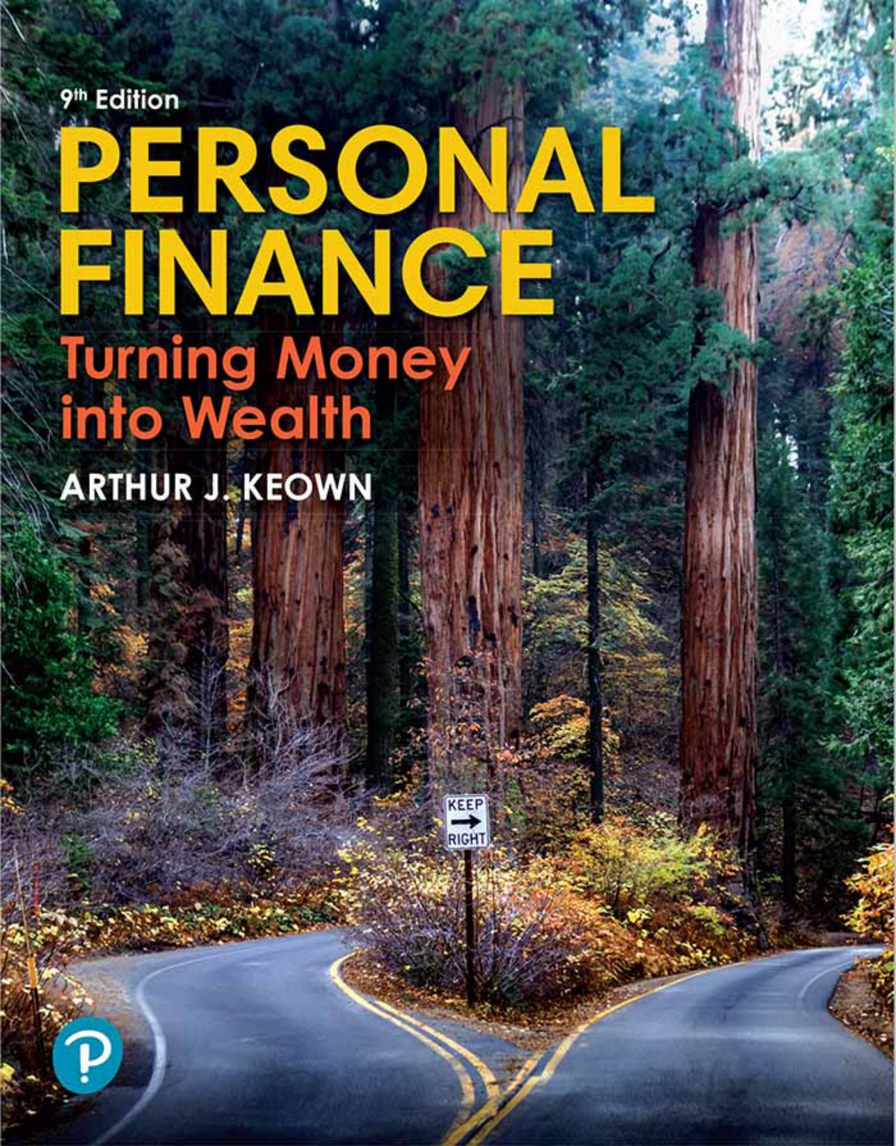
9th Edition

PERSONAL FINANCE

Turning Money into Wealth

ARTHUR J. KEOWN



Personal Finance

Turning Money into Wealth

Ninth Edition

Arthur J. Keown

Virginia Polytechnic Institute and State University
Alumni Distinguished Professor and R. B. Pamplin Professor of Finance

Pearson

To Barb, my partner and my love—
for showing me happiness that money can't buy

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About the Author

Arthur J. Keown is an Alumni Distinguished Professor and the R. B. Pamplin Professor of Finance at Virginia Polytechnic Institute and State University. He received his bachelor's degree from Ohio Wesleyan University, his MBA from the University of Michigan, and his doctorate from Indiana University. An award-winning teacher, he is a member of the Academy of Teaching Excellence at Virginia Tech; he has received numerous Certificates of Teaching Excellence, the W. E. Wine Award for Teaching Excellence, and the Alumni Teaching Excellence Award; and in 1999 he received the Outstanding Faculty Award from the State of Virginia. In 2016, he was named to be one of 10 Alumni Distinguished Professors on campus and the first and only Alumni Distinguished Professor in the Pamplin College of Business. In 2021 he was honored to be chosen by the student body at Virginia Tech to be their Class Sponsor. Professor Keown is widely published in academic journals. His academic research work has appeared in *Journal of Finance, Journal of Financial Economics, Journal of Financial and Quantitative Analysis, Journal of Financial Research, Journal of Banking and Finance, Financial Management, Journal of Portfolio Management*, and many others. Two of his textbooks are widely used in college finance classes all over the country—*Financial Management* and *Foundations of Finance: The Logic and Practice of Financial Management*. Professor Keown is a Fellow of Decision Sciences Institute and served as Department Head for twelve years. In addition, he has served as the coeditor of both the *Journal of Financial Research* and the Financial Management Association's *Survey and Synthesis Series*. He was recently inducted into Ohio Wesleyan's Athletic Hall of Fame for wrestling. His daughter and son are both married and live in Houston, Texas, and Denver, Colorado, while he and his wife live in Blacksburg, Virginia, where he collects original art from *Mad* magazine.

Brief Contents

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Preface

New to This Edition

Since the last edition of *Personal Finance: Turning Money into Wealth*, a lot has changed in the world of personal finance. Much of this change was driven by the Covid-19 pandemic, which resulted in loss of jobs, the national unemployment rate reaching 14.8 percent in April 2020, a dramatic drop in stock prices followed by a recovery, and historically low interest rates. While employment has largely recovered, many individuals who lost their jobs have been unable to find new ones; interest rates are near all-time lows and are just now starting to rise; housing prices have reached all-time highs with the average sales price of a house climbing to $434,200 in June 2021 (and according to the St. Louis Fed, that's over double the price of a home in 2020); consumer debt (including mortgage debt) reached $15 trillion, more than doubling since 2000; and student loans have continued to rise at an alarming rate, now topping $1.6 trillion, with over 11 percent of those student loan balances over 90 days delinquent or in default. According to a recent survey by Capital One, as you might expect, all of this has taken a toll on Americans, with 77 percent of Americans reporting that they feel anxious about their financial situation. As you will see, the entire book is updated to reflect the recent changes in the area of financial planning, including possible tax changes, new laws, the ever-changing investments landscape, the explosion of student loans, and credit card challenges facing graduating students as well as other changes in the world of personal finance. In short, because of these continuous and fast-paced changes occurring in the personal finance landscape, little remains exactly as it was in the previous edition. Some of the more dramatic changes to the new edition include the following revisions.

All text discussions and figures, tables, and facts have been updated to accurately reflect developments in the field of finance in the past few years. Specific highlights include the following:

- **Lessons from the Recent Pandemic.** The Covid-19 pandemic of 2020 resulted in an economic downturn that produced massive job loss and financial hardship. Readers will find financial lessons from the pandemic woven throughout the text, with a section devoted to this topic in Chapter 1. Significant emphasis is placed on the importance of emergency funds.
- **Expanded Coverage of Student Loans.** Chapter 7 offers an expanded discussion of student loans, including entirely new sections on student loan refunds and repaying student loans. Students are strongly encouraged to put together a plan before they graduate for how they will repay their loans, and tools are provided throughout the text to set them on the path to achieving that goal.
- **Updated Coverage of Health Insurance.** Chapter 9 has been updated to include a discussion about the importance of considering health insurance benefits when evaluating job offers as well as a revised discussion of the costs and benefits of high-deductible health plans. A new table has been added that provides a summary of the limited long-term care coverage offered by Medicare, Medigap, and private health insurance.
- **Updated Coverage of Investments.** Chapter 11 includes several new and heavily revised sections, including such topics as "Understanding That Wealth Is More a Function of How Much You Save Than How You Invest," "Staying in the Market and the Impact of 'Big Outliers,'" and "Stocks Are Risky, but Not as Risky as Not Investing in Them—Stay the Course."

◆ **Updated Love & Money Feature.** Even before reading this book and taking this class you have probably realized that the way you approach personal finance has a huge impact on many different areas of your life. Certainly it will affect your ability to buy a house, your investment success, and whether or not you are able to retire early and comfortably, but it also can have just as big an impact on your love life and other personal relationships. While there is no question that money problems can cause tension in relationships, there is also no reason why it has to be this way. As you might expect, while there are some things that you simply shouldn't do when it comes to handling your money and making personal financial decisions if you want your relationships to thrive, there are also some actions you can take to keep money from sabotaging your relationships. In the Love & Money boxes, we'll not only take a look at people's attitudes towards and thinking about money and love, we'll also give you some personal finance advice aimed at helping you build better, stronger, and perhaps lasting relationships.

LOVE & MONEY

As you probably know, communication is one of the keys to a good relationship. But did you know that honest, open communication is especially important when it comes to the topic of money? This might seem like common sense, but it is also easier said than done. If your family is like most, money is probably not something that was talked about openly when you were growing up, and that hesitancy to discuss financial matters is something that is often passed on from one generation to the next. It is also something that can lead to misunderstandings and arguments, and it is often one of the causes of divorce. But the good news is that it's also something that can be overcome.

According to a recent TD Ameritrade survey, almost 80 percent of couples surveyed who said that they discussed money at least once a week also said they were happy. When should financial discussions begin? Well before you get engaged. As you will see, money can impact your love life in some unexpected ways. In fact, in that same survey, 42 percent of respondents said that the biggest mistake they made in their relationship was "waiting too long" to discuss money. That doesn't mean this discussion will be an easy one. In fact, according to a recent Citi Card survey, almost 30 percent of respondents would like to discuss finances more often, but almost 70 percent of those who would like to discuss finances more often avoid those discussions for fear of starting an argument.

That fits with the findings of a Northwestern Mutual study that found money to be a more uncomfortable discussion topic than one's own eventual death, asking adult children to move out, or sex. One reason that discussing finances and money is so tough is that you're also sharing your goals, personal feelings, and intimacies. That's not an easy thing to do, but it's important for a healthy relationship.

So how do you start a conversation about money and your finances? First, you want to pick a "happy time": some sort of positive event like a family wedding, a promotion, or even just a great weekend together. It's just too difficult to bring up money during bad times and much easier to open up when things are good. One way to do this might be to google "how to talk about money with a partner" and then simply share the article and let your partner know that it made you think that this is something you should do. (Or if you still have this text, share a "Money & Love" box or two.)

Once the conversation gets going, share your financial goals with each other, determine your net worth, and then explore a budgeting app like **Mint.com** or **Goodbudget** with your partner. That should get you started, but before you finish, set a date in the future to continue to talk more about your finances, your financial goals, and how you intend to reach them. But feel good that the toughest step, opening up a dialogue about money, is behind you. Well done!

◆ **Emphasis on the Use of the Internet and Apps for Smartphones.** This edition continues to emphasize the use of apps for smartphones and the best of the Internet where appropriate. For example, the Acorn, Mvelopes, Qapital, Mint.com, and Goodbudget apps are easily installed on a smartphone and are both introduced and described when discussing budgeting, saving for your goals, and record keeping. These apps make tedious tasks easy—and, if you can imagine, fun. Apps and the best of personal finance Web sites on the Internet are also introduced when discussing credit cards, student loans, insurance, investments, and retirement planning.

Solving Teaching and Learning Challenges

Once, not that long ago, a fundamental background in financial planning and investments was not necessary for most university students. Financial instruments were not overly complex; students did not have access to numerous, high-limit credit cards which enabled them to amass significant personal debt almost effortlessly; and a college education did not involve much in the way of student loans. In addition, in an earlier age of relatively high, full-time, and stable employment, retirement planning was easy: your long-term employer basically did it for you. In such a period, financial explanations, expectations, and communications were generally straightforward, realistic, and clear. And that—by and large—has changed. Today, we are living in a world where financial instruments are increasingly complex and require a higher level of financial literacy. At an early age students are asked to make financial decisions as to how they will finance their college experience. This includes choosing between various types of student loans and even how much they will need to borrow, which will impact them for years to come. Once they graduate, they will face consumer loan decisions when buying a car, furniture, appliances, or even stereo equipment that involve making decisions on single-payment versus installment loans, secured versus unsecured loans, and variable rate versus fixed-rate loans as well as a decision on the maturity of the loan. Similarly, deciding on a mortgage to buy a house involves choices of not only how much to borrow but also how to select from among the different loan structures with fixed rate, variable rate, and interest-only loans, each one having different implications for the borrower's financial future. This complexity also extends to life insurance. When the time is right to get our first life insurance policy, most of us do not seek it out—instead, someone approaches us and convinces us it's important, and then we buy it. Because insurance has a language all its own, it is often difficult to understand all of the subtle differences between one policy and another and to know how much to buy—once again, financial literacy is the key to making good financial decisions. Finally, just 30 years ago retirement meant taking a pension from your employer and letting Social Security pick up any slack. Not anymore. Thanks to the recent drive to cut spending, employers tend not to provide pensions, and those that still do have reduced them to as little as possible. That leaves a lot of slack for Social Security, and given the unsustainability of those promised benefits from Social Security coupled with the government's drive to cut its own spending, it is likely that the Social Security system that our students see upon their retirement will not be the same one we have now, and that is also true for Medicare. Today's students will have to rely on self-directed retirement plans, 401k and IRA accounts, where they not only decide how much to save, but also how to invest that money—decisions requiring a knowledge of investing terms and tools—with the results of those decisions determining whether they have a retirement of leisure or nightmare. In effect, our students must not only know how much they will need for retirement, but they must also have a solid grounding in the terms, tools, and rules of investing in order to reach their financial goals and avoid the pitfalls that might upend their financial future. The bottom line is that everyone must take responsibility for their own retirement, and the earlier that process begins, the easier it becomes.

For many students, the Personal Finance course is their initial and only exposure to personal finance, so it is important that the material is presented in a way that leaves a lasting impression. Tools, techniques, and equations are easily forgotten, but the logic and fundamental principles that drive their use, once understood, will remain and will become part of each student's "financial personality." *Personal Finance: Turning Money into Wealth*, Ninth Edition, empowers students, through the presentation of the ten fundamental principles of personal finance, to successfully make and carry out a plan for their financial future. Throughout the rest of their lives, students will have the ability to draw on these principles, which will help them effectively deal with an ever-changing financial environment.

Some of the features used to overcome teaching and learning challenges include:

- **The Ten Principles of Personal Finance.** Each chapter of the text touches back on the ten principles introduced in Chapter 1 and shows how to apply these principles to particular situations.

FIGURE 7.4 College Savings Plans Comparison

	529 College Savings Plan	529 Prepaid Tuition Plan	Coverdell Educational Savings Account
Who Owns It?	Contributor	Contributor	Contributor
What Can I Invest In?	Typically, plans provide several investment options.	Purchase units or credits at participating school.	No restrictions.
When Can It Be Used?	No age limit.	Plan may set age or grade limits.	No contributions can be made after beneficiary turns age 18, and withdrawals must be made before beneficiary turns 30. An exception is made for special needs children.
What Expenses Are Covered Besides Tuition and Fees?	Qualified education expenses for postsecondary education or up to $10,000 per student per year for private, public, or religious elementary, middle, and high school tuition only.	Only tuition and mandatory fees for postsecondary or up to $10,000 per student per year for private, public, or religious elementary, middle, and high school education are covered. Few exceptions are made.	Qualified elementary and secondary education expenses or qualified postsecondary education expenses.

- **Extensive Coverage of Student Loans and Paying for College, Covering Almost Half of Chapter 7.** This chapter, titled "Student and Consumer Loans: The Role of Planned Borrowing," gives students an in-depth look at the world of student loans to help untangle the complexities and jargon associated with them and facilitate good decision-making practices.

- **Personal Finance Worksheets.** Companion worksheets are available for this text that provide a step-by-step analysis of many of the personal finance decisions examined in the book. Instructors can assign them as homework or use them to guide students through actual decisions. The worksheets are available in MyLab and at the Instructor's Resource Center.
- **Your Financial Plan.** This series of exercises available in MyLab Finance utilizes the worksheets and generates a very basic financial plan to explore where students are today, where they want to be in the future, and what they need to do to get there. Also included is a section on how to use a financial calculator.

- **Easy-to-Follow Advice.** The proactive checklists, which appear throughout the text, serve as useful learning tools for students. These boxes identify areas of concern and propose questions to ask when buying a car, getting insurance, and investing in mutual funds as well as performing other personal finance tasks.

CHECKLIST 13.1 Picking a Good Bond

- ☐ **Think about the effect of taxes.** Consider municipals, particularly if you're in a high tax bracket.
- ☐ **Keep the inverse relationship between interest rates and bond prices in mind.** If interest rates are very low, the only way they can go is up (which would cause bond prices to drop), so you might want to invest in shorter-term bonds.
- ☐ **If you're buying a corporate bond, avoid losers.** Look for and avoid firms that might experience major financial problems. All other firms are pretty much the same.
- ☐ **Limit yourself to bonds rated AA or above.** In this way, you minimize any worry regarding a possible default by the issuer.
- ☐ **Buy your bond when it's first issued rather than in the secondary market.** The price is generally fair, and the sales commission on a newly issued bond is paid by the issuer.
- ☐ **Avoid bonds that might get called.** Before you buy a bond, ask your broker or financial planner if the bond is likely to be called. If so, pick another one.
- ☐ **Match your bond's maturity to your investment time horizon.** In this way, you can hold the bond to maturity and avoid having to sell in the secondary market, where you don't always get a fair price.
- ☐ **Stick to large issues.** If you think you might have to sell before maturity and are buying a corporate bond, make sure you buy a bond issued by a large corporation—the secondary market is generally more active for them.
- ☐ **When in doubt, go Treasury!** If you're still unsure, it's better to be safe than sorry—buy a Treasury bond.

- **Learning Objectives.** Each chapter opens with a set of action-oriented learning objectives. As these objectives are covered in the text, an identifying icon appears in the margin.

Present Value—What's It Worth in Today's Dollars?

LO3 Calculate the present value of money to be received in the future.

Up until this point, we've been moving money forward in time; that is, we know how much we have to begin with, and we are trying to determine how much that sum will grow in a certain number of years when compounded at a specific rate. We're now going to look at the reverse question: What's the value in today's dollars of a sum of money to be received in the future? That is, what's the present value?

Why is present value important to us? It lets us strip away the effects of inflation and see what future cash flows are worth in today's dollars. It also lets us compare dollar values from different periods. In later chapters, we'll use the present value to determine how much to pay for stocks and bonds.

- **Stop and Think.** These short boxes provide students with insights as to what the material actually means—its implications and the big picture.

STOP & THINK

What do you do if it appears that you won't reach your financial goals? You need to change either your goals or your saving pattern. Fortunately, a small change in your financial lifestyle can produce large benefits down the road. For example, if you are 22 now and you save \$10 per month—that works out to about 33¢ per day—at 12 percent, by age 67 when you retire, it will have grown to over \$240,000. Are there any small changes that you might make to save money?

Discussion Case 1

Jinhee Ju, 27, just received a promotion at work that increased her annual salary to $37,000. She is eligible to participate in her employer's 401(k) plan, in which the employer matches dollar-for-dollar workers' contributions up to 5 percent of salary. However, Jinhee wants to buy a new $25,000 car in 3 years, and she wants to save enough money to make a $7,000 down payment on the car and finance the balance.

Also in her plans is a wedding. Jinhee and her boyfriend, Paul, have set a wedding date 2 years in the future, after he finishes medical school. Paul will have $100,000 of student loans to repay after graduation. But both Jinhee and Paul want to buy a home of their own as soon as possible. This might be possible because at age 30, Jinhee will be eligible to access a $50,000 trust fund left to her as an inheritance by her late grandfather. Her trust fund is invested in 7 percent government bonds.

Questions

1. Justify Jinhee's participation in her employer's 401(k) plan using the time value of money concepts.

◆ **Discussion Cases.** Each chapter closes with a set of at least two mini-cases that provide students with real-life problems that tie together the chapter topics and require a practical financial decision.

Continuing Case: Cory and Tisha Dumont

PART I: Financial Planning

The objective of the Continuing Case is to help you synthesize and integrate the various financial planning concepts you have been learning. The case will help you apply your knowledge of constructing financial statements, assessing financial data and resources, calculating taxes, measuring risk exposures, creating specific financial plans for accumulating assets, and analyzing strengths and weaknesses in financial situations.

◆ **Continuing Case of Cory and Tisha Dumont.** The book is divided into five parts, and at the end of each part, a Continuing Case provides an opportunity to synthesize and integrate the many different financial concepts presented in the book. It gives students a chance to construct financial statements, analyze a changing financial situation, calculate taxes, measure risk exposure, and develop a financial plan.

◆ **Behavioral Insights—Principle 9: Mind Games, Your Financial Personality, and Your Money.** Each chapter has a section devoted to examining the impact of various behavioral traits and biases that we all share and that contribute to an individual's "financial personality." This exploration of patterns of thought and behavior offers insights as to why and how people sometimes make illogical or irrational personal finance decisions.

ACTION PLAN

PRINCIPLE 10 PRINCIPLE 7

Principle 10: Just Do It! Once you have a car and some possessions, it's time for some insurance. Your goal should be to put **Principle 7: Protect Yourself Against Major Catastrophes** into action. Here are some things to consider:

- ◆ **Renter's insurance—do you need it?** Living in a dorm on campus? Chances are you are covered by your parents' "off-premise coverage." Living off-campus is another story. Do you own any computer equipment? Television? Stereo? DVD player? Textbooks? Bicycle? Kitchen gear? Furniture? Shoes and clothing? If you answered "yes," add up how much it would cost to replace all of these items. CNN estimates renter's insurance to be $184 per year. Now what do you think?

◆ **Action Plan—Principle 10: Just Do It!** Each chapter ends with concise directions encouraging students to put into play the personal finance lessons learned in that chapter.

Financial Milestones

What to Do	Time to Act
Apply for Social Security benefits	• Apply at age 61 years, 9 months to collect at age 62. • Apply at age 66 years, 9 months to collect full benefits at age 67. (For people born between 1937 and 1959, the full retirement age varies from 65 years, 2 months to 67 years.) • Apply at age 69 years, 9 months to collect maximum benefits at age 70.
Apply for Medicare benefits	• If you start receiving Social Security benefits before age 65, you will be enrolled automatically in Medicare. • Otherwise, apply at age 64 years, 9 months, even if you won't be collecting Social Security right away.
Receive distributions from your retirement accounts	• Before age 59½, withdrawals are generally considered premature distributions and may be subject to a 10% penalty. • Between ages 59½ and the year in which you turn age 72 (70½ if you reach 70½ before January 1, 2020), you choose whether or not to make withdrawals.
Take mandatory retirement distributions	• By April 1 of the year after you turn age 72 (70½ if you reach 70½ before January 1, 2020), you generally must begin making required minimum distributions (RMDs). (Roth IRAs are not subject to RMD rules.)
Become eligible for a reverse mortgage	• At age 62, you can apply for a reverse mortgage, which lets you turn the equity in your home into a regular stream of income. Note that reverse mortgages are not appropriate for everyone. See your financial consultant for more information.

◆ **Ten Financial Life Events.** The concepts and tools in this book are all tied together in Chapter 17, the final chapter, by examining ten financial life events. Here students will gain a broad perspective on and an overview of the ways personal finance affects almost all parts of their lives. Students will clearly see that in the course of a lifetime they will experience many events that will change their goals, affect their financial resources, and create new financial obligations or opportunities. While there are many life-changing events, we focus on ten of the most common, such as getting married, having a child, and retiring. With each one, we present a comprehensive, step-by-step discussion of how to respond to it—pulling material from throughout the book and tying it all together into an action plan.

Developing Financial Life and Employability Skills

There is no question that everyone needs strong personal finance skills to thrive in today's world. This book is intended to provide you with those skills. While your newly acquired personal finance skills will help you achieve the retirement you want, they also may help you find a job and move up the ladder. A recent study conducted by the Society for Human Research Management found that 47 percent of U.S. companies run credit background checks on potential employees, and the skills acquired from this book will help you to pass that background check with flying colors. In addition, studies have shown that employees with financial problems have difficulties performing on the job. So while at first glance you may not think this book will help you get a job and then advance in your career, you're wrong. This book will do it all in a sense—help you in both your personal and professional life.

Table of Contents Overview

Personal Finance, Turning Money into Wealth provides students with a fundamental background in financial planning and investments with an emphasis on intuitive understanding of the concepts and tools so that when financial decisions have to be made in the future, the student has a strong conceptual framework from which to make those decisions.

Part 1	**Financial Planning**	
	1 The Financial Planning Process	Introduces the financial planning process; discusses its importance; describes the steps of personal financial planning, how to set your goals, how career management and education can determine your income, and how the skills acquired in this course will help you get a job and advance in it.
	2 Measuring Your Financial Health and Making a Plan	Examines the budgeting and planning process, which involves measuring our wealth using a personal balance sheet, using a personal income statement to track where money comes from and where it goes, using ratios to monitor our financial health, and setting up and implementing a cash budget.
	3 Understanding and Appreciating the Time Value of Money	Introduces the concept of the time value of money, providing the student with both an intuitive understanding of it and the ability to move money through time with applications to personal finance.
	4 Tax Planning and Strategies	Provides an understanding of how taxes are imposed, what strategies can be used to reduce them, and what role tax planning plays in personal financial planning. In addition, while the tax documentation in this chapter was current at the time of publication, it can change at any time.
Part 2	**Managing Your Money**	
	5 Cash or Liquid Asset Management	Examines cash management, how to automate your savings, choosing a financial institution, deciding among the various cash management alternatives, comparing rates, establishing a checking account, and how ETFs work.
	6 Using Credit Cards: The Role of Open Credit	Examines how credit cards work, the cost of credit, the different types of credit cards, determining your credit card worthiness, and how to manage your credit cards.
	7 Student and Consumer Loans: The Role of Planned Borrowing	Provides a clear understanding of your choices and costs with respect to consumer loans, how to get the best rate on your consumer loans, controlling your debt, and using student loans and paying for college.
	8 The Home and Automobile Decision	Analyzes smart buying and the home and auto decision.
Part 3	**Protecting Yourself with Insurance**	
	9 Life and Health Insurance	Demonstrates the importance of insurance, determining life insurance needs, major types of insurance coverage, the health insurance decision, how disability insurance works, and the purpose of long-term care insurance.

	10 Property and Liability Insurance	Introduces homeowner's and automobile insurance and how to file a claim and recover on a loss.
Part 4	**Managing Your Investments**	
	11 Investment Basics	Provides an overview of investing by examining setting goals, the intuition behind risk and return and asset allocation, efficient markets, primary and secondary markets, and finding investment information.
	12 Investing in Stocks	Introduces common stocks and how to value them along with a look at their historical risks and returns.
	13 Investing in Bonds and Other Alternatives	Describes bonds; bond valuation and yields, why bonds fluctuate in value, preferred stock and its valuation, and investing in real estate.
	14 Mutual Funds and Exchange-Traded Funds: An Easy Way to Diversify	Introduces mutual funds, ETFs, and investment trusts; the calculation of their returns; and how to select a mutual fund that is right for you.
Part 5	**Life Cycle Issues**	
	15 Retirement Planning	Develops an understanding of the challenges of retirement planning, the steps in setting up a retirement plan, the different types of retirement plans, payment choices, and how to put a plan together and monitor it.
	16 Estate Planning: Saving Your Heirs Money and Headaches	Examines the estate planning process, drafting a will, and avoiding probate.
	17 Financial Life Events—Fitting the Pieces Together	Ties things together by examining the importance of starting to plan and save early, recognizing different financial life events with strategies to deal with them, understanding the keys to financial success, and dealing with debt in the real world.

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Arthur J. Keown

PART 1

Financial Planning

It's easy to avoid thinking about financial planning—after all, sometimes just financial existence seems like a victory. The problem is that by avoiding financial planning, you are actually creating more financial problems for your future. It's just too easy to spend money without thinking—it's saving money and planning that take some thought and effort. The problem is that most of us have no background in financial planning.

Part 1: Financial Planning will begin your introduction to personal finance. We will present some of the personal finance problems you will face in the future, along with a five-step process for budgeting and planning. You will also be introduced to ten fundamental principles of personal finance in Chapter 1 that reappear throughout the book. While the tools and techniques of personal finance may change or be forgotten over time, the logic that underlies these ten principles, once understood, will become part of your "financial personality," and you will be able to draw upon these principles for the rest of your life.

In Part 1, we will focus on the first four principles:

Principle 1: The Best Protection Is Knowledge—After all, financial advice is everywhere; the hard part is differentiating between the good and bad advice, and without that ability, you're ripe for a financial disaster.

Principle 2: Nothing Happens Without a Plan—Financial planning doesn't happen without a plan, so you're going to want to begin by measuring your financial health by finding out where you stand financially, setting your goals, putting together a plan of action, and then putting that plan into play with a budget. Because without a plan, nothing will happen.

Principle 3: The Time Value of Money—In order to understand why it is so important to begin saving early, you need to understand how powerful the time value of money is. Once you understand this concept, saving becomes much more fun.

Principle 4: Taxes Affect Personal Finance Decisions—Like it or not, taxes are part of life, and as a result, your financial plan must take taxes into account.

CHAPTER 1

The Personal Financial Planning Process

Learning Objectives

LO1	**Explain** why personal financial planning is so important.	Facing Financial Challenges
LO2	**Describe** the five basic steps of personal financial planning.	The Personal Financial Planning Process
LO3	**Set** your financial goals.	Establishing Your Financial Goals
LO4	**Explain** how career management and education can determine your income level.	Thinking About Your Career
LO5	**Identify** and explain how skills acquired in this course will help you get a job and advance in it.	Developing Skills for Your Career
LO6	**Explain** the personal finance lessons learned in the recent pandemic.	Lessons from the Recent Pandemic
LO7	**List** ten principles of personal finance.	Ten Principles of Personal Finance

Everybody wants to have it, but nobody wants to talk about it," says Dre from *Black-ish* doing a pretty good job of explaining why taking a course in personal finance makes a lot of sense. *Black-ish*, a TV comedy that follows the Johnsons, an upper-middle-class family, led by "Dre" and Rainbow "Bow" Johnson as they confront many of the same issues faced by millions of Americans. Certainly, Dre's take on money is one shared by many of us. But it's also, as Dre points out in the monologue opening the episode "Keeping Up with the Jones," an attitude that can get you in real trouble. This entire book is dedicated to giving you an understanding of "money" or personal finance that will keep you out of trouble and give you an action plan to do just that. As Mark Cuban of Shark Tank says, "if you don't understand finance, it's awful hard to know what you're doing."[1]

Adam Taylor/©ABC/courtesy Everett Collection

The *Black-ish* episode opens up with Dre and Bow opening up a credit card bill to the shouts of "We owe what?" and "Holy slick Rick." Apparently, the credit card bill included a trip to Disneyland, a new water heater… In digging down, they realize their money problems are deep-seated. When Bow was young, her mom scarred her forever on the topic of money, saying that money is "an artificial masculine construct that fosters hostility and war and builds a wall between you and love." Yikes! No wonder there's a problem. And when she asked her mom again why she avoided talking and learning about money, her mom replied, "Well, because I don't understand it." Probing, Bow asked why they never talked about money, to which her mom replied, "Well, as long as there was enough, I tried not to really involve myself. That's why I let your dad handle it, and now we're living in an RV."

Improbable plot line? Definitely not. In fact, according to the Standard & Poor's Global Financial Literacy Survey, only 37 percent of Americans were able to answer simple questions about inflation, compound interest, and diversification. How much do you know about personal finance? Hopefully more than Dre or Bow, but probably not enough. That's pretty much how it is for everyone until they've made a real effort to learn about personal finance.

Being financially secure involves more than just making money—life will be easier when you learn to balance what you make with what you spend. Unfortunately, financial planning is not something that comes naturally to most people. This text will provide you with the know-how to avoid financial pitfalls and to achieve your financial goals, whether they include buying a car, paying off debt, or saving for your future. In addition to providing the necessary tools and techniques for managing your personal finances, you will learn the logic behind them, allowing you to understand why they work. To make life a little easier, you will be introduced to ten basic principles that reinforce this underlying logic. If you understand these principles, you are well on your way to successful financial planning. It's just too bad neither Dre nor Bow took this class.

[1] "Mark Cuban: Invest in understanding finance," April 20, 2021, https://www.cnbc.com/video/2021/04/20/mark-cuban-invest-in-understanding-finance.html

LO1 Explain why personal financial planning is so important.

Facing Financial Challenges

How big are the financial challenges you face? You may be gaining an appreciation for the cost of college. College tuition and fees at a private school in the United States average around $37,650 per year, and at a public school, the average in-state cost is $10,560 per year. Add to this the cost of housing and food, textbooks and computer equipment, and the "essentials"—a mini-refrigerator, a parking permit, lots of change for the laundry, a bit more cash to cover library fines, and late-night pizza money. How do most students finance the cost of college? The answer is by borrowing.

Today, the typical grad with loans—and that's about half of all college students—will leave college with both a diploma and some $29,200 in student loans. If you add in credit card, personal, and family loans, student debt climbs to over $37,100—and many students are in far more debt than that. Take, for example, Sheri Springs-Phillips, who was written about in the *Wall Street Journal*. She's a neurology resident at Loyola University Medical Center. On her 11-year journey from the South Side of Chicago to becoming a doctor, she piled up $102,000 in debt. Although her friends think she's got it made, she worries about the $2,500 monthly loan payments that begin when she finishes her residency. Fortunately, Sheri is an exception, but just the average level of debt can be daunting. However, with a solid financial plan, even this level of debt is manageable.

Financial planning may not help you earn more, but it can help you use the money you do earn to achieve your financial goals. Let's say you really hope to buy a car when you graduate—one with a stereo loud enough to wake the neighbors (and the dead). That's a financial goal, and a good financial plan will help you achieve it. A solid financial plan could also help you save enough to buy a car or help you balance your budget so maybe someday you won't have a roommate. It may even help you pay off those student loans! Whatever your financial goals, the reality is this: Either you control your finances, or they control you—it's your choice.

STOP & THINK

Why do people *need* to make a financial plan? Because it's always easier to spend than to save. According to a survey by the Federal Reserve, one-quarter of adult Americans have nothing at all saved for retirement. On top of that, only 36 percent of all non-retired Americans think their retirement saving is on track. How do you see yourself in retirement? Now, do you think you need a plan?

Managing your finances isn't a skill you are born with. And, unfortunately, personal finance courses aren't the norm in high school, and in many families, money is not something to talk about—only to disagree on. In fact, financial problems can be a major cause of marital problems. Disagreements about money can instill a fear of finance at an early age, and a lack of financial education just makes matters worse. As a result, most people grow up feeling very uncomfortable about money. But there is nothing to be afraid of; rest assured that personal financial management is a skill well worth learning.

When we first attempt to understand the subject of personal finance, we are often intimidated by the seemingly unending number of investment, insurance, and estate planning options as well as by the fact that the subject has a language of its own. How can you make choices when you don't speak the language? Well, you can't. That's why you're reading this text and taking this course—to learn to navigate the world of money. Specifically, this text and this course will enable you to accomplish the following:

- **Manage the unplanned:** It may seem odd to plan to deal with the unexpected or unplanned. Hey, stuff happens. Unfortunately, no matter how well you plan, much of what life throws at you is unexpected. A sound financial plan will allow you to bounce back from a hard knock instead of going down for the count.
- **Accumulate wealth for special expenses:** Travel, getting married, college for your children, and taking the family on a summer vacation are all examples

of events that carry expenses for which you'll have to plan ahead financially. Financial planning will help you map out a strategy to pay for that goal that you couldn't afford without saving.

- **Save for retirement:** You may not think much about it now, but you don't want to be penniless when you're 65. A strong financial plan will help you look at the costs of retirement and develop a plan that allows you to live the retirement that you desire.
- **"Cover your assets":** A financial plan is no good if it doesn't protect what you've got. A complete financial plan will include adequate insurance at as low a cost as possible.
- **Invest intelligently:** When it comes to investing savings, arm yourself with an understanding of the basic principles of investment. And beware: There are some shady investments and investment advisors out there!
- **Minimize your payments to Uncle Sam:** Why earn money for the government? Part of financial planning is to help you legally reduce the amount of tax you have to pay on your earnings.

The Personal Financial Planning Process

LO2 Describe the five basic steps of personal financial planning.

Financial planning is an ongoing process—it changes as your financial situation and position in life change. However, there are five basic steps to personal financial planning we should examine before we continue.

Step 1: Evaluate Your Financial Health

A financial plan begins with an examination of your current financial situation. How much money do you make? How much are you spending, and what are you spending it on? To survive financially, you have to see your whole financial picture, which requires careful record keeping, especially when it comes to spending.

Keeping track of what you spend may simply be a matter of taking a few minutes each evening to enter all of the day's expenses into a book or a computer program. Is this record keeping tedious? Sure, but it will also be revealing, and it's a first step toward taking control of your financial well-being. In Chapter 2 we take a closer look at the record-keeping process.

Step 2: Define Your Financial Goals

You can't get what you want if you don't *know* what you want. The second step of the financial planning process is defining your goals, which entails writing down (or formalizing) your financial goals, attaching costs to them, and determining when the money to accomplish those goals will be needed. Unfortunately, establishing personal financial goals is something most people never actually do, perhaps because the subject is intimidating or because they have absolutely no idea how to achieve these goals. Although it is not a difficult task, it's an easy one to put off. However, only when you set goals—and analyze them and decide whether you're willing to make the financial commitment necessary to achieve them—can you reach them.

STOP & THINK

According to the Federal Reserve's recent Survey of Consumer Finances, fewer than two-thirds of working-age families participate in retirement plans, and the median family with a retirement account has only $65,000 saved in it, while the top 1 percent of families have a million dollars or more. That report went on to find that almost nine in ten families in the top income fifth have savings in retirement accounts, compared to fewer than one in ten families in the bottom income fifth. In addition, according to a recent Schwab Retirement Plan Survey, saving enough for a comfortable retirement is the leading source of financial stress. But even though Americans feel retirement savings are important, they don't seem to be making much progress actually saving. In fact, according to data gathered by TD Ameritrade, despite planning, nearly 50 percent of Americans have less than $100,000 saved for their retirement. Retirement is only one of many reasons why financial planning is so important. As Carl Sandburg wrote, "Nothing happens unless first a dream." Why do you think goals are so important?

Step 3: Develop a Plan of Action

The third step of the process is developing an action plan to achieve your goals. A solid personal financial plan includes an informed and controlled budget, determines your investment strategy, and reflects your unique personal goals. Although everyone's plan is a bit different, all sound financial plans include several key factors: flexibility, liquidity, protection, and minimization of taxes.

Flexibility Remember when we mentioned planning for the unplanned? That's what flexibility is all about. Your financial plan must be flexible enough to respond to changes in your life and unexpected events, such as losing your job or rear-ending the Honda in front of you. An investment plan that doesn't allow you to access your money until you retire doesn't do you much good when you suddenly get fired for using your office computer to play *League of Legends*, *Madden NFL*, or *World of Warcraft*.

Liquidity
The relative ease and speed with which you can convert noncash assets into cash. In effect, liquidity involves having access to your money when you need it.

Liquidity Dealing with unplanned events requires more than just flexibility. Sometimes it requires immediate access to cold, hard cash. **Liquidity** means the ability to get to your money when you need it. No one likes to think about things such as developing an illness, losing a job, or even wrecking your car. But as we said earlier, stuff happens, so you need to make sure that when it does, you have access to enough money to make it through.

STOP & THINK

In his book *Enough*, John Bogle relates the story of Kurt Vonnegut, author of the best-selling novel *Slaughterhouse-Five*, who was at a party with his friend Joseph Heller, author of the wildly popular novel *Catch-22*. Vonnegut informed Heller that their host, who was a hedge fund manager, had made more money in a single day than *Catch-22* had earned for Heller over its entire history. Heller's response was "Yes, but I have something he will never have… enough."

Protection What if the unexpected turns out to be catastrophic? Liquidity will pay the repair bill for a fender bender, but what if you are involved in a serious accident and you wind up badly injured? What if the cost of an unexpected event is a lot more than you've got? Liquidity enables you to carry on during an unexpected event, but insurance shields you from the catastrophic effect of events that would otherwise threaten your financial security. Insurance offers protection against the costliest unforeseen events, such as flood, fire, major illness, and death. However, insurance isn't free. A good financial plan includes enough insurance, at reasonable rates, to prevent financial ruin.

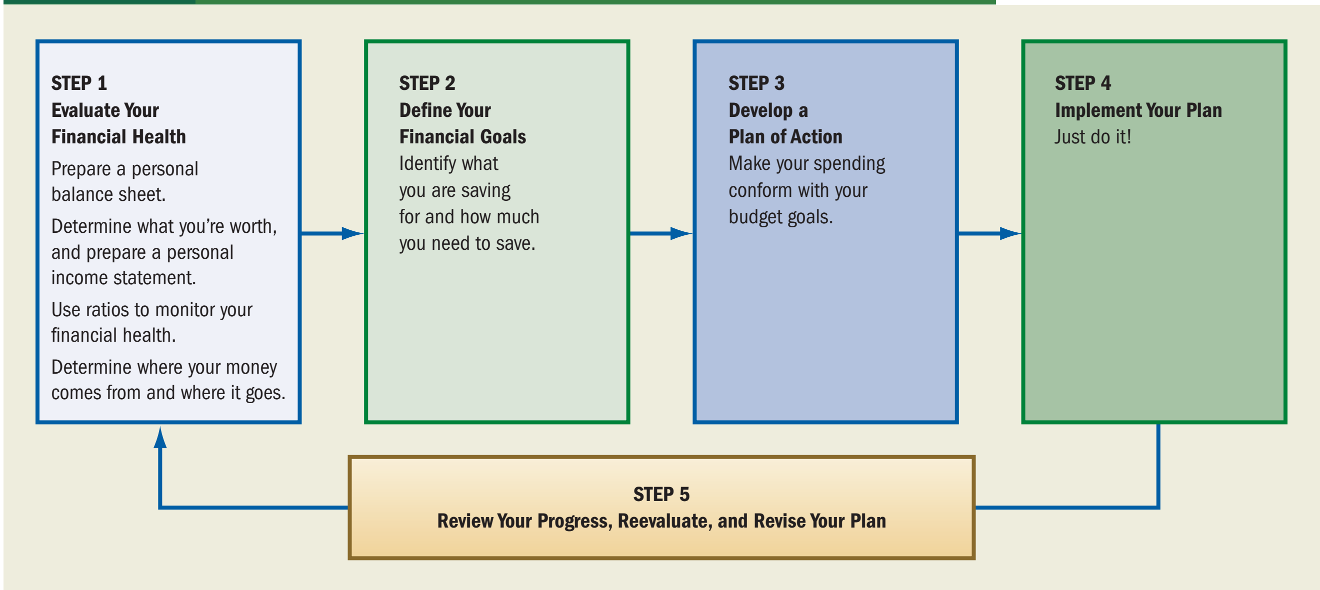
Minimization of Taxes Finally, your financial plan must take taxes into account. Keep in mind that a chunk of your earnings goes to the government, so if you need to earn $1,000 from an investment, make sure it yields $1,000 *after taxes*. While you want to pay as little in tax as possible, your goal is not to minimize taxes per se, but to maximize the cash that is available to you after taxes have been paid.

Step 4: Implement Your Plan

Although it's important to carefully and thoughtfully develop a financial plan, it is equally important to actually stick to that plan. While you don't want to become a slave to your financial plan, you will need to track income and spending as well as keep an eye on your long-term goals.

Remember that your financial plan is not the goal; it is the tool you use to achieve your goals. In effect, think of your financial plan not as punishment but as a road map. Your destination may change, and you may get lost or even go down a few dead ends, but if your map is good, you'll always find your way again. Remember to add new roads to your map as they are built, and be prepared to pave a few yourself to get to where you want to go. Always keep your goals in mind and keep driving toward them.

FIGURE 1.1 The Budgeting and Planning Process



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

Let's say that on your next vacation you'd like to explore Alaska, but the only road map you have of that state is decades old. Well, to stay on course, you'd better get a new map! The same is true for your financial strategy. As time passes and things change—maybe you get married or have children—you must review your progress and reexamine your plan. If necessary, you must be prepared to get a new map—to begin again and formulate a new plan.

Figure 1.1 summarizes these five basic steps to financial planning.

Establishing Your Financial Goals

LO3 Set your financial goals.

Financial goals cover three time horizons: (1) short term, (2) intermediate term, and (3) long term. Short-term goals, such as buying a television or taking a vacation, can be accomplished within a 1-year period. Intermediate-term goals may take from 1 year to 10 years to accomplish. Examples include putting aside college tuition money for your 12-year-old and accumulating enough money for a down payment on a new house. A long-term goal is one for which it takes more than 10 years to accumulate the money. Retirement is a common example of a long-term financial goal.

Figure 1.2 is a worksheet that lists examples of short-term, intermediate-term, and long-term goals. You can use it to determine your own objectives. When setting your goals, be as specific as possible. Rather than aiming to "save money," state the purpose of your saving efforts, such as buying a car, and determine exactly how much you want saved by what time. Also, be realistic. Your goals should reflect your financial and life situations. It's a bit unrealistic to plan for a $150,000 Porsche on an income of $25,000 a year. All this said, you don't really need a goal to save for—saving so that you have money for whatever goal comes up in the future is a good idea. Also, as you'll find out soon, your behavior, specifically saving and controlling spending, has more to do with creating wealth than how good an investor you are or what your income level is.

Once you've set up a list of goals, you need to rank them. Prioritizing goals may make you realize that some of your goals are simply unrealistic, and you may need

FIGURE 1.2 Personal Financial Goals Worksheet

Goal	Priority Level	Desired Achievement Date	Anticipated Cost
Short-Term Goals (less than 1 year)			
Accumulate Emergency Funds Equal to 3 Months' Living Expenses	________	________	________
Pay Off Outstanding Bills	________	________	________
Pay Off Outstanding Credit Cards	________	________	________
Purchase Adequate Property, Health, Disability, and Liability Insurance	________	________	________
Purchase a Major Item	________	________	________
Finance a Vacation or Some Other Entertainment Item	________	________	________
Other Short-Term Goals (Specify)	________	________	________
Intermediate-Term Goals (1 to 10 years)			
Save Funds for College for an Older Child	________	________	________
Save for a Major Home Improvement	________	________	________
Save for a Down Payment on a House	________	________	________
Pay Off Outstanding Major Debt	________	________	________
Finance Very Large Items (Weddings)	________	________	________
Purchase a Vacation Home or Time-Share Unit	________	________	________
Finance a Major Vacation (Overseas)	________	________	________
Other Intermediate-Term Goals (Specify)	________	________	________
Long-Term Goals (more than 10 years)			
Save Funds for College for a Young Child	________	________	________
Purchase a Second Home for Retirement	________	________	________
Create a Retirement Fund Large Enough to Supplement Your Pension So That You Can Live at Your Current Standard	________	________	________
Take Care of Your Parents After They Retire	________	________	________
Start Your Own Business	________	________	________
Other Long-Term Goals (Specify)	________	________	________

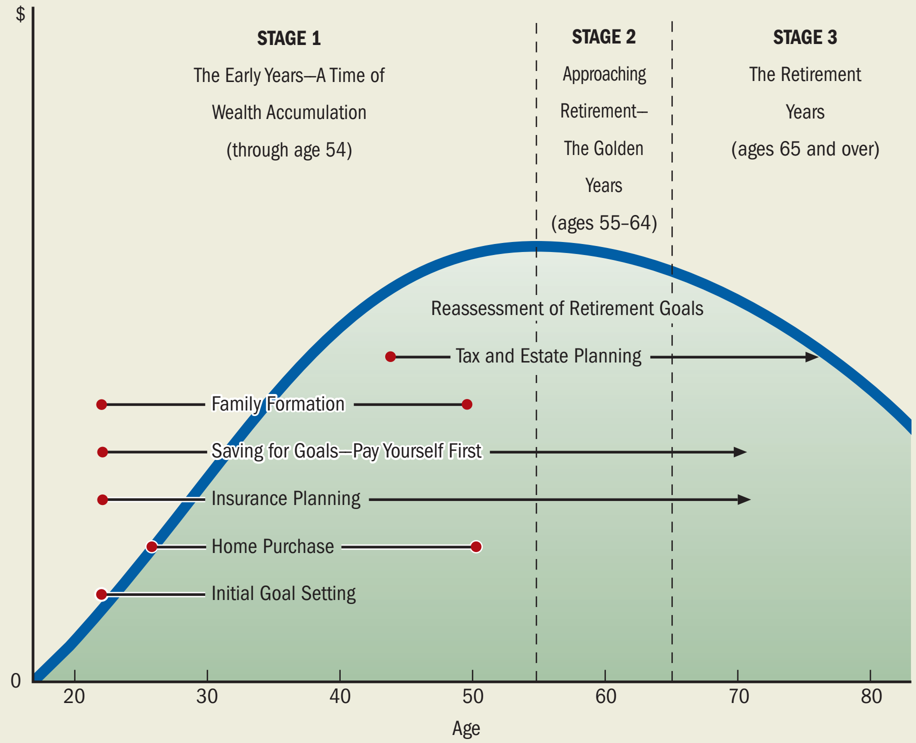
to reevaluate them. However, once you have your final goals in place, they become the cornerstone of your personal financial plan, serving as a guide to action and a benchmark for assessing the effectiveness of the plan.

The Life Cycle of Financial Planning

As we said earlier, people's goals change throughout their lives. Although many of these changes are due to unexpected events, the majority are based on a financial life cycle pattern. Figure 1.3 offers an example of a financial life cycle. Looking at this figure and thinking about what your own financial life cycle may look like allows you to foresee financial needs and plan ahead. Consider retirement. If you're a college student, retirement may be the furthest thing from your mind. However, if you think about your financial life cycle, you'll realize that you need to make retirement funding one of your first goals after graduation.

The first 17 or 18 years of our lives tend to involve negative income (and you thought it was only you). You can think of this as the "prenatal" stage of your financial life cycle. During this period, most people are in school and still depend on their parents to pay the bills. After high school, you may get a job, attend college, or do both. Regardless, once your education is completed, your financial life cycle may

FIGURE 1.3 A Typical Individual's Financial Life Cycle



Complications:

- Marital Status—single, married, divorced, widowed
- Employment Status—employed, unemployed, facing downsizing uncertainty
- Economic Outlook—interest rates, employment level
- Age
- Number of Dependents—children, parents
- Family Money—inheritance

begin in earnest. This first stage can be decades long and centers on the accumulation of wealth. For most people, this period continues through their mid-50s. During this time, goal setting, insurance, home buying, and family formation get the spotlight in terms of planning.

The second and third stages are shorter. During the second stage, which for some people may begin in their early 50s, financial goals shift to the preservation and continued growth of the wealth you have already accumulated. You may begin to think about **estate planning**—that is, planning for the passage of your wealth to your heirs. The third and final stage, retirement, often begins in the mid- to late 60s. During retirement, you are no longer saving; you are spending. However, you must still allow for some growth in your savings simply to keep **inflation** from eating them away.

Estate Planning
Planning for your eventual death and the passage of your wealth to your heirs.

Inflation
An economic condition in which rising prices reduce the purchasing power of money.

Think of the financial life cycle in terms of a family life cycle. Consider a couple who marry in their 20s or 30s, have kids shortly thereafter, spend the next 18 or 20 years raising the kids and putting them through college, and then settle down as a couple again when the kids move out to form their own families. Obviously, a typical individual's experiences don't fit everyone perfectly. Today, with more single-parent families and more young people postponing marriage, it simply isn't reasonable to

TABLE 1.1 The Cost of Raising the Second Child in a Two-Child Family

These calculations are for the second child in a two-child family. For families with only one child, the costs of raising that child are more and can be determined by multiplying the totals by 1.27. For families with more than two children, the costs of an additional child can be determined by multiplying the totals by 0.76.

	Total Spent over 18 Years For								
Annual Income	**Annual Expenses, First 3 Years**	**Total Expenses, First 18 Years**	**Housing**	**Food**	**Transportation**	**Clothing**	**Health Care**	**Child Care and Education**	**Other[2]**
Less than $59,200	$ 9,690	$174,690	$56,880	$34,140	$24,900	$11,700	$15,120	$21,240	$10,710
$59,200–$107,400	12,680	233,610	66,240	41,400	35,490	13,260	21,720	38,040	17,460
More than $107,400	19,770	372,210	98,280	55,020	49,860	20,280	29,610	86,820	32,340

Source: Expenditure on Children by Families, 2015 Annual Report, U.S. Department of Agriculture, Agricultural Research Service: http://www.cnpp.usda.gov/Publications/CRC/crc2015.pdf, March 2017.

refer to any family experience as typical. However, regardless of how unusual your life is, you'll be surprised at how much it has in common with a typical financial life cycle.

The early years are different for everyone. For many people, however, the biggest investment of a lifetime, purchasing a home, occurs during these early years. With a house comes a long-term borrowing commitment and your introduction to debt planning. Although the costs of owning a home may dominate your financial life during this period, you can't lose track of the rest of your plan. Therefore, you must develop a regular pattern of saving. The importance of making saving a habit cannot be overemphasized. Once you make a commitment to save, you need to ask the following questions: (1) How much can I save? (2) Is that enough? (3) Where should I invest those savings dollars?

Decisions that may not seem financial will have a major impact on your financial situation. Take, for example, the decision to have a child. Although this isn't considered primarily a financial decision, it certainly has enormous financial implications. As Table 1.1 illustrates, kids cost a lot. In fact, for a middle-income family earning $83,300 per year, the total cost of raising a second child from birth to age 18 is $233,610, and the cost of a first child would be 27 percent more, or $296,685. And the more you make, the more you spend on raising children. Those with annual incomes of more than $107,400 spend more than twice as much as those with annual incomes less than $59,200. The major differences occur in housing, child care, and education. As you look at these figures, keep in mind that they cover the costs of a child only from birth to age 18—they don't include the costs of college. Considering the $9,690 to $19,770 a year it costs to raise a child, saving to finance that child's college education is a real challenge!

You should also buy insurance to protect your assets. Initially, you may require only medical, disability, and liability insurance, but if you decide to have a family, you will need to provide for your dependents in the event of a tragedy. For families with children, adequate life insurance is essential. You will also need home, auto, and property insurance.

The second stage involves a transition from your earning years, when you will earn more than you spend, to your retirement years, when you will spend more than you earn. Exactly what happens during this transition stage and how long it lasts depend on how well you are prepared for retirement. Much of this transition involves reassessing your financial goals—including insurance protection and estate planning—to make sure you are truly prepared for retirement. As you approach retirement, you must continuously review your financial decisions, including

[2]Other expenses include personal-care items, entertainment, and reading material.

insurance protection and estate planning. Keep in mind that this is your last opportunity to save and prepare for your retirement years, and how well you succeed at that will determine how you live during retirement.

In the last stage, during your retirement years, you'll be living off your savings. Certainly, the decision about when to retire will reflect how well you have saved. Once you retire, your financial focus is on ensuring your continued wealth despite not having income. As always, you'll spend much of your time overseeing the management of savings and assets, but now your concern will be making sure you don't run out of money. You'll be dealing with the question of how much of your savings you can tap into each year without ever running out of money, and your investment strategy will probably become less risky because you now need to preserve rather than create wealth. In addition, your insurance concerns may include protection against the costs of an extended nursing home stay.

Finally, estate planning decisions become paramount. Things like wills, living wills, advance directives, health proxies, power of attorney, and record keeping should all be in place to help protect you, along with your assets for your heirs. These estate planning tools will help ensure that your wishes are understood and honored as you reach the end of your life. They'll also allow you to pass on your estate to whomever you want, while keeping your estate taxes at a minimum.

FACTS OF LIFE

Forty-five percent of those in the United States age 65 and older are financially dependent on relatives, and another 30 percent live on charity. If you're like most young people, fresh out of college, you probably will have an urge to spend all that cash that you may be making for the first time in your life. Feel free to spend, as long as you manage to save for your goals, and *make sure you begin planning for your financial future now*. The key is to start the personal financial planning process early in life and make saving a habit.

Thinking About Your Career

LO4 Explain how career management and education can determine your income level.

Career planning is the process of identifying a job that you feel is important and that will lead to the lifestyle you want. When considering which career is right for you, think about the kind of work you find enjoyable and satisfying. It is also important to choose work that provides the standard of living you hope to achieve. In general, your first job isn't the one you'll spend the rest of your life doing. Most careers involve a series of positions that give you the opportunity to display your skills, that lead to a job that you find satisfying, and that allow you to balance work and your personal life. Figure 1.4 is a job search worksheet that will help you manage your career.

Choosing a Major and a Career

The first steps in career planning are doing a self-assessment and developing an understanding of what you want. First, consider your interests, skills, values, personal traits, and desired lifestyle. What activities do you enjoy? How do you like to spend your time? What other skills do you have that might be of value in a career? Look, too, at your educational record. Which courses did you like most, and which did you like least? Which courses did you do the best in? From there, take a look at your work experience. Make a list of all the jobs you've had and all the volunteer activities you've taken part in. Think about each of these, and determine what about them you found satisfying and what not so satisfying. Why did you leave any of these situations?

Conducting an effective self-assessment means looking at many aspects of your life honestly. Once you are through, you will have a good idea of your skills and interests. Now, you can research career alternatives and identify those in which your abilities are valued. Once you've narrowed down a list of options, look at both the positive and the negative aspects of these professions. Do they offer the status and earning potential you are looking for? Are they part of a stable industry? Might they require

FIGURE 1.4 Job Search Worksheet

Notes

The Search (Complete items 1–3 on this checklist before starting your job search.)

1. **Identify Occupations**
   - List your work and life experience.
   - Review information on jobs—find out what types of jobs are hiring.
   - Identify jobs that use your talents.
2. **Identify Employers**
   - Tell relatives and friends that you are job hunting—you never know who may have a lead!
   - Go to your state employment service office for assistance.
   - Use the Internet or contact employers to get company and job information.
3. **Prepare Materials**
   - Write your résumé. Tailor it, if necessary, using job announcements to "fit" your skills with job requirements.
   - Write cover letters or letters of application.

The Daily Effort

4. **Contact Employers**
   - Call employers directly (even if they're not advertising openings). Ask to speak to the person who would supervise you if you were hired. Make note of names.
   - Go to companies to fill out applications.

The Interview (Complete items 5–8 when you have interviews.)

5. **Prepare for Interviews**
   - Check out the Internet and learn about the company you're interviewing with.
   - Review job announcements to determine how your skills will help you do the job.
   - Assemble résumés, application forms, etc. (make sure everything is neat).
6. **Go to Interviews**
   - Dress right for the interview—that, of course, will depend on the job you're applying for.
   - Go alone.
   - Be positive.
   - Thank the interviewer.
7. **Evaluate Interviews**
   - Send a thank-you note to the interviewer within 24 hours of the interview.
   - Think about how you could improve the interview—remember, this may not be your last interview.
8. **If You Have to Take Tests for the Job—Be Ready**
   - Find out about the test(s) you're taking.
   - Prepare for the test and brush up on job skills.
   - Relax and be confident.
9. **Accept the Job!**
   - Be flexible when discussing salary (but don't sell yourself short). If you're expecting more than they offer, ask for it. The worst that can happen is that they will say no.
   - *Congratulations!*

TABLE 1.2 What Majors in Different College Subjects Earn in the United States

Choice of Major	Unemployment Rate	Underemployment Rate	Median Wage Early Career	Median Wage Mid-Career
Accounting	2.4%	24.1%	$50,000	$75,000
Advert/Public Relations	3.0%	46.8%	$44,000	$70,000
Anthropology	6.0%	54.2%	$33,600	$59,000
Architecture	5.0%	29.4%	$47,000	$75,000
Business Management	3.8%	58.8%	$42,500	$67,000
Chemical Engineering	3.8%	22.7%	$68,000	$110,000
Chemistry	4.0%	37.9%	$42,000	$75,000
Communications	3.6%	54.1%	$40,000	$72,000
Elementary Education	1.7%	15.4%	$36,000	$44,000
Environmental Studies	4.3%	50.2%	$38,000	$65,000
Finance	3.5%	37.6%	$55,000	$90,000
Foreign Language	3.3%	47.4%	$36,000	$63,000
Performing Arts	3.8%	63.0%	$35,000	$56,000
Psychology	3.9%	50.0%	$35,000	$58,000

Sources: U.S. Census Bureau, American Community Survey (IPUMS); U.S. Department of Labor, O*NET. Data updated July 17, 2020. https://www.newyorkfed.org/research/college-labor-market/college-labor-market_compare-majors.html, accessed March 1, 2021.

travel or frequent relocation? Talk to people in the occupations you've targeted to learn more about what they do as well as what they like and dislike about their jobs.

Once you've made a self-assessment, looked at career options, and talked to people in the workplace, you may be ready to decide on a career field that fits your interests and that is realistically achievable. If you are a college student who has not yet chosen a major, you will want to consider which major puts you in line for the kind of job you'd like when you graduate. You may want to talk to the people at your school's career center to find out more about how specific college majors relate to different occupations. While you want to make sure you choose a career that fits your interests, it is also good to have an idea of what that job pays when you're making this decision. Let's take a look at the average annual earnings of full-time employed college graduates with only a bachelor's degree based on their college major. As you can see from Table 1.2, the major you choose can affect how readily jobs in your field are found and how much you eventually earn. While looking at these numbers, keep in mind that these are averages—you might earn more or less than the figure given. And picking one of the "low earners" in terms of majors doesn't mean you won't be successful and earn a good wage—just look at Kenneth Chenault, the former CEO and chairman of American Express. He majored in history at Bowdoin. Also keep in mind that although money isn't everything, it shouldn't be ignored.

If you're still lost, you might want to try the Internet, which offers a wealth of career advice. *Occupational Outlook Handbook*, published by the U.S. Bureau of Labor Statistics, is a good source for career advice. This guide is located at **http://www.bls.gov/ooh/home.htm** and provides information on duties, education

FACTS OF LIFE

If you want to scope out salaries for other jobs, try the Federal Reserve Bank of New York's Labor Market Outcomes of College Graduates by Major at https://www.newyorkfed.org/research/college-labor-market/college-labor-market_compare-majors.html.

TABLE 1.3 Common Interview Questions

1. Tell me a little about yourself.
2. What do you know about our company and this position?
3. What are your short-term and long-term goals?
4. What is your greatest strength, and what is your greatest weakness?
5. What is the hardest thing you have ever had to do?
6. Describe a time you worked with a difficult person, perhaps a fellow student, professor, or coworker.
How did you handle it then and how would you handle it now?
7. How would you rate your performance under pressure?
8. How did you choose your major, and what was your most rewarding college experience?
9. Did you participate in extracurricular activities or clubs while in school?
10. What did you like the most/least about your last job(s)?
11. What motivates you, and how do you motivate others?
12. Describe a project you have worked on and your contribution.
13. Why should we hire you? What can you do for our company?
14. Are your grades a good indicator of your professional potential?
15. Is there anything else that we should know about you?

and training, pay, and outlook for hundreds of occupations. It's comprehensive, too; in fact, it looks at what it takes to get into that industry, whether there is on-the-job training, the number of projected new jobs, the growth rate in jobs, and the median pay.

Getting a Job After the Pandemic – the World of Zoom

Getting your first real job is a job in itself. One of the most important things to remember is to *start early*. There is a saying that "Eighty-five percent of success is simply showing up." That means that if you're graduating in May, you have to put your résumé together the summer before your senior year. Why start that early? There are three reasons. First, the beginning of fall semester is generally hectic, so if you wait until then to create your résumé, you may get delayed by a month or two. Beginning in the summer guarantees you'll be prepared to start your job search in the fall. Second, when you begin submitting your résumé before other seniors, you send a message to potential employers that you are both serious and organized—two traits employers love. Third, for many companies, the fall is the beginning of their recruiting cycle.

As you know, your job search should start off with your résumé, but unfortunately, it can also end with your résumé. That means your first move should be to carefully check over your résumé and make sure it has all the basics in there – your email address and phone number, your major, any jobs or internships you might have had, and any leadership roles you've taken on along the way. Also, keep in mind that the first pass on your résumé may be done by a computer. That means you might want to mirror the language used in the job posting to help make it to the second level. That also means that one résumé does not fit all jobs. You will need to make sure to customize your résumé to fit each job application by including key words and language that are in the job description. In effect, you want to look closely at the job posting and make sure your résumé speaks to the position being posted.

In other words, make sure your résumé is robot friendly, because you won't get a job if you can't make it past the first screening. Hopefully, you'll be chosen for an interview, and that's something that you might hear about in a phone call. So, make sure you set up your voice mail for such a call by using a professional-sounding recorded greeting, and, of course, check it daily.

Next, while you may have an in-person interview, that's not always the case today. As a result, you should be prepared for a Zoom interview. During the pandemic, the business world became comfortable communicating via Zoom, Microsoft Teams, or something similar – you should expect that to continue into the future because it is both convenient and inexpensive. That means you should prepare ahead of time for Zoom interviews and get comfortable with the technology. If you have only used it to watch class, try connecting with a friend to make sure your connection is working well. You'll also want to do some common-sense things like silencing your phone, letting everyone in your household know when you have an interview coming up, and know where your mute button is and how to use it, just in case. You'll want to have a space prepared for interviews, one that has good lighting. Then make sure you have your computer situated so that you aren't looking down or up and that the lighting makes you easy to see. Too often those using Zoom use back lighting that makes them look like they are in a witness protection program. Your background can also be used to showcase things that might serve as conversation starters. You might display things like keepsakes from college clubs, activities, or something you are proud of. Also, make sure your computer works by calling a friend or relative to check your connection and surroundings.

You're still not finished. Once you've done all this, set up or update your LinkedIn profile, and also create a profile on whatever online job platform that is recommended by your school, like Handshake or Symplicity Recruit. While all this may take some time, it is much better to be prepared ahead of time. In addition, you should assume that your potential employer will google you and will also check out your social media presence; that means you need to take a close look at it and perhaps do some cleaning up. Then, practice your interview pitch, including any anecdotes about past jobs and internships, that you might want to bring up.

FACTS OF LIFE

According to a recent recruiting survey, the most common mistake that job interviewees make is talking too much.

Finally, when you are selected for an interview, the key is to be prepared. You'll find practicing answers to common questions will help you feel more comfortable when the interview time comes around. While you can't be ready for every question, there are some relatively standard questions that you should be equipped to answer. Table 1.3 lists fifteen of the most common interview questions. Many colleges' career development offices provide courses or help in developing the interpersonal skills that are necessary for a good interview. Next, use the library or the Internet to find as much information as possible about the company you're interviewing with. Understand how the company makes its money, know its history and its financial status, and read up on any new developments. And be sure to make a good first impression. Dress appropriately and get a good night's rest before your interview. If it is an in-person interview, plan to arrive about 30 minutes early to guard against any unexpected delays. If it is a Zoom interview, start setting things up at least a half hour early. Display strong body language, make good eye contact, and keep a straight but relaxed posture. These are all part of a confident image. When the interview has ended, make sure you thank the interviewer for his, her, or their time and for giving you the opportunity to meet. Finally, when you get home, send a follow-up letter, thanking the interviewer again and reiterating your interest in the position.

Being Successful in Your Career

If you are just starting out, it is likely that you'll work for at least three or four different companies and have more than ten different jobs over the course of your working life. You may switch jobs or even careers for many reasons: You may be offered great opportunities, your personal interests may shift, or the job market in your industry may change. In this era of regular corporate restructuring, job security is not what it used to be. To protect yourself, be sure to keep your skills marketable through education and by keeping up with changing technology. To increase your value as an employee:

- Do your best work.
- Project the right image—an image aligned with the organization's values and wants.
- Gain an understanding of the power structure so that you can work within it.
- Gain visibility. Make those with power aware of your contributions.
- Take new assignments. Gain experience and an understanding of the various operations of the organization.
- Be loyal to and supportive of your boss. Remember, your boss controls your immediate future.
- Continually acquire new skills—in particular, skills that are not easy to duplicate.
- Develop a strong network of contacts in case you ever need to look for a new job.
- Pay attention to ethics because the most damaging event you, as an employee, can experience is a loss of confidence in your ethical standards. Ethical violations end careers.

The bottom line is that managing your career is an ongoing process that will end only when you finally retire.

What Determines Your Income?

What you earn does not determine how happy you are, but it does determine the standard of living you can afford. There is great variation in what different people earn at the same job with different companies, but one thing is clear: The more specialized skills and training a job requires, the higher it tends to pay.

Without question, the key differentiating factor in determining your eventual salary is how well educated you are, as Figure 1.5 shows. Right now, you may be making the best single investment you will ever make—your education. Interestingly, being married is also a trait of the wealthy. Whereas a married couple heads 70 percent of all middle-class households, that number climbs to 85 percent for wealthy households. Your financial plan must be realistic, and it must be based on your income. Let's look at some basic principles of a solid financial strategy.

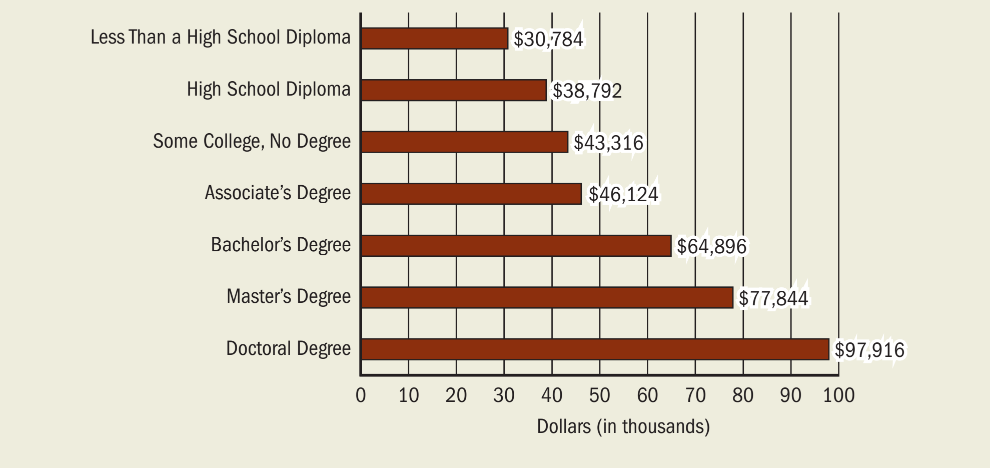
STOP & THINK

A recent survey conducted by *Family Circle* magazine found that 84 percent of those surveyed felt that doing work they love was more important than making money, and 88 percent said they valued health and a happy home life above wealth. There's no reason why you shouldn't have both, provided you take what you learn in this text and this course and then put together and implement a financial plan. Are you ready to try it?

Keeping a Perspective—Money Isn't Everything

Your personal financial plan allows you to extend your financial strategy beyond the present, enabling you to achieve goals that are well off in the future. In effect, personal financial planning allows you to be realistic about your finances—to act

FIGURE 1.5 Education and Earnings



Source: Bureau of Labor Statistics, https://www.bls.gov/careeroutlook/2020/data-on-display/education-pays.htm, accessed April 23, 2021.

your wage. Unfortunately, for some people financial goals become all-consuming. They see nothing but dollar signs and lose a healthy perspective on what is actually important in life. In the first version of the movie *Arthur*, there is an exchange between Dudley Moore and Liza Minnelli in which Moore, who plays Arthur Bach, says, "Money has screwed me up my whole life. I've always been rich, and I've never been happy." To this, Minnelli, who plays Linda Marolla (Arthur's girlfriend), replies, "Well, I've always been poor, and I've usually been happy." Arthur's mother then steps in and responds, "I've always been rich, and I've always been happy!" It's true: Money does not equal happiness. In fact, the *Wall Street Journal* reported the results of an international happiness survey and found that respondents from *Forbes*'s annual list of the 400 richest Americans scored 5.8 on the happiness scale. That's the same score reported by the Inuit of northern Greenland and the hut-dwelling Maasai of Kenya. But keep in mind that even though money doesn't necessarily bring happiness, facing college expenses or retirement without the necessary funding certainly brings anxiety. In fact, a 2020 survey by Capital One found that money is the leading cause of stress among Americans.

STOP & THINK

Philosopher Arthur Schopenhauer, in *The Wisdom of Life*, said that wealth is "like seawater: the more you drink, the thirstier you become." What do you think Schopenhauer meant by this?

Developing Skills for Your Career

LO5 Identify and explain how skills acquired in this course will help you get a job and advance in it.

Today it seems like most students are interested in knowing *if and how* studying personal finance will help them get and keep a good job and even advance in that job. After all, personal finance is aimed at helping you manage and budget your money, achieve your financial goals, protect your assets, invest wisely, deal with different financial life events, and (as the title of this text says) "turn money into wealth."

There is no question that what you learn in this course will help you personally, but it's important to know that it will also help you in your business career—yes, it might not seem obvious at first glance, but how you manage your personal finances will help you in the business world. Good personal finance skills will help you to both land the job you want and also succeed in it. That may sound far-fetched, but there is plenty of research to support it. In addition, some of the skills learned in this course, like critical thinking, information technology and computing, and ethical skills, will also help you get ahead and succeed in business. Moreover, it is only through the aggregate of your educational experience that you will have the opportunity to develop the skills that employers have identified as critical to success in the workplace. Throughout this course, and specifically through this text, you'll have the opportunity to develop and practice many of those skills.

You probably don't think that your credit history could play a role in getting that job that you want, but in some cases it can. In fact, a study conducted by CareerBuilder found that 72 percent of U.S. companies run credit background checks on potential employees.[3] Exactly what they are looking for is uncertain, but it is clear that they consider *how responsible you are with respect to your own personal finances* very important. Moreover, an abundance of research has shown that when employees are financially stressed, they are also distracted, and productivity suffers. Not a good scenario for promotion. So, having control over your finances may actually help you both get a job and succeed at it. Through this course, you will learn how to control your finances and manage your money responsibly.

The study of personal finance also provides students with many of the skill sets that employers seek out and value in business graduates who market themselves in virtually any discipline. The ability to bring critical thinking to problem-solving scenarios and make decisions or form judgments related to a particular situation or set of circumstances is an important attribute that the study of personal finance enhances. Critical thinking involves purposeful and goal-directed thinking used to define and solve problems, make decisions, and form judgments related to a particular situation or set of circumstances. This is what we do in personal finance when we, for example, look at the question "How much should I save for retirement?" We develop a structured format that defines the problem, then formulate it intuitively as a mathematical model, and provide approaches to solving it that achieve our goal.

Many problems explored in personal finance involve *saving now* to achieve a future goal (as in retirement planning) or involve *borrowing now* and repaying the loan in the future (such as taking out a student loan to further your education or a mortgage to buy a house). In effect, many of our personal finance decisions involve comparing money and cash flows that occur in different time periods. As a result, many times we will rely on Excel or financial calculators that operate similarly to Excel to solve personal finance problems that students will learn about in this text. These information technology and computing skills are very important to employers. Implicit in the study of personal finance is the ability to model the problem—that is, to lay out the different cash flows as well as dates for those cash flows that reflect the true timing of those cash flows. As a result, you learn how to model and solve personal finance problems, a real-world skill that translates from your personal life to your life at work.

So, getting back to the question we asked earlier, perhaps you aren't a finance major and you're wondering whether this course will benefit you in your career. The answer is a resounding "yes," and it will help you not only in your business career but also in your life.

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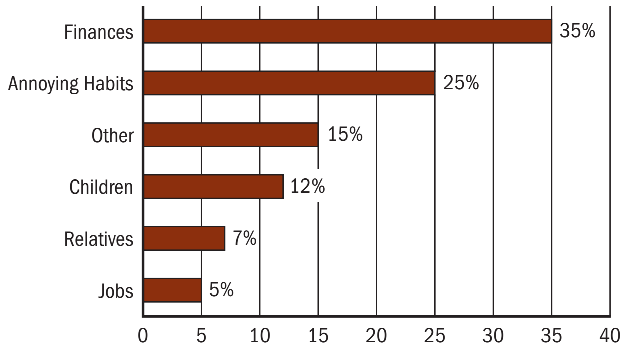
[3]Gary Rivlin, "The Long Shadow of Bad Credit in a Job Search," *New York Times*, May 11, 2013, http://www.nytimes.com/2013/05/12/business/employers-pull-applicants-credit-reports.html

LOVE & MONEY

It might not surprise you to hear that how well you approach your own personal finances has an impact on many different areas of your life. You probably already know that it will affect your ability to buy a house, your investment success, and whether you are able to retire early and comfortably, but have you ever thought about how it might also affect your love life and other personal relationships? Yes, personal finance has a huge impact on the success, or failure, of your love life! But even though there is no question that money problems can cause tension in relationships, there is also no reason why it has to be this way. As you might expect, while there are some things that you simply shouldn't do when it comes to handling your money and making personal financial decisions if you want your relationships to thrive, there are also some actions you can take to keep money from sabotaging your relationships. In the Love & Money boxes, we'll take a look at people's attitudes toward money and love. We'll also give you some personal finance advice aimed at helping you build better, stronger, and perhaps longer-lasting relationships.

To appreciate the link between love and money, take a look at a recent Harris Poll clearly showing that finances are the biggest cause of stress in relationships.



What Are the Main Causes of Stress in Your Relationship?

Personal finance and money, or the mishandling thereof, can even stop a relationship before it starts; that is to say, debt can get you dumped. According to a recent TD Ameritrade survey, 44 percent of the respondents said that credit card debt would make them less likely to date a person, while a WalletHub survey found 53 percent of those surveyed would not marry someone with bad credit. One reason why credit card debt and bad credit are such a social turnoff is that they may be viewed as a signal of financial irresponsibility, a quality no one looks for in a potential mate. While we all know that stress can lead to arguments, additional research has found that when we argue about money, we tend to hold on to feelings of resentment longer than we do with other types of arguments. Clearly, financial fights are toxic, especially if they start early in your relationship. As a result, research finds that it may be wise to invest in financially based premarital counseling to help avoid arguments about how money will be used in the household.[4] The bottom line here is that money and your personal finance skills and habits play a big role in determining who you might end up with and also whether you stay together. In the Love & Money boxes, we'll give you advice to improve your odds of relationship success.

We will also deal with **ethical problems/issues** in personal finance. For example, we will examine something as simple as "What type of moral obligation do you have in disclosing problems your car may have if you are selling it to another individual?" We will also look at more complex moral dilemmas. For example, "Are payday loans evil?" After all, their interest rates often go as high as 400 percent! Although they can be predatory, they may be a useful alternative for someone who has nowhere else to turn for a loan. Many of the ethical questions we examine won't have easy or obvious answers, but understanding the techniques of moral reasoning and argumentation that are needed to analyze these moral and ethical issues will serve you well in your business career when you come upon an unexpected moral dilemma.

[4]Sonja L. Britt and Sandra J. Huston, "The Role of Money Arguments in Marriage," *Journal of Family and Economic Issues* 33, no. 4 (2012): 464–76. doi:10.1007/s10834-012-9304-5.

Lessons from the Recent Pandemic

LO6 Explain the personal finance lessons learned in the recent pandemic.

The Covid-19 pandemic of 2020 resulted in an economic downturn that produced massive job loss and financial hardship for many Americans. It was a very uneven recession, resulting in only a slight setback for the wealthiest Americans while having more of a depression-like impact for those at the bottom of the economic ladder. And it happened in an instant. Ten percent of Americans ages 25 to 54 lost their jobs between February and April 2020, with the service sector being hardest hit. There were massive job losses for those working in hotels, restaurants, and other hospitality service jobs. These were low-paying jobs, with cooks typically making about $13.40 an hour or $28,700 a year and restaurant servers making around $11 an hour or $26,800 a year. It should come as no surprise that many times those with the low-paying jobs are living paycheck to paycheck with no emergency fund.[5] It was also a recession that hit minorities, who dominate the workforce in those service industries, the hardest.

There is no way to minimize the impact of Covid-19 on the nation's personal finances. A Harris Poll conducted in late September 2020 found that 84 percent of Americans surveyed said that they were experiencing Covid-19-related financial stress. Moreover, roughly two in five Americans were worried about their financial situation 12 months down the line. Unfortunately, no one can change the past, but these questions remain: Can the lessons learned be used to change your financial future? What have we learned from the Covid-19 recession?

First, it is clear that too many of us have insufficient emergency funds—because, let's face it, stuff happens. Without question one of your first financial goals should be to put together an emergency fund that is sufficient to carry you through a financial emergency. Right now, 37 percent of Americans can't handle a $400 financial emergency. We will talk about that in the next chapter, and it will form the foundation for one of our *Ten Principles of Personal Finance*, which will be introduced in the next section. Many people think of an emergency fund as money put aside to take care of common emergencies—things like replacing a broken washing machine or fixing a transmission on your car. But an emergency fund does much more than that. It means you have real control over your life in the case of an "emergency." It means that if a pandemic results in a loss of your job, you don't have to be terrified that you'll lose your house or not have enough money to pay for food, and you don't have to desperately take the first job offered—you can take more time and look for a job that is right for you. And when you have this kind of control, it is priceless.

Second, never try to time the market—but do rebalance. As investors watched the stock market drop by over a third in a month's time in the early spring of 2020, many investors felt the market would go down further and sold their stock holdings. Then, as stocks began their climb back, they didn't want to reinvest as prices rose. By the fall they realized that if they had just stayed invested, their stock portfolios would have been about 50 percent higher. Needless to say, staying the course was the right thing to do, but fear and emotions are hard to control. Unfortunately, all too often market timing leads to "selling low and buying high"—which is definitely not a recipe for financial success. Keep in mind that this is also the lesson many investors learned the hard way during the market crash of late 2008 and early 2009. But the bottom line is that even in the midst of a crisis, your long-term goals should stay the same. And if that's the case, your investments should probably remain the same too. How does rebalancing fit in all this? When market movements cause your investment mix to stray from your target level of stocks, say 50 percent stocks and 50 percent bonds, buy more stock if the percent of stock holdings drops below your target of 50 percent, or sell some of your stocks if the percent of your stock holding rises above your target of 50 percent. That means, in 2020 you would have been buying stocks during the market dips.

Third, budgets are more important than ever! In times of uncertainty, discipline is your friend, and without question, budgeting is the easiest way to monitor and control spending. Remember, there's no such thing as a "great deal" when you're trying to conserve cash, and a budget will highlight expenditures that aren't high priority and can be postponed. This might also be a good time to reassess your lifestyle—is

[5]U.S. Bureau of Labor Statistics, https://www.bls.gov/oes/current/oes352014.htm

it realistic? If you have trouble controlling spending or you feel you aren't saving enough, try using one of the budgeting software apps like Mint.com, Acorn.com, or Qapital. We'll introduce them in more detail in the next chapter.

Fourth, credit card debt is not your friend. In early 2020 as the pandemic was fast approaching, Americans owed nearly $1 trillion in credit card debt, which was an all-time record according to the Federal Reserve. In fact, 62 percent of U.S. adults carried credit card debt in the 12 months prior to the pandemic. If there ever is a time to avoid credit card debt and the high interest rates that accompany them, it's during a recession. Unfortunately, you don't always know when something like the Covid-19 pandemic is on the way. That means there is no good time to carry a credit card balance from one month to the next—because you never know when the bottom of the economy might drop out.

Fifth, communication is of paramount importance. In trying times, it is extremely important to be proactive. For example, if you're struggling to pay your credit card bill, contact your creditors to see if you qualify for a reduced interest rate on any of your payments and ask for discounts and deferment options. Don't let your rent go unpaid; again, if there are problems, contact your landlord. If you have problems paying your mortgage, contact your lender and see what can be done to make it all less painful for you. Communicate, communicate, communicate because the worst thing you can do is not pay your bills and just hope that things work out—if ignored, they generally don't work out at all.

Finally, keep calm in times of crisis. You don't have to worry about everything financial. It is important to remember that it is only the intersection of *things that matter* and *things you can control* that you should focus your attention on. During the pressure of the pandemic, it was all too easy to focus on things out of your control, like the economy, stock market, and even taxes. But what do you have control over? Look at how much you are saving, your spending habits, and how you manage your investments including the fees that you pay on them—those things both matter and are under your control. In times of economic panic, how do you accomplish this? The answer is by automating your saving and investing and by having and using a financial plan as a blueprint for your action and reaction.

Ten Principles of Personal Finance

LO7 List ten principles of personal finance.

To the first-time student of personal finance, this text may seem like a collection of tools and techniques held together solely by the binding on the book. Not so! In fact, the techniques and tools we use to teach personal financial management are all based on very straightforward logic. We can sum up this logic in ten simple principles. *Although it's not necessary to understand personal finance in order to understand these principles, it's necessary to understand these principles in order to understand personal finance.*

These principles are used throughout the text to unify and relate the topics being presented, which will help you better understand why the tools work. Let's face it; your situation and the personal finance challenges you'll face won't fit into a simple formula. You have to understand the logic behind the material in the text in order to apply it to your life.

Let's identify the ten principles that form the foundations of personal finance. Some are as much statements of common sense as they are theoretical statements. If these principles are all you remember from this course, you'll still have an excellent grasp of personal finance and, thus, a better chance of attaining wealth and achieving your financial goals. Let's take a look at the first eight principles and then the last two—the last two are separated out because they will take on special importance as we help you understand your financial personality and the behavioral aspects of personal finance and then put in place an action plan for today and as you move from college into the real world.

Principle 1: The Best Protection Is Knowledge

Finding advice on personal finance isn't hard—the hard part is differentiating between good advice and bad. The Internet, radio, television, newspapers, magazines, and even old-fashioned books are teaming up with financial gurus and guru wannabees, showering you with the latest advice on what to do with your money. While much of that advice will make someone rich, it may not be you; it may be the advice giver instead—and, even worse, that someone may be getting rich at your expense. You can turn to a professional financial planner to help you establish a lifetime financial plan, but it will be up to you to manage it. The bottom line is that you need to understand the basics of personal financial management if you are going to achieve your financial goals—it's also the only way you can protect yourself. A solid understanding of personal finance will

- Enable you to protect yourself from incompetent investment advisors.
- Provide you with an understanding of the importance of planning for your future.
- Give you the ability to make intelligent investments and take advantage of changes in the economy and interest rates.
- Allow you to extract the principles you learn here and elsewhere and apply them to your own situation.

Because financial problems in real life seldom perfectly reflect textbook problems and solutions, you must be able to abstract what you learn in order to apply it. The only way you can effectively abstract something is to understand it. As with almost everything in life, it's much easier to do it right if you understand what you're doing and why you're doing it.

And when you know what you're doing, you don't have to rely on insurance salespeople, personal financial advisors, and stockbrokers—after all, they may actually be acting in *their own* interests rather than in *your* best interests. For example, an insurance salesperson, motivated by a potential commission, may try to sell you insurance you don't need. A personal financial advisor may try to sell you financial products, such as mutual funds, that are more expensive than similar products because he or he receives a hefty commission on them.

That doesn't mean you should avoid insurance salespeople or financial planners, but you should choose them carefully. Pick a financial planner just as you pick a competent and trustworthy doctor—look for one who fits your needs and has a proven record of ethical and effective assistance to clients. If you trust your doctor—or financial planner—you have to believe they have your best interests at heart. Just keep your eyes open, and, of course, be aware of ulterior motives when making financial decisions.

Principle 2: Nothing Happens Without a Plan

Most people spend more time planning their summer vacation than they do planning their financial future. It's easy to avoid thinking about retirement, to avoid thinking about how you're going to pay for your children's education, and to avoid thinking about tightening your financial belt and saving money. We began this text with the statement that it is easier to spend than to save. We can go beyond even that and say that it is easier to think about how you're going to spend your money than it is to think about how you're going to save your money.

STOP & THINK

All too often we utter those two words of regret, "*if only*," wistfully thinking about a "do-over" in life and feeling that if we had made a different decision, then things would have turned out better for us. One of the places you least want to have that "*if only*" feeling of regret is when it comes to your finances because "do-overs" don't happen in real life. The only way to avoid that "*if only*" feeling is with a plan.

If you're like most people, you can probably spend money without thinking about it, but you can't save money without thinking about it. That's the problem. Saving isn't a natural event: It must be planned. Unfortunately, planning isn't natural either. Begin with a modest, uncomplicated financial plan. Once the discipline of saving becomes second nature, or at least accepted behavior, modify and expand your plan. The longer you put off devising a financial plan, the more difficult accomplishing goals becomes. When goals appear insurmountable, you may not even attempt to reach them.

Principle 3: The Time Value of Money

Perhaps the most important concept in personal finance is that money has a time value associated with it. Simply stated, because you can earn interest on any money you receive, money received today is worth more than money received in, say, a year. For example, if you earn $1,000 today and invest that money at 5 percent, then 1 year from today, that $1,000 will be worth $1,050. If, however, 1 year from today you earn another $1,000, that will be worth just that $1,000—$50 less than the $1,000 you earned today. Although this idea is not a major surprise to most people, they simply don't grasp its importance. The importance of the time value of money is twofold. First, it allows us to understand how investments grow over time. Second, it enables us to compare dollar amounts in different time periods. If you can't do that, you'll be lost in personal finance.

In this text, we focus on ways to create and preserve wealth. To create wealth, we invest savings and allow them to grow over time. This growth is an illustration of the time value of money. In fact, much of personal finance involves efforts to move money through time. Early in your financial life cycle, you may borrow money to buy a house. In taking out that home mortgage, you are really spending money today and paying later. In saving for retirement, you are saving money today with the intention of spending it later. In each case, money is moved through time. Either you spend in today's dollars and pay back in tomorrow's dollars, or you save in today's dollars and later spend in tomorrow's dollars. Without recognizing the existence of the time value of money, it is impossible to understand **compound interest**, which allows investments to grow over time.

Compound Interest
Interest paid on interest. This occurs when interest paid on an investment is reinvested and added to the principal, thus allowing you to earn interest on the interest as well as on the principal.

You'll also find that time is your ally. If you are 20 right now and plan on retiring at 68, you'll end up with $1 million if you begin today and save $33 at the end of each month and earn 12 percent on your investment, but you'll have to save $300 a month if you earn only 6 percent; if you begin at age 40, those figures jump to $366 a month at 12 percent and $1,151 at 6 percent; if you don't begin until age 50, you'll have to save $1,320 a month at 12 percent and $2,582 at 6 percent, as shown in Table 1.4. As you can see, it's a lot easier if you start early and earn a high return. This is all because of the time value of money.

Principle 4: Taxes Affect Personal Finance Decisions

Because taxes help determine the realized return of an investment, they play an important role in personal finance. No investment decision should be made without first knowing the effect of taxes on the return of that investment. Thus, you must look at all your alternatives on an after-tax basis. Taxes aren't the same on all investments, so you will find that effective personal financial planning requires you to have an understanding of the tax laws and how they affect investment decisions.

Principle 5: Stuff Happens, or the Importance of Liquidity

Although much of the focus of personal financial planning is on long-term investing for lifetime goals, you must also plan for the unexpected—and it's not just unexpected pandemics; it's all kinds of other stuff that just happens. This means that

TABLE 1.4 Importance of the Interest Rate and Starting Early—Just Do It!—to Accumulate $1 Million by Age 68 Investing Your Money at 6% and 12%

Making Your Last Payment on Your 68th Birthday and Your First When You Turn:	At 6% Your Monthly Payment Would Be:	At 12% Your Monthly Payment Would Be:
20	$300	$33
25	413	59
30	573	108
35	806	198
40	1,151	366
50	2,582	1,320
60	8,141	6,253

some of your money must be available to you at any time, or *liquid*. If liquid funds are not available, an unexpected need, as a result of, say, job loss or injury, may force you to cash in a longer-term investment. You may need to act immediately, which might entail, for example, having to sell a rental property when real estate prices are low. And what if you don't have something to sell? In that case, you'll have to borrow money fast. That kind of borrowing may carry a high interest rate. It will also mean making unexpected loan repayments, which you may not be financially prepared to make. Generally, unplanned borrowing is tough to pay off; it is yet another reason to have adequate liquid funds available, and that generally means having enough liquid funds to cover 3 to 6 months of living expenses. Exactly how much is needed will be discussed in the next chapter.

Principle 6: Waste Not, Want Not—Smart Spending Matters

Managing your money involves more than just saving and investing—it also involves spending, specifically smart spending. If you're going to work hard for your money, you don't want to waste it. Unfortunately, smart spending isn't always practiced. In fact, studies suggest that over 1 in 20 of us—that's over 17 million Americans—are shopaholics; that is, they can't control their urge to shop.

When we talk about smart shopping, we will be talking about more than the $4 lattes, the two-pack-a-day cigarette habit, the magazines, and the 450 extra satellite channels; we'll also be talking about buying a car and a house and getting the most out of every dollar you spend.

The first step in smart buying is to differentiate want from need and understand how each purchase fits into your life. The second step is doing your homework to make sure what you get has the quality that you expect. The third step involves making a purchase and getting the best price, and the last step is maintaining your purchase.

Principle 7: Protect Yourself Against Major Catastrophes

The worst time to find out that you don't have the right amount or the right kind of insurance is just after a tragedy occurs. Just look at the fire victims in California who didn't have any fire insurance. As you'll see, insurance is an unusual item to purchase. In fact, most people don't "buy" insurance; they're "sold" insurance. It's generally the insurance salesperson who initiates the sale and leads the client through the process of determining what to purchase.

What makes this process a problem is that it is extremely difficult to compare policies because of the many subtle differences they contain. Moreover, most individuals have insurance but have never read their policies. To avoid the consequences of a major tragedy, you need to buy the kind of insurance that's right for you and to know what your insurance policy really says.

The focus of insurance should be major catastrophes—those events that, although improbable, can be financially devastating. Hurricanes, floods, earthquakes, and fires are examples. These are the events that can inflict losses that you can't afford to sustain, and these are the events insurance should protect you against.

Principle 8: Risk and Return Go Hand in Hand

Why do people save money? The answer is simple: People generally save money and invest it in order to earn interest and grow their money so they will have even more money in the future. What determines how much return or interest you get on your money? Well, investors demand a *minimum return* greater than the anticipated level of inflation. Why? If inflation is expected to be 4 percent and the expected returns on the investment are only 1 percent, then the return isn't enough to cover the loss of purchasing power due to inflation. That means the investor has, in effect, lost money, and there's no sense in making an investment that loses money.

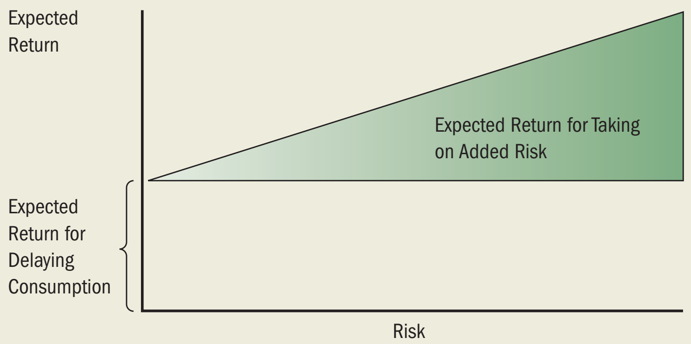
Now that you know what the minimum return is, how do you decide among investment alternatives? While all investments are risky to some degree, some are safer than others. Why would investors put their money in a risky investment when there are safer alternatives? The answer is that they won't unless they are compensated for taking that additional risk. In other words, investors demand additional expected return for taking on added risk. Notice that we refer to "expected" return rather than to "actual" return. You may have expectations and even assurances of what the returns from investing will be, but because risk exists, you can never be sure what those returns are actually going to be.

Let's face it; when it comes to investing, nothing is guaranteed in the future, and some investments have more uncertainty or risk—that is, there's a greater chance that the large return you're expecting may not turn out. Just look at investing in government bonds versus bonds issued by Macy's. In each case, you're lending money—that's what you're doing when you buy a bond because a bond is just like a loan. The entity that issues the bond is borrowing the money, and the person (you) who buys the bond is lending the money. Because there is more risk with Macy's bonds—that is, there's a greater chance that Macy's might not be able to pay you back—Macy's bonds promise a higher rate of interest than government bonds do; otherwise, no one would buy Macy's bonds. After all, you know the government will be around to pay off its loans, but Macy's may not be. It's that added incentive of additional interest that convinces some investors to take on the added risk of buying a Macy's bond rather than a government bond. The more risk an investment has, the higher its expected return should be. This relationship between risk and expected return is shown graphically in Figure 1.6.

Fortunately, **diversification** lets you reduce, or "diversify away," some of your risk without affecting your expected return. The concept of diversification is illustrated by the old saying "Don't put all your eggs in one basket." When you diversify, you are spreading your money among several investments instead of putting all your money in one. Then, if one of those investments goes bust, another—you hope—goes boom to make up for the loss. In effect, diversification allows you to weather the ups and downs of investing. You don't experience the great returns, but you don't experience the great losses either—instead, you receive the average return.

Diversification
Acquisition of a variety of different investments, instead of just one, to reduce risk.

FIGURE 1.6 The Risk–Return Trade-Off



BEHAVIORAL INSIGHTS

PRINCIPLE 9

Principle 9: Mind Games, Your Financial Personality, and Your Money Sure, you want to avoid financial mistakes—the problem is that a lot of those mistakes are built right into your brain. In recent years, a lot has been discovered about how our behavioral biases can lead to big financial mistakes. In effect, your mind can get in the way of good financial decision making. Take, for instance, what's called "mental accounting." Mental accounting is the tendency for people to separate money into different mental accounts, or buckets, each with a different purpose. How does this impact your personal finance decisions? It shows itself when you keep money in a savings account that pays 2 percent interest while not paying off what you owe on a credit card that charges you 14 percent interest. It also shows up when you get your tax return, view it as "mad money," and promptly go out and spend it while at the same time pinching pennies to save for your child's education.

This idea of mental accounts is just one of several behavioral biases and mental shortcuts that lead us unknowingly down the path to major financial mistakes. Let's look at another one of these behavioral biases, the "sunk cost effect"—once we put money into something, we become attached to it and are more likely to spend good money after bad money. For example, say you buy a very used car for $1,000, and almost immediately after you buy it, the transmission goes out. A new transmission is going to cost $1,500. This bias leads you to want to make the repair, even though the repair will cost more than the car is worth. That's because if you don't repair your car, that $1,000 you spent for it is wasted. But what's happened in the past doesn't matter; you want to base your decisions on what they're going to produce in the future. In effect, the sunk cost effect can cause you to make decisions based on the amount of money and time you have already invested in something, and the end result can be to pour good money after bad money into a car, a house, or almost anything.

Making all this harder is that everyone relates to money and financial decisions differently—and for many, it is difficult to separate out the emotions involved. In addition, some of us are more sensitive to advertising and more easily swayed to buy what we might not have intended to buy, while others take naturally to financial discipline. Unfortunately, your financial personality is tough to change. At an early age, many people seem to

STOP & THINK

Envy and "the comparison complex" are two behavioral traits we all have that make us focus on what others have rather than on what is important in life. Studies have shown that watching TV makes people more likely to feel that happiness is based on wealth and what you can buy, and as a result, they become less content with their lives. Have you ever felt that way? Think of an example.

become "financially wired" in ways that make it hard to save, while others find it hard to spend. Our views on spending and saving and whether we have a tendency to "just not think about it" will go a long way toward determining our financial success. In fact, there are people who view money as an evil and feel uncomfortable with wealth. Recognizing your financial personality will allow you to gain control over your financial life and help you make decisions based on choice rather than emotion and habit. Moreover, when you recognize what your financial personality is and how it impacts your decisions, you won't have to repeat the same financial mistakes for the rest of your life. Just look at Dre and Bow in the introduction to this chapter—making money is only part of the answer; you also have to, as Mark Cuban said, "understand finance."

Throughout this text, we will try to alert you to some of the things that might be going on in your brain that you don't know about—at least those things that affect your financial decisions. If you understand these biases, you can control them, and if you recognize what your financial personality is, you can take it out of the process and avoid some of the pitfalls you'd otherwise be subject to. In fact, the last principle we will look at is based on one of these behavioral biases, and it's made tougher for some because of their financial personality.

ACTION PLAN

Principle 10: Just Do It! Each chapter will be closing with an Action Plan, and this chapter closes with the final principle, which calls you to action. Good advice is good only if you act on it.

PRINCIPLE 10

Making the commitment to actually get started may be the most difficult step in the entire personal financial planning process. In fact, people are programmed against taking on unpleasant tasks—it's one of the behavioral biases that we all have—because of a natural desire to procrastinate. If you don't believe that, just think of the last term paper you had to write—more likely than not, much of it was written the night before it was due, even though you knew, weeks before, when it would be due. However, the positive reinforcement associated with making progress toward your goals and taking control of your financial affairs generally means that once you take the first step, the following steps become much easier.

It's much easier to save than to spend, right? No, just checking—you know the opposite is true. For most people, savings are a residual. That means that you spend what you like and save what is left, so the amount you save is simply what you earn minus what you spend. When you pay yourself first, what you spend becomes the residual. That is, you first set aside your savings, and what is left becomes the amount you can spend—that's the first step in putting your financial plan into action.

FACTS OF LIFE

Saving early can make a big difference. Say you save $50 a month at 10 percent.

Start at 25 and by 65 you'll have:	Start at 45 and by 65 you'll have:
$316,204	$37,968

Chapter Summaries

LO1 Explain why personal financial planning is so important.

SUMMARY: Personal financial planning will enable you to (1) manage the unplanned, (2) accumulate wealth for special expenses, (3) save for retirement, (4) "cover your assets," (5) invest intelligently, and (6) minimize your payments to Uncle Sam.

LO2 Describe the five basic steps of personal financial planning.

SUMMARY: There are five basic steps to personal financial planning:

1. Evaluate your financial health.
2. Define your financial goals.
3. Develop a plan of action.
4. Implement your plan.
5. Review your progress, reevaluate, and revise your plan.

In fact, the last step in financial planning is often the first because no plan is fixed for life.

KEY TERMS

Liquidity, page 6 The relative ease and speed with which you can convert noncash assets into cash. In effect, liquidity involves having access to your money when you need it.

LO3 Set your financial goals.

SUMMARY: To reach your financial goals, you must first set them. This process involves writing down your financial goals and attaching costs to them, along with identifying when the money to accomplish those goals will be needed. Once you have set your goals, they will become the cornerstone of your personal financial plan, a guide to action, and a benchmark for evaluating the effectiveness of the plan.

Over your lifetime, your goals will change, and you will see that a general financial life cycle pattern applies to most people, even you. There are three stages in the financial life cycle: (1) the early years—a time of wealth accumulation, (2) approaching retirement—the golden years, and (3) the retirement years.

KEY TERMS

Estate Planning, page 9 Planning for your eventual death and the passage of your wealth to your heirs.

Inflation, page 9 An economic condition in which rising prices reduce the purchasing power of money.

LO4 Explain how career management and education can determine your income level.

SUMMARY: In general, the better educated you are, the more you will earn. This is because the more specialized skills and training are needed for a job, the higher it tends to pay.

LO5 Identify and explain how skills acquired in this course will help you get a job and advance in it.

SUMMARY: This course is not just about managing money. It also helps you develop critical thinking, quantitative reasoning, and ethical skills that you help in your personal and professional life.

Explain the personal finance lessons learned in the recent pandemic. LO6

SUMMARY: The recent pandemic demonstrated that too many of us have insufficient emergency funds. In addition, it showed that the financial issue that Americans worry about most is retirement. Other major problems that surfaced involved having too much debt and inadequate health insurance. A lack of financial planning left many Americans ill-prepared for the pandemic.

List ten principles of personal finance. LO7

SUMMARY: There are ten principles on which personal financial planning is built and that motivate the techniques and tools introduced in this text.

KEY TERMS

Compound Interest, page 23 Interest paid on interest. This occurs when interest paid on an investment is reinvested and added to the principal, thus allowing you to earn interest on the interest as well as on the principal.

Diversification, page 25 Acquisition of a variety of different investments, instead of just one, to reduce risk.

Problems and Activities

1. What financial strategies should you develop as a result of studying personal financial planning? What financial problems might you avoid?
2. List the five steps in the financial planning process. List an activity, or financial task, that you should accomplish in each step in the financial planning process.
3. Financial goals should be specific, realistic, prioritized, and anchored in time. Using these characteristics, identify five financial goals for yourself.
4. As the cornerstone of your financial plan, goals should reflect your lifestyle, serve as a guide to action, and act as a benchmark for evaluating the effectiveness of your plan. For one of the goals identified in Problem 3, explain this statement.
5. The goal of financing the cost of education is obviously important in your present stage of the financial life cycle. Explain how this goal might continue to be important in future stages.
6. For three of the questions in Table 1.3, write a concise and descriptive response. Practice your answers, and then present them to someone willing to give you suggestions for improving your responses or your delivery.
7. Explain how your financial situation is related to your career aspirations.
8. Considering the influence of finances on couple relationships, identify at least three smart financial strategies someone wanting to form a relationship and raise children should follow.
9. Explain how **Principle 5: Stuff Happens, or the Importance of Liquidity** and **Principle 7: Protect Yourself Against Major Catastrophes** may be related. What are you currently doing to protect yourself, and your financial future, from “stuff and other major catastrophes”?

Discussion Case 1

Jeremiah, an accountant, and Bethany just returned from their honeymoon in the Bahamas. They celebrated their marriage and Bethany's completion of her MBA program. They have been encouraged by their parents to establish some personal and financial goals for their future. However, they do not know how to set or achieve these goals. They know that they would like to own their own home and have children, but those are the only goals they have considered. Jeremiah knows of a financial advisor who might be able to help with their predicament, but they don't think they can afford professional help.

Questions

1. If you were serving as the couple's financial advisor, how would you explain the five steps in the financial planning process and their importance to future financial success?
2. What financial goals (short-term, intermediate-term, and long-term) would you determine to be the most important and which the least important to Jeremiah and Bethany, considering their current life cycle stage? Support your answer.
3. What four common concerns should guide the development of their financial plan? How are these related to Principles 4, 5, and 7?
4. List five tips for Bethany to keep in mind when preparing for interviews.
5. Identify three important strategies for young professionals such as Jeremiah and Bethany to remember to ensure success in their chosen careers. Why do "ethical violations end careers"?
6. As a new couple, what information can you provide Jeremiah and Bethany about possible roadblocks? For example, what are some of the commonly reported disagreements among couples according to a recent Harris Poll?
7. Why is Principle 10 the most important principle? Why is it equally relevant to financial planning and career planning?

Discussion Case 2

Nicholas and Himal Delgado, from Rochester, Minnesota, are the proud new parents of twin daughters. This was quite a shock to them and 2-year-old Jarred. They were not prepared for twins, and this has complicated their financial plans as well as most everything else! They had planned to pay for education costs, but now they are uncertain how to prepare for having three children in college at the same time. They love their family and truly believe that money isn't everything, but their dream to retire early and travel seems to be fading with every new expense. They need help with Step 5: Review Your Progress, Reevaluate, and Revise Your Plan. Himal has told Nicholas that she wants to attend a personal finance class at the community center, but Nicholas thinks they should seek assistance from a financial planner. As Nicholas points out, even though expenses are rising, they both have good jobs with the potential for rapid advancement and salary increases.

Questions

1. Explain to Nicholas and Himal why personal financial planning is crucial to their future. Why are Principles 1 and 2 important if they choose to seek professional advice? How might the behavioral finance biases of mental accounting and sunk costs influence their response to the professional's advice?

2. Using the information in Table 1.1, estimate the cost of raising Jarred and the twins from birth to age 18 if the Delgados' current annual income is approximately $95,000 and both parents plan to continue working full-time.
3. Explain how understanding and applying Principles 3 and 8 will be critical to funding the children's education.
4. Setting financial goals involves specifically defining the goal, determining its future cost, and pinpointing the future time when the money will be needed. Write a specific and realistic goal for funding the children's education.
5. In addition to funding the children's education, name two other short-, intermediate-, and long-term goals the Delgados should consider as they revise their financial plan.
6. With three children to consider, how might Principles 5, 6, and 7 be relevant to the Delgados' situation?

CHAPTER 2

Measuring Your Financial Health and Making a Plan

Learning Objectives

LO1	**Calculate** your level of net worth or wealth using a balance sheet.	**Using a Balance Sheet to Measure Your Wealth**
LO2	**Analyze** where your money comes from and where it goes using an income statement.	**Using an Income Statement to Trace Your Money**
LO3	**Use** ratios to identify your financial strengths and weaknesses.	**Using Ratios: Financial Thermometers**
LO4	**Set** up a record-keeping system to track your income and expenditures.	**Record Keeping**
LO5	**Implement** a financial plan or budget that will provide for the level of savings needed to achieve your goals.	**Putting It All Together: Budgeting**
LO6	**Decide** whether a professional financial planner will play a role in your financial affairs.	**Hiring a Professional**

You probably have something in common with the characters on the CBS/TBS sitcom *2 Broke Girls*—that being the "broke" part. This show is about two young women (Max, a streetwise waitress and nanny, and Caroline, the sophisticated daughter of a Bernie Madoff–like criminal who finds herself disgraced and penniless after her father's arrest) starting out on their own in Brooklyn.

With a setup like this, it's no surprise that this sitcom is littered with money lessons. It shows the need for planning—after all, as Caroline has found out, if you have money, you don't want to take it for granted; it can be gone in a heartbeat. It

Darren Michaels/© CBS/Courtesy: Everett Collection

also shows that if life deals you a financial blow, all is not lost; you can start over financially, but you do have to work at it, and you have to have a plan. As we watch Max and Caroline forge a friendship and develop a dream, we see that not having money isn't the end of life. Life can still be good, but taking financial control and attaining your goals can make it even better.

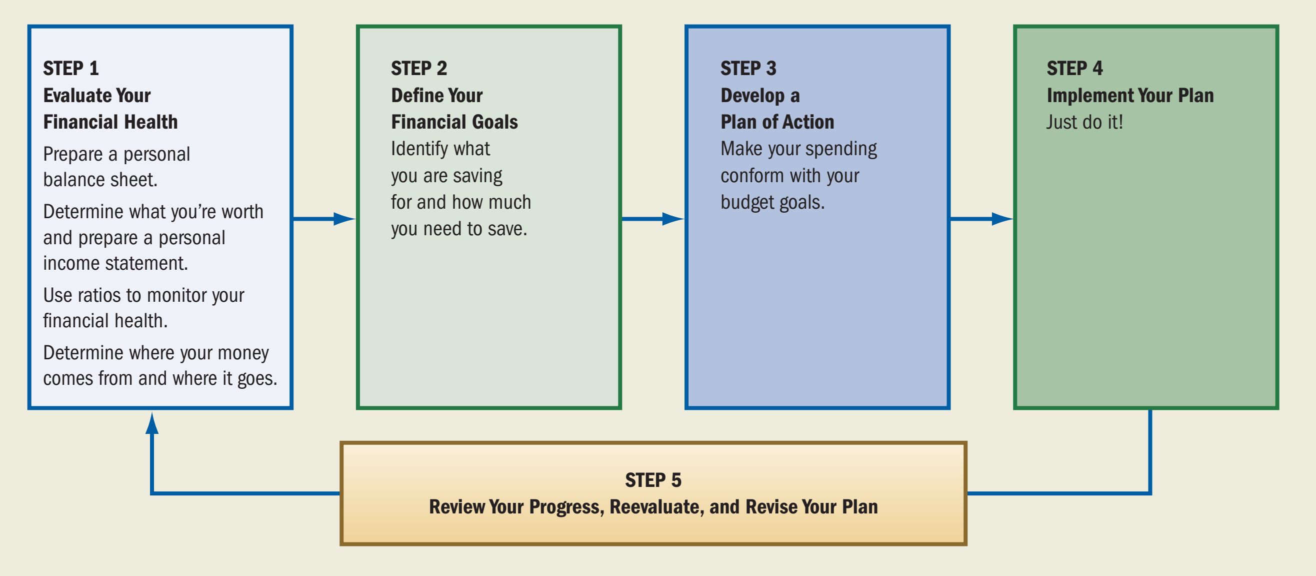
For Max and Caroline, their goal is to one day open their own cupcake shop. With each episode, we watch their many misadventures as they struggle to earn and save every penny to fulfill their dream. What are they doing to earn and save their money? In addition to their waitress jobs, they shop at the Goodwill (a definite first for Caroline), they share a one-bedroom apartment in Brooklyn (which definitely exceeds the real estate rental power of someone on a shoestring budget), they use coupons, they even open a dessert bar, and they spend their spring break housesitting at a rich customer's New York apartment. At the end of each episode, they give viewers the latest tally of their saving efforts for their cupcake business venture—which in the spring of 2017, after many ups and downs, totaled $6,475.54.

What would help Max and Caroline reach their goal? Clearly, it is some advice about managing their money and putting together a budget. Starting out in the real world with no money, the fastest way to achieve their dream begins with keeping track of what comes in and what goes out. Remember **Principle 2: Nothing Happens Without a Plan**. Because, after all, if you don't know where your money goes, it's hard to save it. And that's the first step toward never being "1 broke girl or guy."

PRINCIPLE 2

Planning and budgeting require control—they don't come naturally. Without the ability to measure our financial health and develop a plan and budget, we will not achieve our financial goals. Showing financial restraint isn't as much fun as spending with reckless abandon, but it's a lot more fun than winding up broke. Making and sticking with a plan isn't necessarily easy, and it often involves what some people would consider sacrifices (such as getting a job over spring break instead of going down to Cancun, Panama City, Las Vegas, or wherever) or just skipping that daily designer coffee. The fact is, though, that the rewards of taking

FIGURE 2.1 The Budgeting and Planning Process: Evaluating Your Financial Health and Developing a Plan of Action



financial control are worth any small sacrifices and more. After all, if you're like most people, you can probably spend money without thinking about it, but you can't save money without thinking about it—and without saving, you'll never own your own cupcake shop or achieve your own financial goal.

In this chapter, we begin the budgeting and planning process that was first outlined in Figure 1.1—specifically, working on Steps 1 and 3, as shown in Figure 2.1. We begin by measuring our wealth using a personal balance sheet and then a personal income statement to help figure out where our money came from and where it went. With this information in hand, we will use ratios to check into the status of our financial health and look at ways to keep track of all this. Finally, we will set up and implement a cash budget.

Personal Balance Sheet
A statement of your financial position on a given date. It includes the assets you own, the debt or liabilities you have incurred, and your level of wealth, which is referred to as net worth.

Assets
What you own.

LO1 Calculate your level of net worth or wealth using a balance sheet.

Using a Balance Sheet to Measure Your Wealth

Before you can decide how much you need to save to reach your goals, you have to measure your financial condition—what you own and what you owe. Corporations use a balance sheet for this purpose, and so can you. A **personal balance sheet** is a statement of your financial position on a given date—a snapshot of your financial status at a particular time. It lists the **assets** you own, the debt or **liabilities** you've incurred, and your general level of wealth, which is your **net worth or equity**. Assets represent what you own. Liabilities represent your debt or what you owe. To determine your level of wealth or net worth, you subtract your level of debt or borrowing from your assets. Figure 2.2 is a sample balance sheet worksheet. We will now look at each section.

Liabilities
What you owe; your debt or borrowing.

Net Worth or Equity
A measure of the level of your wealth. It is determined by subtracting the level of your debt or borrowing from the value of your assets.