PART 1:
FINANCIAL PLANNING

Chapter 1

Financial Planning:
The Ties That Bind

Learning Objectives

- Explain why personal financial planning is so important.
- Describe the five basic steps of personal financial planning.
- Set your financial goals.
- List fifteen principles of a solid financial strategy.
- Explain how career management and education can determine your income level.

Why Personal Financial Planning?

- Need a financial plan because it's easier to spend than to save.
- Want a financial plan since it helps you achieve financial goals.
- Use financial planning, not to make more money, but to achieve goals.
- Control your finances or they will control you.

Here's What You Can Accomplish

- Manage the unplanned
- Accumulate wealth for special expenses
- Save for retirement
- "Cover your assets"
- Invest intelligently
- Minimize tax payments

The Personal Financial Planning Process

- Financial planning is an ongoing process – it changes as your financial situation and position in life change.

- Five basic steps to personal financial planning:
  - Evaluate your financial health
  - Define your financial goals
  - Develop a plan of action
  - Implement your plan
  - Review your progress, reevaluate, and revise your plan

Personal Financial Planning Process

Step 1: Evaluate Your Financial Health

- Examine your current financial situation.
  - How wealthy are you?
  - How much money do you make?
  - How much are you spending and what are you spending it on?
- Assess your financial situation using careful record keeping.

Personal Financial Planning Process

Step 2: Define Your Financial Goals

- Define your goals:
  - Accumulate wealth for retirement.
  - Provide funds for a child's college education.
  - Buy a new automobile.
- Over time, goals change.

Personal Financial Planning Process

Step 3: Develop a Plan of Action

- **Flexibility**
  - Plan for life changes and the unexpected.
- **Liquidity**
  - Immediate use of cash by quickly and easily converting an asset.
- **Protection**
  - Prepare for the unexpected with insurance.
- **Minimizing Taxes**
  - Keep more of what you earn.

Personal Financial Planning Process

Step 4: Implement Your Plan

- Carefully and thoughtfully develop a financial plan, then stick to it.
- Your financial plan is not the goal - it is the tool used to achieve goals.
- Keep goals in mind and work towards them.

Personal Financial Planning Process

Step 5: Review Your Progress, Reevaluate, and Revise Your Plan

- Review progress and be prepared to formulate a different plan.
- The last step in financial planning often returns to the first. No plan is fixed.
- Goals are fantasy without a plan.

Establishing Your Financial Goals

- Financial Goals Cover 3 Time Horizons
  - **Short-term** -- within 1 year
  - **Intermediate-term** -- 1 to 10 years
  - **Long-term** -- more than 10 years

Short–Term Goals

- Accumulate Emergency Funds Equaling 3 Months' Living Expenses
- Pay Off Bills and Credit Cards
- Purchase Insurance
- Purchase a Major Item
- Finance a Vacation or Entertainment Item

Intermediate-Term Goals

- Save for Older Child's College
- Save for a Down Payment or a Major Home Improvement
- Pay Off Major Debt
- Finance Large Items (Weddings)
- Purchase a Vacation Home

Long-Term Goals

- Save for Younger Child's College
- Purchase Retirement Home
- Create a Retirement Fund to Maintain Current Standard of Living
- Take Care of Elderly Family Members
- Start a Business

Stage 1 The Early Years—A Time of Wealth Accumulation

- **Prior to age 54**:
  - Purchase a home
  - Prepare for child rearing costs
  - Save for a child's education
  - Establish an emergency fund
  - Start retirement savings
- **Develop a regular pattern of saving by asking**:
  - How much can be saved?
  - Is that enough?
  - Where should the savings be invested?

Stage 2 Approaching Retirement—The Golden Years

- **Transition years between ages 55-64**.
- Retirement goals are the center of attention.
- Continuously review your financial decisions, insurance protection and estate planning.
- Unplanned events, such as corporate downsizing, divorce, or the death of a spouse, have dramatic effects on your goals.

Stage 3 The Retirement Years

- **After age 65, live off savings**
  - Retirement age depends on savings.
- Less risky investment strategy
  - Preserving rather than creating wealth.
- Review insurance, consider extended nursing home protection.
- Estate planning decisions are critical. Trim estate tax bills, have wills, living wills, and health proxies.

Thinking About Your Career

- Choosing a Major and a Career
- Getting a Job
- Making it a Successful Career
  - You'll work for at least 3 different companies, have over 10 different jobs.
  - Job switching results from great opportunities or downsizing.
  - Job security is a thing of the past.

Being Successful in Your Career

- Have a marketable skill, be well educated, and keep up with technology.
- Do good work.
- Project the right image.
- Understand and work within the power structure.
- Gain visibility.
- Take new assignments.
- Acquire new skills.
- Develop a strong network.
- Be ethical.

What Determines Your Income?

- Specialized skills received higher pay.
- Education is key determinant of salary*
  - Advanced degrees earn $72,824
  - Bachelor's degrees earn $51,194
  - High school graduates earn $27,280
  - Non-graduates earn $18,826
- Being married may affect your wealth
  - 70% of middle class households are married
  - 85% of wealthy households are married

*US Census Bureau 2002

Fifteen Principles of Personal Finance

- These principles form the foundation of personal finance.
- They will provide you with:
  - an excellent grasp of your own personal finance
  - a better chance of attaining wealth and achieving financial goals

Principle 1: The Risk–Return Trade-Off

- Savings allow for more future purchases.
- Borrowers pay for using your savings.
- Investors demand a minimum return to delay consumption - above anticipated inflation.
- Investors demand higher return for added risk.

Principle 2: The Time Value of Money

- Money has a time value.
- Money received today is worth more than money received in the future.
- Compound interest - interest paid on interest.

Principle 3: Diversification Reduces Risk

- "Don't put all your eggs in one basket."
- To diversify, place money in several investments, not just one.
- Diversification reduces risk without affecting expected return.
- Won't experience great returns or great losses—receive an average return.

Principle 4: All Risk Is Not Equal

- Some risk **cannot** be diversified away.
- If stocks move in opposite directions, combining them can eliminate variability.
- If stocks move in same direction, not all variability can be diversified away.

Principle 5: The Curse of Competitive Investment Markets

- In efficient markets, information is instantly reflected in prices.
- Cannot earn higher than expected profits from public information.
- Difficult to “beat the market” -- “bargains” don’t remain so for very long.

Principle 6: Taxes Affect Personal Finance Decisions

- Taxes influence the realized return of investments.
- Maximize after-tax return.
- Compare investment alternatives on an after-tax basis.

Principle 7: Stuff Happens, or the Importance of Liquidity

- Have funds available for the unexpected.
- Without liquid funds:
  - Long-term investments must be liquidated.
  - Results in lower price, tax consequences, or missed opportunities.
- With nothing to sell:
  - Pay higher interest to borrow money quickly.

Principle 8: Nothing Happens Without a Plan

- People spend money without thinking, but you can’t save without thinking about it.
- Saving must be planned
  - Start off with a modest, uncomplicated plan.
  - Later modify and expand your plan.
- Remember - financial plans cannot be postponed.

Principle 9: The Best Protection Is Knowledge

- Take responsibility for your financial affairs:
  - Protect yourself from incompetent advisors.
  - Take advantage of changes in the economy and interest rates.
  - Understand personal finance then apply it.

Principle 10: Protect Yourself Against Major Catastrophes

- Have the right insurance before a tragedy occurs.
- Know your policy coverage.
- Insurance focus should be on major catastrophes which can be financially devastating.

Principle 11: The Time Dimension of Investing

- Take **more** risk on long-term investments.
- Large-company stock prices up 10.4% annually over the past 78 years.
- 20 year-olds investing retirement money will likely earn more in the stock market than other investment alternatives.

Principle 12: The Agency Problem—Beware of the Sales Pitch

- The agency problem - those who act as your agent may actually act in *their own* interests.
- Insurance salespeople, financial advisors, and stockbrokers receive commissions, so select them carefully.
- Find an advisor who fits your needs, is ethical and effective.

Principle 13: Pay Yourself First

- For most people, savings are residual. Spend what you like, save what is left.
- Pay yourself first so what you spend becomes the residual.
- Reinforce the importance of long-term goals, ensuring goals get funded.

Principle 14: Money Isn't Everything

- Extend financial plans to achieve future goals.
- See more than just $$$ - know what is important in life.
- Money doesn't bring happiness, but facing expenses without the funding brings on anxiety.

Principle 15: Just Do It!

- Making the commitment to get started is difficult, but the following steps will be easier.
- One of your investment allies – TIME - is stronger now than it ever will be.
- Take investment action now — **just do it**!