Are you on track to becoming financially free? Find Out If You Are On Track Or Falling Behind, With This Simple Formula

Will you eventually become financially free? It's a question that's on a lot of people's mind lately. To become financially free you must spend less than you earn and save the difference. You then need to turn your savings into investment capital. This the rocket fuel for financial freedom.

With all the importance placed on savings, wouldn't it be nice to know if you are on track? Well, you've come to the right place, as I have a quick formula that will show you if you are on track for financial freedom. Also, I include a few tips below that will help you on your path to independence.

Before we begin, let's agree on which measurement to use. On one of my podcasts, I asked this question of listeners – are you rich? I went on to explain how traditional measurements of wealth, like net income or assets, don't give an accurate reading of wealth. After all, you can make a $1M a year and still be poor.

So, what's the best way to measure wealth? **Your liquid net worth is the single best measurement to use.** Why? Because it's one of the quickest measurements of financial health. To make the calculation, you simply subtract what you owe (your liabilities) from what you own (your assets). It's also the easiest number to track progress on year after year.

The Formula

In the book "The Millionaire Next Door" by Stanley and Danko, the authors provided a simple formula for determining if you are on track in building wealth based on your *expected net worth*.

Here's the formula: Expected net worth = Your age X your annual income (pretax), divided by ten.

What makes the formula a good yardstick, is that it takes into account age differences. For example, is a 20 year old with a $15,000 net worth necessarily less successful at building wealth than a 60 year old with $500,000? The 60 year old has a lot more money but a lot less time.

Also, if you expect to inherit wealth, don't include that amount in the calculations. This keeps it simple. Think of it this way - if you are on track without including your inheritance, the money coming to you will be a very nice bonus.

While this formula isn't perfect, it's a good "back of the napkin" calculation to check your status quickly. Some may say that it's not complete because it doesn't account for inflation, taxes, and interest rates. True. But it does provide a very close approximation that's a quick, simple, and easy-to-calculate snapshot of how well you are progressing toward financial freedom. You don't need to be perfect here, close enough works just fine.

Let's run thru an example:

For example, if you were a 30 year old earning $100,000 per year with no inheritances then you should have a net worth of $300,000 because 30 times 100,000 divided by 10 equals 300,000. A person in this situation would be considered on track to becoming financially free. She is not over achieving, but she's not under achieving either.

Before we continue, did you already calculate your expected net worth yet? If not, let's pause here so you can calculate your number based on your age and income.

Are you where you should be? Don't get discouraged if you are behind. Later in this article, I'll give you some tips on how to increase your net worth. For now, let's continue.

Stanley and Danko then went on to create two benchmarks to help people gauge their progress on a scale. People whose current net worth is twice as large as their expected net worth are considered prodigious accumulators of wealth (PAWs). That's a fancy phrase for "You're doing great!" People whose net worth is less than half their expected number are considered under-accumulators of wealth (UAWs). That's a fancy phrase for "You have work to do!"

So where do you appear on the yardstick? Are you a PAW or a UAW, or are you somewhere in between?

If you are not where you thought you were or want to be, let this be your wake up call. I know it's never pleasant to find out your behind in life. But information is power. It's exactly why you go to the doctor for your yearly checkups (you do go don't you?). It's better to know if you are behind schedule or on track. That way, you can take action. After all, ignorance is not bliss. Think of this as a sneak preview into your future, while you still have time to take action to change your situation.

If you are a PAW then congratulations – you are doing great. If you are less than a PAW, what can you do to improve your situation?

Glad you asked. Here are three quick lessons to help you become a PAW:

Lesson #1: Have a budget and stick to it. Every successful person I know has a budget. When Stanley and Danko asked the millionaires they surveyed for their book this question, "Do you know how much your family spends each year for food, clothing and shelter?" almost two-thirds answered "Yes". Budgeting takes time, but it's worth it. The authors found that prodigious accumulators of wealth spend nearly twice as many hours per month planning their investments as under accumulators of wealth. The majority of PAWs agreed with the following statements, while the majority of UAWs did not:

"I spend a lot of time planning my financial future."

"Usually, I have sufficient time to handle my investments properly."

"When it comes to the allocation of my time, I place the management of my assets before my other activities."

In short, inspect what you expect. Budgeting is for winners.

Lesson #2. Save your money. Why? Because only saving makes you really rich (unless of course you've started the next Google). And saving your money comes from having a surplus every month. And having a surplus comes from living below your means. You get the idea. Most of the PAWs Stanley and Danko profiled did not buy designer items and they dedicated several pages to the spending habits of millionaires comparing UAWs and PAWs on items like suits, watches, and cars. Saving is difficult for many (See *Freedomation: Will You Really Have Enough Money* on the blog for more about this), which is why you have to make it part of your DNA if you are to achieve financial independence.

Lesson #3: Don't Drive Away Your Wealth. The majority of millionaires surveyed in Stanley and Danko's book own their cars, rather than lease. Approximately a quarter had a current-year model, but another quarter drive a car that is four years old or older. More than a third tend to buy used vehicles. What is the most popular car maker among millionaires, according to their follow on book, Stop Acting Rich? Toyota. So who's driving all those BMWs and Mercedes? Not millionaires. Eighty-six percent of "prestige/luxury" cars are bought by non-millionaires. In fact, Stanley writes that "one in three people who traded in their old car for a new one were upside down and owed more on the trade-in than its market value." It's tough to get wealthy doing stuff like that.

Remember, this self-test is your wake up call. Are you on track to financial independence? Either you are a PAW – or you're not. As they say, the numbers don't lie. If your number places you at less than a PAW, you are behind. This puts your financial independence in jeopardy.

Make the changes today that put you back on track for financial freedom. Don't leave it to chance. Doing the same things financially for the next five years that you did for the last five, will only leave you in the same or worse situation. Take action today to better your financial situation. Make it your goal to become a PAW. Start today. You can do it.

To your financial freedom.