Use the â€œ80/20 Ruleâ€• to Focus on Your Big Financial Opportunities

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Iâ€™m a big fan of the â€œ80/20 Ruleâ€•. Also known as Paretoâ€™s Principle, it states that 80% of an o usually determined by only 20% of the inputs. It holds true for a surprising number and variety of things. For example:

* 82.7% of the world GDP comes from the richest 20% of the population (1);

* In general, 80% of a companyâ€™s profits come from about 20% of its customers;

* 20% of church members are typically responsible for roughly 80% of church participation, according to a survey published in 28nineteen.com.

It doesnâ€™t always work out to exactly 80% and 20%, but the principle is usually a good rule of thumb. In fact, the derivation of â€œrule of thumbâ€• comes from the 80/20 rule: Your thumbs account for 20% of your fingers but do 80% of their work. So the principle is fairly universal.

I like the 80/20 rule not just because it helps us understand things, but also because it can help us manage things more effectively. Things like our finances.

Thatâ€™s why we named the tool to measure and manage a householdâ€™s finances â€œThe 8020 Worksheetâ„¢â€•. The main part of the worksheet lists the high-impact assets and liabilities, and the cash flow associated with each. Numerous lower impact Financial Planning are captured separately and totaled into a single â€œVariable Living Expensesâ€• number on the worksheet. This way, you can focus o the few high-impact items that matter most - the ones that determine most of your overall financial situation.

80% of your household wealth usually comes from only about 20% of your assets

What are some of those high-impact items? For the average U.S. household, two items - real estate and retirement/pension accounts - account for 80.7% of household net worth (2). So these should certainly be areas to focus on for your wealth creation. For example, how can you build equity in your home faster? Pre-paying the mortgage might be an option. And maximizing your contributions to Roth IRAs and matching 401(k) accounts will help build up your retirement account total. What are your other high-impact assets? Are you taking steps to optimize them?

The 80/20 rule can be applied to debts, too. Which one can you pay off relatively quickly to free up monthly cash flow? Maybe a car loan or a student loan. Once thatâ€™s paid off, youâ€™ll have more monthly cash to help pay off another debt. Sooner than you think, youâ€™ll be able to make good progress on paying off your biggest debts - the ones having the greatest negative impact on your financial progress and Personal Finance.

Numerous small expenditures do matter, and they shouldnâ€™t be neglected. Thatâ€™s good budget management. But identifying and optimizing the few assets and liabilities that determine most of your overall financial success - thatâ€™s good financial planning.

(1) Source: The World Bank.

(2) Source: â€œWealth is Good, Cash Flow is Betterâ€• e-booklet, p.10. Data modeled from Federal Reserve Board 2007 Survey of Consumer Finances and U.S. Bureau of Labor Statistics 2010

Consumer Expenditure Survey.

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