2470; 6.8%) when each child reaches age 15 or so.

Final grades

During the six months after the Reids' yearlong financial diet, MONEY kept in touch to see how the financial advice was taking.

The highlight of the half-year from September through February was a welcome upsurge in income. Last September, Rose began working 30 hours a week when her former employer, State Farm, convinced her to fill in for an injured worker. Pay: $750 per week, or about $2,200 per month after taxes. Thanks to bartering, child-care costs are zero. A neighbor who works mornings watches the Reids' four kids during the afternoons while Rose works. In return, Rose minds the woman's two-year-old son in the morning. 'By Christmas, we could have no Visa balance,' she exulted last fall.

But it didn't quite work out that way. Some of Rose's pay went toward unforeseen expenses, such as an $880 retainer for son Andrew's teeth, which wasn't covered by insurance. And though they paid for all of their Christmas presents in cash--'we've never done that before,' Rose says with pride--the tinsel-time total hit a hefty $2,000. Rose gave John a CD player and a golf bag. His gift to her was a ruby-and-diamond ring (he'll say only that the trinket set him back between $500 and $1,000). What's more, the family decided to resume their North Carolina beach vacations (probable cost: $2,000). 'We missed it last year,' explains Rose. 'And we're both working now, so we feel we can afford it.'

Despite such expenditures, when Rose's stint at State Farm ends in May, the couple project they'll have their Visa completely paid off and enough money set aside to replace their house's badly crumbling roof (estimated cost if they do it themselves: $4,000). By late winter, they had already reduced their Visa and personal loan debt by another $3,500 since September. The next goal for this financially older and wiser couple: 'To start saving,' says John, sounding committed.

But unfortunately, determination isn't everything. It's certain that, in several ways, the couple has a new lease on their financial life. Compared with 18 months ago, the new, improved Reids now shun credit cards. They feel more in control, pleased with their financial progress and hopeful about their prospects. Still, the bald truth is that, for the Reids, trying to live within their means in a world thick with temptations is undoubtedly a lifelong battle--as it is, of course, for so many of us.

'Transforming yourself from a spender to a saver,' sums up Scheyer, 'is extremely difficult.'

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