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FINANCIAL PLANNING

15E



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**Personal Financial Planning,
Fifteenth Edition**

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For Bonnie, Lauren, and Evan
RSB

For our children:
Zachary, Jessica, and Caren
LJG

For Colwyn,
Grace, and Rhett
MDJ

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Preface

- Why can't I budget more effectively and what should I do about it?
- How much money should I set aside for emergencies?
- How do I pick the best credit card and best manage it?
- Would I be better off renting or buying a home?
- How much of a mortgage can I afford?
- What are the implications of the Affordable Care Act for my health insurance?
- What essential principles will help guide my understanding of future changes to health insurance?
- What features do I need in car and homeowner's insurance and how do I get the best prices?
- What do I need to know about stocks and bonds to make good investments?
- How do I choose the best mutual funds and exchange traded funds (ETFs)?
- How do I plan for retirement?
- How do tax-deferred investment vehicles work and what should I do about them?
- Do I really need a will if I'm young and just getting started?
- Isn't estate planning just for rich people?

So many questions about managing our personal finances—and the stakes are so high! *Personal Financial Planning*, 15th edition, provides a framework for answering these questions and more. Careful planning allows us to best adapt to changes in the financial environment and the associated changes in our own lives. This book provides tools for preparing personal financial plans that serve as road maps for achieving goals. It emphasizes the dynamics of the financial planning process by considering the impact of life changes—birth, marriage, divorce, job and career, and death.

Personal Financial Planning addresses all of the major financial planning issues and problems that individuals and families encounter. It links together all of the major elements of effective money management. All of the latest financial planning tools and techniques are discussed. This comprehensive text is written in a personal style that uses state-of-the-art pedagogy to present the key concepts and procedures used in sound personal financial planning and effective money management. The roles of various financial decisions in the overall personal financial planning process are clearly delineated.

The book serves individuals who are, or will be, actively developing their own personal financial plans. It meets the needs of instructors and students in a first course in personal financial planning (often called “personal finance”) offered at colleges and universities, junior and community colleges, professional certification programs, and continuing education courses. The experiences of individuals and families are used to demonstrate successes and failures in various aspects of personal financial planning. A conversational style and liberal use of examples and worksheets guide students through the material and emphasize important points. The benefits of the book's readability accrue not only to students but also to their instructors.

ORGANIZATION OF THE BOOK

Personal Financial Planning is divided into six parts. Part 1 presents the foundations of personal financial planning, beginning with the financial planning process and then covering financial statements and budgets and also taxes. Part 2 concerns the management of basic assets, including cash and savings instruments, automobiles,

and housing. Part 3 covers credit management, including the various types of open account borrowing and consumer loans. Part 4 deals with managing insurance needs and considers life insurance, health care insurance, and property insurance. Part 5 covers investments—including stocks, bonds, mutual funds, ETFs, and real estate—and how to make transactions in securities markets. Part 6 is devoted to retirement and estate planning.

Pedagogy

Each chapter opens with six learning goals that link the material covered to specific learning outcomes and anchor the text's *integrated learning system*. The learning goal numbers are tied to major chapter headings and restated and reviewed point by point in the end-of-chapter summary. New to the 15th edition, the use of spreadsheets has been thoroughly integrated to supplement and complement the use of financial calculators in making personal financial decisions. At the end of each of the major sections, *Test Yourself* questions allow readers to reinforce their understanding of the material before moving on to the next section. As students read through the chapters, these *Test Yourself* questions allow them to test their understanding of the material in each section. Students can find the answers to the *Test Yourself* questions on the book's companion website by going to www.cengage.com/finance/billingsley/planning/15e. They're also found in the instructor's manual.

Each chapter contains several *Financial Planning Tips* and *Financial Road Signs*, which provide important hints or suggestions to consider when implementing certain parts of a financial plan. *Worksheets* are included to simplify demonstration of various calculations and procedures and to provide students with helpful materials that they can use in managing their own personal finances. The worksheets are numbered for convenient reference in end-of-chapter problems, and they include descriptive captions. Numerous exhibits, each including a descriptive caption, are used throughout to more fully illustrate key points in the text. Also included in each chapter is a *running glossary* that appears in the margin and provides brief definitions of all highlighted terms in the accompanying text. Most chapters discuss how the Internet can be used in various phases of personal financial planning. End-of-chapter material includes a *Summary*, which restates each learning goal and follows it with a brief paragraph that summarizes the material related to it. The next element is the *Financial Impact of Personal Choices* feature, which presents a personal financial planning decision related to an important topic in each chapter and evaluates the outcome. Selected chapters also provide a useful feature, *Key Financial Relationships*, which concisely summarizes the analytical frameworks used and provides related practice problems and their solutions. Then each chapter provides *Financial Planning Exercises*, which include questions and problems that students can use to test their grasp of the material. Following this feature is *Applying Personal Finance*, which generally involves some type of outside project or exercise. Two *Critical Thinking Cases* that highlight the important analytical topics and concepts are also provided.

Major Changes in the 15th Edition

The 15th edition has been thoroughly updated to consider the most up-to-date techniques of contemporary personal financial planning. We emphasize that the key principles of personal financial planning remain valid: save, diversify your investments, watch your expenditures, and borrow carefully. This edition reflects feedback from past users, practicing financial planners, finance industry experts, students, and our own research. It provides helpful new approaches, expanded coverage in certain areas, streamlined coverage in others, and enhanced pedagogy anchored by a state-of-the-art integrated learning system. The basic organizational structure, topical coverage, superior readability, and useful instructional aids that marked the success of the

first 14 editions have been retained and extended. Important changes in this edition are described below, first as general changes and then as specific chapter-by-chapter changes.

General Changes and Hallmark Features

- The 15th edition includes in each chapter a series of highlighted practical examples illustrating everyday applications of the covered material. The featured examples include “The Sooner You Start an IRA, the Better” (Chapter 1), “Determining the Value of an Investment” and “Keeping Track of Loans” (Chapter 2), “Applying Tax Rates” and “Determining the Amount Owed or Refunded” (Chapter 3), “Determining the Extent of FDIC Insurance Protection” (Chapter 4), “Calculating the Maximum Affordable Mortgage Loan” (Chapter 5), “Credit Card Choice Trade-offs” and “Paying Only the Minimum on Your Credit Card” (Chapter 6), “Calculating the Total Finance Charge and Payment on a Simple Interest Loan” (Chapter 7), “Appropriate Use of Term Life Insurance” and “Using Low-Load Whole Life Insurance—Building Cash Value” (Chapter 8), “Effect of Per-Illness, Per-Accident Deductible” (Chapter 9), “Effect of Co-insurance,” and “Homeowner’s Policy Coverage Limits” (Chapter 10), “Limit Orders” and “Using Margin Trades to Magnify Returns” (Chapter 11), “Inflation-Adjustment of TIPS Bonds” and “Calculating the Approximate Yield to Maturity” (Chapter 12), “Calculating a Mutual Fund’s NAV” and “Calculating the Value of Income-Producing Property” (Chapter 13), “Effect of Inflation on Future Retirement Needs” and “Measuring the Benefits of a Roth IRA Over a Taxable Account” (Chapter 14), and “Disadvantage of Joint Tenancy with the Right of Survivorship” and “Use of Life Insurance in an Estate” (Chapter 15).
- The 15th edition includes a feature in each chapter, *You Can Do It Now*, which allows the reader to act on the presented material on the spot. The *You Can Do It Now* features include “Start a List of Your Financial Goals” and “Recognize that YOU are Your Most Important Asset” (Chapter 1), “Track Your Expenses” and “Save Automatically” (Chapter 2), “Tax Planning” (Chapter 3), “Shop for the Best Short-Term Rates” and “Reconcile Your Checkbook” (Chapter 4), “What’s Your Car Worth?” and “Rent vs. Buy a Home?” (Chapter 5), “How Does Your Credit Report Look?” and “Is Your Credit Card a Good Deal?” (Chapter 6), “Current Auto Loan Rates” (Chapter 7), “Shop for a Customized Life Insurance Policy” and “Check Out the Best Life Insurance Companies” (Chapter 8), “Compare Policies on an ACA Health Insurance Exchange” (Chapter 9), “Check Out the Best Homeowner’s Insurance Companies” and “Evaluate the Best Auto Insurance Companies” (Chapter 10), “How’s the Market Doing Right Now?” and “Get a Quick Perspective on Your Asset Allocation” (Chapter 11), “What’s the Market P/E Ratio Telling You?” and “How Do Stock and Bond Market Returns Compare This Year?” (Chapter 12), “Objective Mutual Fund Resources” and “How to Choose the Best ETF for You” (Chapter 13), “Get a Rough Estimate of Your Future Social Security Benefits” and “Calculating the Benefits of a Traditional IRA” (Chapter 14), and “Estate Planning Conversations” and “Importance of Naming Alternative Beneficiaries” (Chapter 15).
- The 15th edition contains the *Financial Impact of Personal Choices* feature, which presents a personal financial planning decision related to an important topic in each chapter and evaluates the outcome. The *Financial Impact of Personal Choices* feature includes “Andrew Cuts Back on Lunch Out and Lattes” (Chapter 1), “No Budget, No Plan: Mason Bought a Boat!” (Chapter 2), “Hazel and Jacob’s Tax Management Strategy” (Chapter 3), “Josie Likes Cash—Too Much?” (Chapter 4), “Brianna Wants to Buy a House but Doesn’t Want a Roommate Now” (Chapter 5), “Austin Has Had It and Files for Bankruptcy” (Chapter 6), “Maya and Ian Calculate Their Auto Loan Backward” (Chapter 7), “Ella and Thomas Consider ‘Buying Term and Investing the Rest’” (Chapter 8), “Wyatt Expands His Health Insurance Coverage” (Chapter 9), “Jayden Saves on His Car Insurance” (Chapter 10),

“Emma and William Get Serious About Their Retirement Asset Allocation” (Chapter 11), “Brooke and Josie Like High-Flying Stocks” (Chapter 12), “Mackenzie Finds a Simple Retirement Investment Plan” (Chapter 13), “Kaitlyn and Ava’s Different Approaches to Traditional IRA” (Chapter 14), and “The (Un)intended Effects of Benjamin’s Beneficiary Designations” (Chapter 15).

- The 15th edition includes a summary of *Key Financial Relationships* at the end of selected chapters. Practice problems illustrating the application of these key analytical frameworks are also provided.
- The highly regarded *Worksheets* are provided in a user-friendly Excel® format that students can download from the book’s companion Internet site. Students have the option of using the Worksheets multiple times and having some of the calculations within the Worksheets completed electronically.
- The book has been *completely updated and redesigned* to allow improved presentation of each of the text’s pedagogical features.
- The 15th edition continues to place emphasis on *using the Internet*. Included are a number of features that either link students to relevant Internet sites or describe how the Internet can be incorporated into the personal financial planning process.
- Step-by-step *use of a handheld financial calculator and financial spreadsheets* to make time value calculations is integrated into relevant discussions in this edition. To improve understanding, relevant keystrokes are highlighted in these demonstrations. Basics of the time value of money are introduced in Chapter 2, “Using Financial Statements and Budgets,” and Appendix E now explains how financial calculators can be used to make time value calculations. The use of financial calculators and spreadsheets are reinforced in later chapters, where the time value techniques are applied. For example, using a calculator and a spreadsheet to find the future value of a deposit given various compounding periods is shown in Chapter 4, “Managing Your Cash and Savings,” and calculating estimates of future retirement needs is demonstrated in Chapter 14, “Planning for Retirement.” The inclusion of calculator keystrokes and spreadsheet functions should help the reader learn how to develop financial plans more effectively by using this important tools of the trade.
- The 15th edition continues and updates the well-received *Behavior Matters*, which relates each chapter’s topic to the reader’s everyday behavior and shows how readers might adapt their behavior to become more financially savvy. The *Behavior Matters* features show how all-too-common behavioral biases can adversely affect how we process financial information and make financial decisions. The feature helps link the text discussions to actual financial planning ideas, experiences, and practices—all intended to fully engage readers in the personal financial planning process. The *Behavior Matters* features include “Practicing Financial Self-Awareness” (Chapter 1), “Pessimistic Budgeting Works” (Chapter 2), “Do We Really Like Paying Taxes?” (Chapter 3), “Saving More ...Automatically” (Chapter 4), “Watch Out for ‘Anchoring’: The Case of the Used Car Salesperson Strategy,” (Chapter 5), “Behavioral Biases and Credit Card Use” (Chapter 6), “The Paradox of More Financial Choices” (Chapter 7), “Choosing Between Whole Life and Term Life Insurance” (Chapter 8), “Behavioral Biases in Making Health Insurance Decisions” (Chapter 9), “Behavioral Biases in Buying Property Insurance” (Chapter 10), “Is Short-Term Thinking Hardwired in Us? Looking for Patterns That Aren’t There...” (Chapter 11), “Investor Overreaction” (Chapter 12), “Behavioral Biases in Mutual Fund Investing” (Chapter 13), “Behavioral Biases in Retirement Planning” (Chapter 14), and “Aversion to Ambiguity in Estate Planning” (Chapter 15).
- Exhibits and Worksheets, and end-of-chapter *Financial Planning Exercises* and *Critical Thinking Cases*—have been retained and improved as part of the integrated learning system. The *Planning Over a Lifetime* feature continues to highlight how the chapter’s topic is important to readers in different life stages.

Specific Chapter-by-Chapter Changes and Summaries

Because instructors often like to know where new material appears, the significant changes that have been made in the 15th edition are summarized next.

Chapter 1 on understanding the financial planning process has been carefully revised to focus on the most important themes in the book. Emphasis is placed on setting realistic goals for your finances, helpful ways to save money by changing everyday habits, and being more financially self-aware.

Chapter 2 on using your financial statements and budgeting has been restructured, streamlined, and updated. Calculator keystrokes, spreadsheets, and time lines appear in discussions of the time value of money. There are new discussions on setting realistic budgeting plans and avoiding potential budgeting mistakes, how to choose the right personal finance software, and practical ways to change your behavior to spend less.

Chapter 3 on preparing your taxes has been updated to reflect the changes in tax laws, rates, procedures, and forms in effect at the time we revised the chapter. Importantly, this includes the many changes brought by the Tax Cuts and Jobs Act of 2017. The material emphasizes current tax practices and explains the nature of progressive tax rates, average tax rates, itemized deductions, individual retirement accounts (IRAs), and other types of tax issues. The chapter continues to provide readers with sidebar advice on avoiding common errors, tax tips, and audit triggers. There are new features about what documents you'll need to collect to prepare for tax time, effective ways to reduce your tax liability, and tips for choosing the most appropriate tax preparer for you.

Chapter 4 on managing your cash and savings has been revised to reflect up-to-date capital market conditions. The potential use of I savings bonds to manage inflation risk is emphasized. There are practical explanations of why you should start saving *now*, what to look for when choosing a new bank, planning tips for when and when not to use your debit card, and tips for what you should and shouldn't store in a safety deposit box.

Chapter 5 on making automobile and housing decisions considers new market developments and sources of information. The chapter discusses when it makes sense to lease a car, when to buy versus rent a house, how to know when it's time to buy your first home, how to tell what kind of house you need (prioritizing your needs and being practical), and the top ten home improvement projects based on the percentage of the investment recovered at the sale of a home.

Chapter 6 on consumer credit and credit cards, focuses on the positive aspects of using credit and what it takes to build and maintain a strong credit history. The chapter explores the dangers of making only the minimum payment on your credit cards and why "mental accounting" can be dangerous, tips for choosing the right credit card, risky situations for using your debit card, protecting yourself from identity theft, and how to use credit through the different stages of your life.

Chapter 7 on using consumer loans, analyzes the benefits and uses of consumer credit for both single-payment and installment loans. The discussion concentrates on the key issues surrounding loan provisions, finance charges, and other credit considerations. There are suggested questions to ask before you loan money to family and friends, a discussion about 0 percent annual percentage rate (APR) loans and

their potential limitations, and a discussion of what lenders are looking at when you submit a loan application—your credit report, debt history, employment history, and savings.

Chapter 8 on insuring your life, discusses how to choose the right life insurance, the benefits of buying a whole-life policy, the differences between whole life and term life insurance, knowing what to expect during your life insurance medical exam, potential conflicts of interest in dealing with insurance agents, and key considerations for life insurance use in each stage of life.

Chapter 9 on insuring your health, has been updated and includes a discussion of the new rules and guidelines for student health care, Medicare Advantage plans, how to save on health insurance, and how to choose the right plan for you. There's also a discussion about the rationale for health-care reform and the controversy over the Affordable Health Care Act of 2010. The chapter also includes tips on buying disability income insurance, buying long-term care insurance, and health-care apps for your smart phone.

Chapter 10 on protecting your property, discusses behavioral biases when buying property insurance, how to handle a denied insurance claim, and buying auto insurance—getting multiple quotes, how the car itself affects the price of the policy, and how much auto insurance you need. We continue to emphasize practical advice for reducing homeowner's insurance premiums, filing auto insurance claims, preventing auto theft, strategies to avoid liability, and obtaining discounts for auto safety and good driving.

Chapter 11 on investment planning has been revised and updated with discussions of why people are more likely to make short-term investments (and why you might want to avoid this tendency), the importance of saving for retirement, and how to begin investing online.

Chapter 12 on investing in stocks and bonds continues to emphasize the risk–return characteristics of these securities. As part of the revision process, we present new information on successful stock and bond investing, analysis of Apple's financial performance and valuation, tips for avoiding common investing mistakes, properly interpreting overly optimistic equity analysis, how accrued interest affects bond prices, and how to invest in stocks and bonds at each stage of life. A new section on the dollar cost averaging investment strategy has been added to the chapter.

Chapter 13 on investing has been updated and discusses target-date mutual funds, choosing the best mutual funds, avoiding “dog” funds, choosing between exchange traded funds (ETFs) and mutual funds, and a lengthy new discussion and exhibit about how to evaluate ETF performance. There's also a *Behavior Matters* feature about behavioral biases in mutual fund investing—how educating yourself can help you break harmful investing tendencies.

Chapter 14 on planning for retirement has several valuable features discussing behavioral biases in retirement planning, an app for your smart phone that will help you plan for retirement, a discussion about protecting private-sector defined benefit retirement plans, tips for managing your 401(k) account, and coverage about converting a traditional IRA to a Roth IRA and the implications of doing so.

Chapter 15 on preserving your estate has been updated to reflect the most recent estate tax laws and tax rates. The chapter discusses online estate planning resources, the details of choosing a suitable guardian for minor children in case of death, tips

for writing a will, reasons to use a trust, and a feature about recognizing and overcoming aversion to ambiguity in estate planning.

SUPPLEMENTARY MATERIALS

Because we recognize the importance of outstanding support materials to the instructor and the student, we have continued to improve and expand our supplements package.

Instructor Supplements

Instructor's Manual and Test Bank

A comprehensive *Instructor's Manual* has been prepared to assist the instructor. For each chapter, the manual includes:

- An outline
- Discussion of major topics
- A list of key concepts
- Solutions to all *Test Yourself* questions, end-of-chapter *Financial Planning Exercises*, and *Critical Thinking Cases*

The *Test Bank* has been revised, updated, and expanded, and all solutions have been checked for accuracy. It includes true–false and multiple-choice questions, as well as four to six short problems for nearly every chapter. Each question is tagged with the corresponding learning objective and learning outcomes. The *Instructor's Manual* has been revised by Professor Sam Hicks, CPA, of VirginiaTech.

Testing with Cognero

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Microsoft PowerPoint®

Enhance lectures and simplify class preparation. Chapter PowerPoint® presentations are available to instructors on the text's instructor Web site. Each presentation consists of a general outline of key concepts from the book. The PowerPoints were revised by Professor Sam Hicks, CPA, of VirginiaTech.

STUDENT SUPPLEMENTS

Financial Planning Worksheets

Financial Planning *Worksheets* identical to those presented in the text can be downloaded from this text's student companion Internet site. Each *Worksheet* provides a logical format for dealing with some aspect of personal financial planning, such as preparing a cash budget, assessing home affordability, or deciding whether to lease or purchase an automobile. Providing worksheets electronically in Excel® format allows students to complete them multiple times for mastery, and many of the worksheets can actually be used to calculate figures needed to make financial decisions.

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Ed Anthony, Trevecca Nazarene University
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Professor Billingsley's consulting to date has focused on two areas of expertise. First, he has acted extensively as an expert witness on financial issues. Second, he has taught seminars and published materials that prepare investment professionals for the CFA examinations. This has afforded him the opportunity to explore and discuss the relationships among diverse areas of investment analysis. His consulting endeavors have taken him across the United States and to Canada, Europe, and Asia. A primary goal of Professor Billingsley's consulting is to apply the findings of academic financial research to practical investment decision making and personal financial planning.

Lawrence J. Gitman is an emeritus professor of finance at San Diego State University. He received his bachelor's degree from Purdue University, his M.B.A. from the University of Dayton, and his Ph.D. from the University of Cincinnati. Professor Gitman is a prolific textbook author and has more than 50 articles appearing in various finance journals.

An active member of numerous professional organizations, Professor Gitman is past president of the Academy of Financial Services, the San Diego Chapter of the Financial Executives Institute, the Midwest Finance Association, and the FMA National Honor Society. In addition, he is a Certified Financial Planner® (CFP®). Gitman formerly served as a director on the CFP® Board of Governors, as vice-president-financial education for the Financial Management Association, and as director of the San Diego MIT Enterprise Forum. He has two grown children and lives with his wife in La Jolla, California, where he is an avid bicyclist.

Michael D. Joehnk is an emeritus professor of finance at Arizona State University (ASU). In addition to his academic appointments at ASU, Professor Joehnk spent a year (1999) as a visiting professor of finance at the University of Otago in New Zealand. He received his bachelor's and Ph.D. degrees from the University of Arizona and his M.B.A. from Arizona State University. A Chartered Financial Analyst (CFA), he has served as a member of the Candidate Curriculum Committee and of the Council

of Examiners of the Institute of Chartered Financial Analysts. He has also served as a director of the Phoenix Society of Financial Analysts and as secretary-treasurer of the Western Finance Association, and he was elected to two terms as a vice-president of the Financial Management Association.

In addition, Dr. Joehnke was the editor of *Institutional Asset Allocation*, which was sponsored by the Institute of Chartered Financial Analysts and published by Dow Jones–Irwin. He also was a contributor to the *Handbook for Fixed Income Securities* and to *Investing and Risk Management*, Volume 1 of the Library of Investment Banking. In addition, he served a six-year term as executive co-editor of the *Journal of Financial Research*. He and his wife live in Prescott, Arizona, where they enjoy hiking and other activities in the surrounding areas.



PART 1

Foundations of Financial Planning

CHAPTERS

- 1 Understanding the Financial Planning Process
- 2 Using Financial Statements and Budgets
- 3 Preparing Your Taxes



CHAPTER 1

Understanding the Financial Planning Process

LEARNING GOALS

- LG1** Identify the benefits of using personal financial planning techniques to manage your finances.
- LG2** Describe the personal financial planning process and define your goals.
- LG3** Explain the life cycle of financial plans, their role in achieving your financial goals, how to deal with special planning concerns, and the use of professional financial planners.
- LG4** Examine the economic environment's influence on personal financial planning.
- LG5** Evaluate the impact of age, education, and geographic location on personal income.
- LG6** Understand the importance of career choices and their relationship to personal financial planning.

How Will This Affect Me?

The heart of financial planning is making sure your values line up with how you spend and save. That means knowing where you are financially and planning on how to get where you want to be in the future no matter what life throws at you. For example, how should your plan handle the projection that Social Security costs may exceed revenues by 2035? And what if the government decides to raise tax rates to help cover the federal deficit? An informed financial plan should reflect such uncertainties and more.

This chapter overviews the financial planning process and explains its context. Topics include how financial plans change to accommodate your current stage in life and the role that financial planners can play in helping you achieve your objectives. After reading this chapter you will have a good perspective on how to organize your overall personal financial plan.

Financial Fact or Fantasy?

Are the following statements Financial Facts (true) or Fantasies (false)? Consider these statements as you read through this chapter.



- An improved standard of living is one of the payoffs of sound personal financial planning.
- A savings account is an example of a tangible asset because it represents something on deposit at a bank or other financial institution.
- Personal financial planning involves translating personal financial goals into specific plans and strategies that put these plans into action.
- Over the long-run, gaining only an extra percent or two on an investment makes little difference in the amount of earnings generated.
- Inflation generally has little effect on personal financial planning.
- Your income level depends on your age, education, and career choice.

1-1 THE REWARDS OF SOUND FINANCIAL PLANNING

LG1

What does living “the good life” mean to you? Does it mean having the flexibility to pursue your dreams and goals in life? Is it owning a home in a certain part of town, starting a company, being debt free, driving a particular type of car, taking luxury vacations, or having a large investment portfolio? Today’s complex, fast-paced world offers a bewildering array of choices. Rapidly changing economic, political, technological, and social environments make it increasingly difficult to develop solid financial strategies that will improve your lifestyle consistently. Today, a couple may need two incomes just to maintain an acceptable standard of living, and they may have to wait longer to buy a home. Moreover, the financial crisis of 2007–2008 dramatizes the need to plan for financial contingencies. No matter how you define it, the good life requires sound planning to turn financial goals into reality.

The best way to achieve financial objectives is through *personal financial planning*, which helps define financial goals and develop appropriate strategies to reach them. We should not depend solely on employee or government benefits—such as steady salary increases or adequate funding from employer-paid pensions or Social Security—to retire comfortably. Creating flexible plans and regularly revising them is the key to building a sound financial future. Successful financial planning also brings rewards that include greater flexibility, an improved standard of living, wise spending habits, and increased wealth. Of course, planning alone does not guarantee success; but having an effective, consistent plan can help you use your resources wisely. Careful financial planning increases the chance that your financial goals will be achieved and that you will have sufficient flexibility to handle such contingencies as illness, job loss, and even financial crises.

The goal of this book is to remove the mystery from the personal financial planning process and replace it with the tools you need to take charge of your personal finances and your life. To organize this process, the text is divided into six parts as follows.



FINANCIAL PLANNING TIPS

Be SMART in Planning Your Financial Goals

Success is most likely if your goals are:

Specific: What do I want to achieve? What is required of me and what are my constraints?

Measurable: How much money is needed? How will I know if I am succeeding?

Attainable: How can I do this? Is this consistent with my other financial goals?

Realistic: Am I willing and able to do this?

Timely: What is my target date? What short-term goals must be achieved along the way to achieve my longer term goals?

Source: Inspired by Paul J. Meyer's, *Attitude Is Everything*, The Meyer Resource Group, 2003.

standard of living

The necessities, comforts, and luxuries enjoyed or desired by an individual or family.

- Part 1: Foundations of Financial Planning
- Part 2: Managing Basic Assets
- Part 3: Managing Credit
- Part 4: Managing Insurance Needs
- Part 5: Managing Investments
- Part 6: Retirement and Estate Planning

Each part explains a different aspect of personal financial planning, as shown in Exhibit 1.1. This organizational scheme revolves around financial decision making that's firmly based on an operational set of financial plans. We believe that sound financial planning enables individuals to make decisions that will yield their desired results. Starting with Part 1—where we look at personal financial statements, plans, and taxes—we move through the various types of decisions you'll make when implementing a financial plan.

1-1a Improving Your Standard of Living

With personal financial planning we learn to acquire, use, and control our financial resources more efficiently. It allows us to gain more enjoyment from our income and thus to improve our **standard of living**—the necessities, comforts, and luxuries we have or desire.

Americans view standards of living, and what constitute necessities or luxuries, differently depending on their level of affluence. For example, 45 percent of Americans consider a second or vacation home a key symbol of affluence, while others see taking two or more annual vacations or living in an exclusive neighborhood as an indicator of wealth.

So our quality of life is closely tied to our standard of living. Although other factors—geographic location, public facilities, local cost of living, pollution, traffic, and population density—also affect quality of life, wealth is commonly viewed as a key determinant. Material items such as a house, car, and clothing, as well as money available for health care, education, art, music, travel, and entertainment, all contribute to

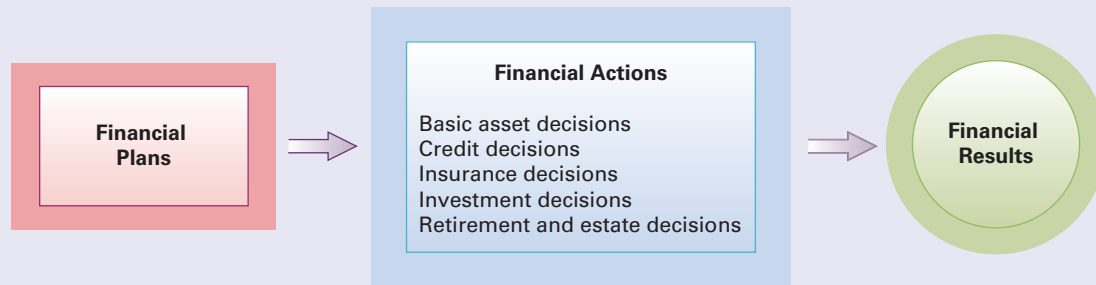
Financial Fact or Fantasy?

An improved standard of living is one of the payoffs of sound personal financial planning.

Fact: The heart of sound financial planning and effective money management is the greater enjoyment of the money one makes by improving one's standard of living.



This text emphasizes making financial decisions regarding assets, credit, insurance, investments, and retirement and estates.



average propensity to consume

The percentage of each dollar of income, on average, that a person spends for current needs rather than savings.

our quality of life. Of course, many so-called wealthy people live “plain” lives, choosing to save, invest, or support philanthropic organizations with their money rather than indulge themselves with luxuries.

One trend with a profound effect on our standard of living is the *two-income family*. What was relatively rare in the early 1970s has become commonplace today, and the incomes of millions of families have risen sharply as a result. About 75 percent of married adults say that they and their mate share all their money—while some partners admit to having a secret stash of cash. Two incomes buy more, but they also require greater responsibility to manage the money wisely.

1-1b Spending Money Wisely

Using money wisely is a major benefit of financial planning. Whatever your income, you can either spend it now or save some of it for the future. Determining your current and future spending patterns is an important part of personal money management. The goal, of course, is to spend your money so that you get the most satisfaction from each dollar.

Current Needs

Your current spending level is based on the necessities of life and your **average propensity to consume**, which is the percentage of each dollar of income, on average, that is spent for current needs rather than savings. A minimum level of spending would allow you to obtain only the necessities of life: food, clothing, and shelter. Although the quantity and type of food, clothing, and shelter purchased may differ among individuals depending on their wealth, we all need these items to survive. Some people with high average propensities to consume earn low incomes and spend a large portion of it on basic necessities. On the other hand, many “ultra-consumers” choose to splurge on a few items and scrimp elsewhere; these people also exhibit high average propensities to consume. Conversely, individuals earning large amounts quite often have low average propensities to consume, in part because the cost of necessities represents only a small portion of their income.

Still, two people with significantly different incomes could have the same average propensity to consume because of differences in their standard of living. The person making more money may believe it is essential to buy better-quality items or more items and will thus, on average, spend the same percentage of each dollar of income as the person making far less.



FINANCIAL PLANNING TIPS

Easy Ways to Save More Money

You can save more money by being purposeful in your spending.

- **Cook at home more.** Ease your way in by cooking at home at least once a week.
- **Make rather than buy your coffee.** While a latte is great, we all know that it's an expensive habit. Don't stop cold—just skip it as often as you can and make your coffee at home instead.
- **Take your lunch to work.** Lunch with coworkers may be the norm and a wise way to build helpful relationships. So it may not be practical to take your lunch all of the time. But it will save you money to take your lunch at least occasionally.
- **Avoid late fees by paying your bills on time.** You can have many bills like utilities paid automatically so there is no reason to pay late fees.
- **Avoid ATM fees.** Many banks do not waive ATM withdrawal fees. Be sure to use ATMs that do not charge a fee.

- **Avoid using credit cards with an annual fee.** The number of no-fee cards with reward plans makes it unnecessary to pay an annual fee.
- **Disconnect the landline phone.** You may do just fine with your mobile phones and no landline, which would save you some money.
- **Borrow books from the library and don't buy them.** Library cards are free and the book and media selection is usually up-to-date.
- **Don't buy bottled water, bottle your own.** Buy bottled water only occasionally just so you can get the bottle to fill with your own water.
- **Drive your car a long time.** Keep your car until the repair costs and questionable reliability make it necessary to find a replacement.

Source: Adapted from "30 Easy Ways to Save Money You Probably Aren't Doing Yet," <https://www.dumblittleman.com/30-easy-ways-to-save-money-and-no-you/>, accessed January 2020.

Future Needs

A carefully developed financial plan should set aside a portion of current income for deferred, future spending. Placing these funds in various savings and investment vehicles allows you to generate a return on your funds until you need them. For example, you may want to build up a retirement fund to maintain a desirable standard of living in your later years. Instead of spending the money now, you defer actual spending until the future when you retire. Nearly half of Americans say they fear running out of money in retirement due to rising health care costs and financial market downturns. Other examples of deferred spending include saving for a child's education, a primary residence or vacation home, a major acquisition (such as a car or home entertainment center), or even a vacation.

The portion of current income we commit to future needs depends on how much we earn and also on our average propensity to consume. Most Americans believe that it would take a net worth of over \$2.3 million to feel wealthy. And yet Exhibit 1.2 shows that median net worth is \$97,300. The more we earn and the less we devote to current spending, the more we can commit to meeting future needs. In any case, some portion of current income should be set aside regularly for future use. This practice creates good saving habits.

Financial Fact or Fantasy?

A savings account is an example of a tangible asset because it represents something on deposit at a bank or other financial institution.

Fantasy: A savings account, like stocks, bonds, and mutual funds, is an example of a financial asset—an intangible, a "paper" asset. Real assets, in contrast, refer to tangibles—physical items like houses, cars, and appliances.



The financial snapshot of the “average American” gives you an idea of where you stand in terms of income, net worth, and other measures. It should help you set some goals for the future.

| Median Income and Assets | |
|--|-----------|
| What Do We Earn? | |
| All families | \$52,700 |
| What Are We Worth | |
| All families | \$97,300 |
| Home Ownership | |
| Value of primary residence | \$185,000 |
| Mortgage on primary residence | 111,000 |
| How much Savings Do We Have? | |
| Pooled investment funds (excluding money market) | \$114,000 |
| Stocks | 25,000 |
| Bonds | 100,000 |
| Bank accounts/CDs | 24,500 |
| Retirement accounts | 60,000 |

Source: Adapted from Jesse Bricker, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Lindsay Jacobs, Kevin B. Moore, Sarah Pack, John Sabelhaus, Jeffrey Thompson, and Richard A. Windle, “Changes in U.S. Family Finances from 2013 to 2016: Evidence from the Survey of Consumer Finances,” Board of Governors of the Federal Reserve System, Washington, DC (September 2017, vol. 103, no. 3), data are for 2016, <https://www.federalreserve.gov/publications/files/scf17.pdf>, Tables 1–4, accessed January 2020.

wealth

The total value of all items owned by an individual, such as savings accounts, stocks, bonds, home, and automobiles.

financial assets

Intangible assets, such as savings accounts and securities, that are acquired for some promised future return.

tangible assets

Physical assets, such as real estate and automobiles that can be held for either consumption or investment purposes.

1-1c Accumulating Wealth

In addition to using current income to pay for everyday living expenses, we often spend it to acquire assets such as cars, a home, or stocks and bonds. Our assets largely determine how wealthy we are. Personal financial planning plays a critical role in the accumulation of wealth by directing our financial resources to the most productive areas.

One’s **wealth** is the net total value of all the items the individual owns. Wealth consists of financial and tangible assets. **Financial assets** are intangible, paper assets, such as savings accounts and securities (stocks, bonds, mutual funds, and so forth). They are *earning assets* that are held for the returns they promise. **Tangible assets**, in contrast, are physical assets, such as real estate and automobiles. These assets can be held for either consumption (e.g., your home, car, artwork, or jewelry) or investment purposes (e.g., a duplex purchased for rental income). In general, the goal of most people is to accumulate as much wealth as possible while maintaining current consumption at a level that provides the desired standard of living. To see how you compare with the typical American in financial terms, check out the statistics in Exhibit 1.2.

TEST YOURSELF

- 1-1** What is a *standard of living*? What factors affect the quality of life?
- 1-2** Are consumption patterns related to quality of life? Explain.
- 1-3** What is *average propensity to consume*? Is it possible for two people with very different incomes to have the same average propensity to consume? Why?
- 1-4** Discuss the various forms in which wealth can be accumulated.

1-2 THE PERSONAL FINANCIAL PLANNING PROCESS

LG2

personal financial planning

A systematic process that considers important elements of an individual's financial affairs in order to fulfill financial goals.

Many people mistakenly assume that personal financial planning is only for the wealthy. However, nothing could be further from the truth. Whether you have a lot of money or not enough, you still need personal financial planning. If you have enough money, planning can help you spend and invest it wisely. If your income seems inadequate, taking steps to plan your financial activities will lead to an improved lifestyle. **Personal financial planning** is a systematic process that considers the important elements of an individual's financial affairs and is aimed at fulfilling his or her financial goals.

Everyone—including recent college graduates, single professionals, young married couples, single parents, mid-career married couples, and senior corporate executives—needs to develop a personal financial plan. Knowing what you need to accomplish financially, and how you intend to do it, gives you an edge over someone who merely reacts to financial events as they unfold. Just think of the example provided by the recent financial crisis. Do you think that a financial plan would have helped in weathering the financial storm?

Purchasing a new car immediately after graduation may be an important goal for you. But buying a car is a major expenditure involving a large initial cash outlay and additional consumer debt that must be repaid over time. It therefore warrants careful planning. Evaluating (and possibly even arranging) financing before your shopping trip, as opposed to simply accepting the financing arrangements offered by an auto dealer, could save you a considerable amount of money. Moreover, some dealers advertise low-interest loans but charge higher prices for their cars. Knowing all your costs in advance can help you find the best deal. Using personal financial planning concepts to reach all your financial goals will bring similar positive benefits.

Behavior Matters

Practicing Financial Self-Awareness

Are you aware of your financial behavior, its causes, and its consequences? For example, are you routinely relying too heavily on your credit card, which puts you more in debt? Are you saving enough to buy a new car or to fund your retirement? And the bottom line: Are you continuing the same financial behavior you have in the past and yet expecting different results?

The first decisive step in taking control of your life is to be aware of what you're thinking, feeling, and doing. Be financially self-aware: observe your own thoughts, feelings, and behavior concerning your finances. Take notes on things that affect how you feel and what you do about financial decisions. Watch yourself and be honest about your feelings concerning money and your future.

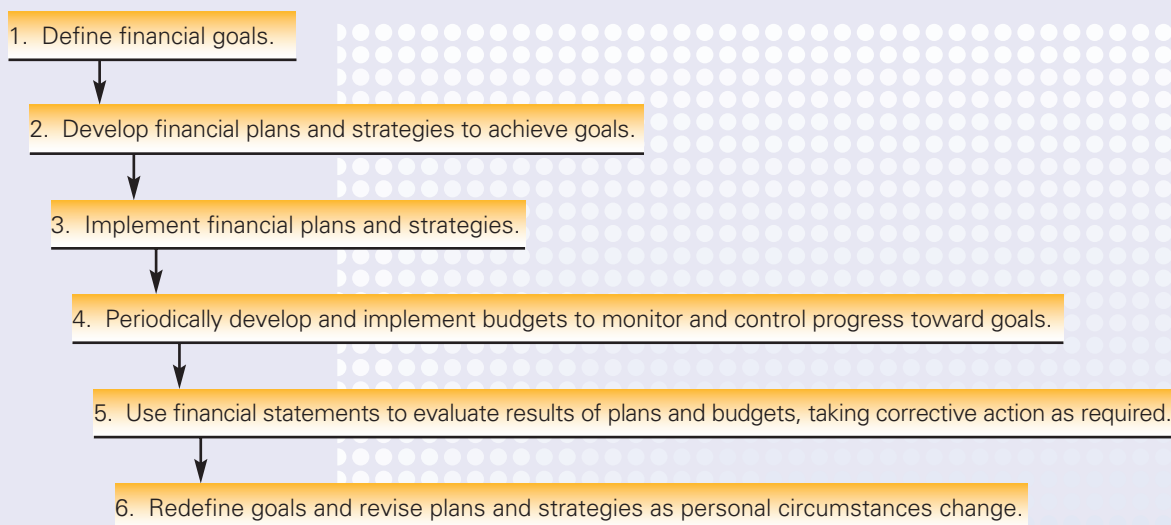
Then ask yourself two critically important questions:

- **Have I clearly stated the financial goals that are important to me and, if so, what am I doing today to make sure I achieve them?** The heart of financial planning is determining where you are today and where you want to be in the future. This implies the need for a financial plan: limited resources sometimes bring painful trade-offs.
- **Is the way I spend money consistent with what I believe?** Financial planning that works is taking the time to develop a plan that purposely lines up your values and your use of money.

Source: Adapted from Carl Richards, "Practicing Radical Self-Awareness," Behaviorgap.com, 2011.



The financial planning process translates personal financial goals into specific financial plans and strategies, implements them, and then uses budgets and financial statements to monitor, evaluate, and revise plans and strategies as needed. This process typically involves the six steps shown in sequence here:



financial goals

Results that an individual wants to attain, such as buying a home, building a college fund, or achieving financial independence.

1-2a Steps in the Financial Planning Process

If you take a closer look at financial planning, you'll see that the process translates personal financial goals into specific financial plans, which then helps you implement those plans through financial strategies. The financial planning process involves the six steps shown in Exhibit 1.3.

The financial planning process runs full circle. You start with financial goals, formulate and implement financial plans and strategies to reach them, monitor and control progress toward goals through budgets, and use financial statements to evaluate the plan and budget results. This leads you back to redefining your goals so that they better meet your current needs and to revising your financial plans and strategies accordingly.

Let's now look at how goal setting fits into the planning process. In Chapters 2 and 3, we'll consider other information essential to creating your financial plans: personal financial statements, budgets, and taxes.

1-2b Defining Your Financial Goals

Financial goals are the results that an individual wants to attain. Examples include buying a home, building a college fund, or achieving financial independence. What are your financial goals? Have you spelled them out? It's impossible to effectively manage your financial resources without financial goals. We need to know where we are going, in a financial sense, to effectively meet the major financial events in our lives. Perhaps achieving financial independence at a relatively early age is important to you. If so, then saving, investing, and retirement planning will be an important part of your financial life. Your financial goals or preferences must be stated in monetary terms because money and the satisfaction it can bring are an integral part of financial planning.

money

The medium of exchange used as a measure of value in financial transactions.

utility

The amount of satisfaction received from purchasing certain types or quantities of goods and services.

The Role of Money

About 75 percent of Americans believe that money is freedom. **Money** is the medium of exchange used to measure value in financial transactions. It would be difficult to set specific personal financial goals and to measure progress toward achieving them without the standard unit of exchange provided by the dollar. Money, as we know it today, is the key consideration in establishing financial goals. Yet it's not money, as such, that most people want. Rather, we want the **utility**, which is the amount of satisfaction received from buying quantities of goods and services of a given quality that money makes possible. People may choose one item over another because of a special feature that provides additional utility. For example, many people will pay more for a car with satellite radio than one with only an audio player. The added utility may result from the actual usefulness of the special feature or from the "status" it's expected to provide, or both. Regardless, people receive varying levels of satisfaction from similar items, and their satisfaction isn't necessarily directly related to the cost of the items. We therefore need to consider utility along with cost when evaluating alternative qualities of life, spending patterns, and forms of wealth accumulation.

The Psychology of Money

Money and its utility are not only economic concepts but also closely linked to the psychological concepts of values, emotion, and personality. Your personal value system—the important ideals and beliefs that guide your life—will also shape your attitude toward money and wealth accumulation. If you place a high value on family life, you may choose a career that offers regular hours and less stress or choose an employer who offers flextime rather than a higher-paying position that requires travel and lots of overtime. You may have plenty of money but choose to live frugally and do things yourself rather than hire someone to do them for you. Or you may spend a high proportion of your current income on acquiring luxuries. Financial goals and decisions should be consistent with your personal values. You can formulate financial plans that provide the greatest personal satisfaction and quality of life by identifying your values.

Money is an important motivator of personal behavior due to its strong effect on self-image. Each person's unique personality and emotional makeup determine the importance and role of money in his or her life. Depending on timing and circumstances, emotional responses to money may be positive (love, happiness, security) or negative (fear, greed, insecurity). For example, some people feel satisfaction in their work when they receive a paycheck. Others feel relief in knowing that they can pay past-due bills. You should become aware of your own attitudes toward money because they are the basis of your "money personality" and money management style. Exhibit 1.4 explores attitudes toward money.

Some questions to ask yourself include: How important is money to me? Why? What types of spending give me satisfaction? Am I a risk taker? Do I need large financial reserves to feel secure? Knowing the answers to these questions is a prerequisite for developing realistic and effective financial goals and plans. For example, if you prefer immediate satisfaction, then you will find it more difficult to achieve long-term net worth or savings goals than if you are highly disciplined and primarily concerned with achieving a comfortable retirement at an early age. Trade-offs between current and future benefits are strongly affected by values, emotions, and personality. Effective financial plans are both economically and psychologically sound. They must not only consider your wants, needs, and financial resources but must also realistically reflect your personality and emotional reactions to money.

1-2c Money and Relationships

The average couple spends between 250 and 700 hours planning their wedding. While most couples spend less than \$10,000 on the big day, the average cost is about \$30,000, depending on where they live. But with all the hoopla surrounding the wedding day, many couples overlook one of the most important aspects of

Our attitudes toward money influence how we spend, save, and invest. Which of the following attitudes toward money best describes you? You may be predominately one type or a combination of types.

The Spender: You only live once

Spenders see shopping as entertainment. They would rather have something tangible than something intangible like savings or an investment. Spenders have a hard time saving money.

The Builder: Make it so

Builders see money as a tool. They use money to achieve their goals and dreams. Examples include self-made millionaires, entrepreneurs, corporate leaders, and dedicated hobbyists. Builders can miscalculate risks or ignore the need for a margin of error. They may start projects simply for the challenge but not finish them as the next new thing beckons.

The Giver: It's better to give than to receive

Givers enjoy taking care of other people. They volunteer and give to charities. Givers commit their time, energy, and money to their beliefs. Most givers simply enjoy making other people happy and doing good deeds. Givers sometimes ignore their own needs, and their long-term financial plans can suffer as a result.

The Saver: A bird in the hand is worth two in the bush

Savers can accumulate significant wealth even on a modest income. They tend to be organized and to avoid money-wasting activities. Although savers can be good investors, they can be too risk averse and prefer holding too much cash. Such conservatism means that their investments often grow too slowly.

Source: Adapted from Diane McCurdy, CFP, *How Much Is Enough?* (John Wiley & Sons, 2005). Copyright © 2005 by John Wiley & Sons. All rights reserved. Reproduced by permission.

marriage: financial compatibility. Money can be one of the most emotional issues in any relationship, including that with a partner, your parents, or children. Most people are uncomfortable talking about money matters and avoid such discussions, even with their partners. However, differing opinions on how to spend money may threaten the stability of a marriage or cause arguments between parents and children. Learning to communicate with your partner about money is a critical step in developing effective financial plans.

Your parents should play an important role in your financial planning. As they age, you may have to assume greater responsibility for their care. Do you know what health care coverage and financial plans they have in place? Where do they keep important financial and legal documents? What preferences do they have for health care should they become incapacitated? Asking these questions may be difficult, but having the answers will save you many headaches.

The best way to resolve money disputes is to be aware of your partner's financial style, consistently communicate openly, and be willing to compromise. It's unlikely that you can change your partner's style, but you can work out your differences. Financial planning is an especially important part of the conflict resolution process.

1-2d Types of Financial Goals

Financial goals cover a wide range of financial aspirations: controlling living expenses, meeting retirement needs, setting up a savings and investment program, and minimizing your taxes. Other important financial goals include having enough money to live as well as possible now, being financially independent, sending children to college, and providing for retirement.

Financial goals should be defined as specifically as possible. Saying that you want to save money next year is not a specific goal. How much do you want to save, and for what purpose? A goal such as “save 10 percent of my take-home pay each month to start an investment program” states clearly what you want to do and why.

Because they are the basis of your financial plans, your goals should be realistic and attainable. If you set your savings goals too high—for example, 25 percent of your take-home pay when your basic living expenses already account for 85 percent of it—then your goal is unattainable and there’s no way to meet it. But if savings goals are set too low, you may not accumulate enough for a meaningful investment program. If your goals are unrealistic, they’ll put the basic integrity of your financial plan at risk and be a source of ongoing financial frustration. You must also use realistic assumptions when setting goals. Exhibit 1.5 will help you do a reality check.

It’s important to involve your immediate family in the goal-setting process. When family members “buy into” the goals, it eliminates the potential for future conflicts and improves the family’s chances for financial success. After defining and approving your goals, you can prepare appropriate cash budgets. Finally, you should assign priorities and a time frame to financial goals. Are they short-term goals for the next year, or are they intermediate or long-term goals that will not be achieved for many more years? For example, saving for a vacation might be a medium-priority short-term goal, whereas buying a larger home may be a high-priority intermediate goal and purchasing a vacation home a low-priority long-term goal. Normally, long-term financial goals are set first, followed by a series of corresponding short-term and intermediate goals. Your goals will continue to change with your life situation, as Exhibit 1.6 demonstrates.

EXHIBIT 1.5

Check Your Financial Planning Assumptions

It’s important to make sure that your financial planning assumptions are realistic. Consider these common assumptions.

- Assumption 1:** Saving a few thousand dollars a year should provide enough to fund my child’s college education.
- Reality:** Over the last 30 years, the cost of a four-year college degree has *doubled*—even after adjusting for inflation. That’s more than a few thousand dollars to save each year.
- Assumption 2:** An emergency fund lasting 3 months should be adequate.
- Reality:** Tell that to the average unemployed person in the United States in 2011 who looked for work for over 9 months. While this is the longest average duration of unemployment since 1948, it would be wise to keep an emergency fund that covers at least 6 months.
- Assumption 3:** I will be able to retire at 65 and should have plenty to live on in retirement.
- Reality:** The average 65-year-old man can expect to live to about 84 and a 65-year-old woman can expect to live to about 87. That planning horizon could easily leave you short on funding. So it would be wise to determine how much you need to set aside to fund a realistic life expectancy horizon. This might imply saving more now, retiring later, or working part-time after retirement.
- Assumption 4:** I’m relying on the rule of thumb that I will need only 70 percent of my pre-retirement income to manage nicely in retirement.
- Reality:** Like all rules of thumb, one size does not necessarily fit all. While it’s true that you won’t have work-related expenses in retirement, you’re likely to have much higher health care costs. And it’s important to consider long-term care insurance to protect against such high costs. So betting on 70 percent could leave you short.

Sources: Adapted from http://www.savingforcollege.com/tutorial101/the_real_cost_of_higher_education.php and Catherine Rampell, “Average Length of Unemployment at All-Time High,” <http://economix.blogs.nytimes.com/2011/06/03/average-length-of-unemployment-at-all-time-high/>, accessed January 2020.

Financial goals are not static; they change continually over a lifetime. Here are some typical long-term, intermediate, and short-term goals for a number of different personal situations.

| Personal Situation | Long-Term Goals (6+ years) | Intermediate Goals (2–5 years) | Short-Term Goals (1 year) |
|---|--|---|---|
| College senior | <ul style="list-style-type: none"> • Begin an investment program • Buy a townhouse • Earn a master's degree | <ul style="list-style-type: none"> • Repay college loans • Trade in car and upgrade to a nicer model • Buy new furniture | <ul style="list-style-type: none"> • Find a job • Rent an apartment • Get a bank credit card • Buy a new stereo |
| Single, mid-20s | <ul style="list-style-type: none"> • Begin law school • Build an investment portfolio • Save enough for a down payment on a home | <ul style="list-style-type: none"> • Begin regular savings program • Take a Caribbean vacation • Buy life insurance • Start a retirement fund | <ul style="list-style-type: none"> • Prepare a budget • Buy a new flat-screen television • Get additional job training • Build an emergency fund • Reduce expenses by 10 percent |
| Married couple with children, late 30s | <ul style="list-style-type: none"> • Diversify investment portfolio • Buy a larger home | <ul style="list-style-type: none"> • Buy a second car • Increase college fund contributions • Increase second income from part-time to full-time | <ul style="list-style-type: none"> • Repaint house • Get braces for children • Review life and disability insurance |
| Married couple with grown children, mid-50s | <ul style="list-style-type: none"> • Decide whether to relocate when retired • Retire at age 62 • Travel to Europe and the Far East | <ul style="list-style-type: none"> • Take cruise • Shift investment portfolio into income-producing securities • Sell house and buy smaller residence | <ul style="list-style-type: none"> • Buy new furniture • Review skills for possible career change |

goal dates

Target dates in the future when certain financial objectives are expected to be completed.

1-2e Putting Target Dates on Financial Goals

Financial goals are most effective when they are set with goal dates. **Goal dates** are target points in the future when you expect to have achieved or completed certain financial objectives. They may serve as progress checkpoints toward some longer-term financial goals and/or as deadlines for others.

EXAMPLE: Target Dates for Financial Goals

Ruby and Hunter Simmons are both 28 and have been married for one year. They have set financial goals of buying a boat for \$5,000 in 2021, accumulate a net worth of \$10,000 by 2025, and accumulate a net worth of \$50,000 by 2033.

Long-Term Goals

Long-term financial goals should indicate wants and desires for a period covering about 6 years out to the next 30 or 40 years. Although it's difficult to pinpoint exactly what you will want 30 years from now, it's useful to establish some tentative

long-term financial goals. However, you should recognize that long-term goals will change over time and that you'll need to revise them accordingly. If the goals seem too ambitious, you'll want to make them more realistic. If they're too conservative, you'll want to adjust them to a level that encourages you to make financially responsible decisions rather than squander surplus funds.

Short-Term Goals and Intermediate Goals

Short-term financial goals are set each year and cover a 12-month period. They include making substantial, regular contributions to savings or investments in order to accumulate your desired net worth. Intermediate goals bridge the gap between short- and long-term goals, and both intermediate and short-term goals should be consistent with those long-term goals. Short-term goals become the key input for the cash budget, a tool used to plan for short-term income and expenses. To define your short-term goals, consider your immediate goals, expected income for the year, and long-term goals. Short-term planning should also include establishing an emergency fund with at least 6 months' worth of income. This special savings account serves as a safety reserve in case of financial emergencies such as a temporary loss of income.

Unless you attain your short-term goals, you probably won't achieve your intermediate or long-term goals. It's tempting to let the desire to spend now take priority over the need to save for the future. But by making some short-term sacrifices now, you're more likely to have a comfortable future. If you don't realize this for another 10 or 20 years, then you may discover that it's too late to reach some of your most important financial goals.

Worksheet 1.1 is a convenient way to summarize your personal financial goals. It groups them by time frame (short-term, intermediate, or long-term) and lists a priority for each goal (high, medium, or low), a target date to reach the goal, and an estimated cost.

We have filled out the form showing the goals that Dylan and Julia Butler set in December 2020. The Butlers were married in 2017, own a condominium in a Midwestern suburb, and have no children. Because Dylan and Julia are 28 and 26 years old, respectively, they have set their longest-term financial goal 33 years from now, when they want to retire. Dylan has just completed his fifth year as an electrical engineer. Julia, a former elementary school teacher, finished her MBA in May 2019 and began working at a local advertising agency. Dylan and Julia love to travel and ski. They plan to start a family in a few years, but for now they want to develop some degree of financial stability and independence. Their goals include purchasing assets (clothes, speakers, furniture, and car), reducing debt, reviewing insurance, increasing savings, and planning for retirement.

Financial Fact or Fantasy?

Personal financial planning involves translating personal financial goals into specific plans and arrangements that put these plans into action.

Fact: Personal financial plans are based on the specific financial goals that you set for yourself and your family. Once in place, the plans are put into action using the various financial strategies explained in this book.



Do It Now

Start a List of Your Financial Goals

Yogi Berra summed it up: "If you don't know where you're going, you might not get there." And so it is with your financial goals. Pick up some paper now and start a list of your financial goals. May be it's as simple as saving \$25 by the end of the month or as lofty as saving \$200,000 for retirement by the time you're 50. You'll never achieve your goals if you don't know what they are, much less know whether they're realistic. Go ahead and dream. List your goals (short-term, intermediate, and long-term) and start laying out how you'll get there. **You can do it now.**

Set financial goals carefully and realistically, because they form the basis for your personal financial plans. Each goal should be clearly defined and have a priority, time frame, and cost estimate.

| Personal Financial Goals | | | |
|---|----------|-------------------------------|------------------|
| Name(s) <u>Dylan and Julia Butler</u> | | Date <u>December 27, 2020</u> | |
| Short-Term Goals (1 year or less) | | | |
| Goal | Priority | Target Date | Cost Estimate \$ |
| Buy new tires and brakes for Honda | High | Feb. 2021 | 500 |
| Take Utah ski trip | Medium | Mar. 2021 | 1,800 |
| Buy career clothes for Julia | High | May 2021 | 1,200 |
| Buy new work cloths for Dylan | Medium | June 2021 | 750 |
| Replace stereo speakers | Low | Sept. 2021 | 1,100 |
| | | | |
| Intermediate Goals (2 to 5 years) | | | |
| Goal | Priority | Target Date | Cost Estimate \$ |
| Start family | High | 2023 | - |
| Take 2-week Hawaiian vacation | Medium | 2023 - 24 | 7,500 |
| Repay all loans except mortgage | High | 2024 | 10,000 |
| Trade Honda and buy larger car | High | 2024 | 30,000 |
| Review insurance needs | High | 2024 | - |
| Accumulate \$30,000 net worth | High | 2024 | - |
| Buy new bedroom furniture | Low | 2025 | 5,000 |
| Long-Term Goals (6+ years) | | | |
| Goal | Priority | Target Date | Cost Estimate \$ |
| Begin college fund for children | High | 2026 | ? /year |
| Diversify/increase investment portfolio | High | 2027 | varies |
| Take vacation to Italy | Low | 2028 | 10,000 |
| Increase college fund contributions | High | 2028 | - |
| Accumulate \$50,000 net worth | High | 2028 | - |
| Buy larger home | High | 2030 | 250,000 |
| Accumulate \$100,000 net worth | High | 2030 | - |
| Retire from jobs | High | 2058 | ? |

TEST YOURSELF

- 1-5** What is the role of money in setting financial goals? What is the relationship of money to utility?
- 1-6** Explain why financial plans must be psychologically as well as economically sound. What is the best way to resolve money disputes in a relationship?
- 1-7** Explain why it is important to set realistically attainable financial goals. Select one of your personal financial goals and develop a brief financial plan for achieving it.
- 1-8** Distinguish between long-term, intermediate, and short-term financial goals. Give examples of each.

1-3 FROM GOALS TO PLANS: A LIFETIME OF PLANNING

LG3

How will you achieve the financial goals you set for yourself? The answer, of course, lies in the financial plans you establish. Financial plans provide the roadmap for achieving your financial goals. The six-step financial planning process (introduced in Exhibit 1.3) results in separate yet interrelated components covering all the important financial elements in your life. Some elements deal with the more immediate aspects of money management, such as preparing a budget to help manage spending. Others focus on acquiring major assets, controlling borrowing, reducing financial risk, providing for emergency funds and future wealth accumulation, taking advantage of and managing employer-sponsored benefits, deferring and minimizing taxes, providing for financial security when you stop working, and ensuring an orderly and cost-effective transfer of assets to your heirs.

In addition to discussing your financial goals and attitudes toward money with your partner, you must allocate responsibility for money management tasks and decisions. Many couples make major decisions jointly and divide routine financial decision-making on the basis of expertise and interest. Others believe it is important for their entire family to work together as a team to manage the family finances. They hold family financial meetings once every few months to help their children understand how the household money is spent. These meetings also serve as a forum for children to request a raise in allowance, a new bike, or funds for a school trip. The entire family is involved in the decision-making process on how surplus funds will be allocated.

Giving children an allowance is a good way to start teaching them to budget and save. By setting their own financial goals and taking steps to reach them, they will develop their own money management skills.

1-3a The Life Cycle of Financial Plans

Financial planning is a dynamic process. As you move through different stages of your life, your needs and goals will change. Yet certain financial goals are important regardless of age. Having extra resources to fall back on in an economic downturn or period of unemployment should be a priority whether you are 25, 45, or 65. Some changes—a new job, marriage, children, moving to a new area—may be part of your original plan.



ARIEL SKELLEY/JUPITER IMAGES

More often than not, you'll face unexpected "financial shocks" during your life: loss of a job, a car accident, divorce or death of a spouse, a long illness, or the need to support adult children or aging parents. With careful planning, you can get through tough times and prosper in good times. You need to plan ahead and take steps to weather life's financial storms successfully. For example, setting up an emergency fund or reducing monthly expenses will help protect you and your family financially if a setback occurs.

As we move from childhood to retirement age, we traditionally go through different life stages. Exhibit 1.7 illustrates the various components of a typical *personal financial planning life cycle* as they relate to these different life stages. While the exhibit shows more detail, the life cycle involves three general stages: (1) wealth accumulation, (2) wealth preservation, and (3) wealth transfer. It shows that the young tend to borrow, the middle-aged tend to save the most, and when we get older we run down our savings to fund retirement. After retirement, any remaining wealth is transferred to our heirs. This exhibit presents the organizing framework of the entire financial planning process. We will refer to it throughout the book—and we suggest you do so for the rest of your life.

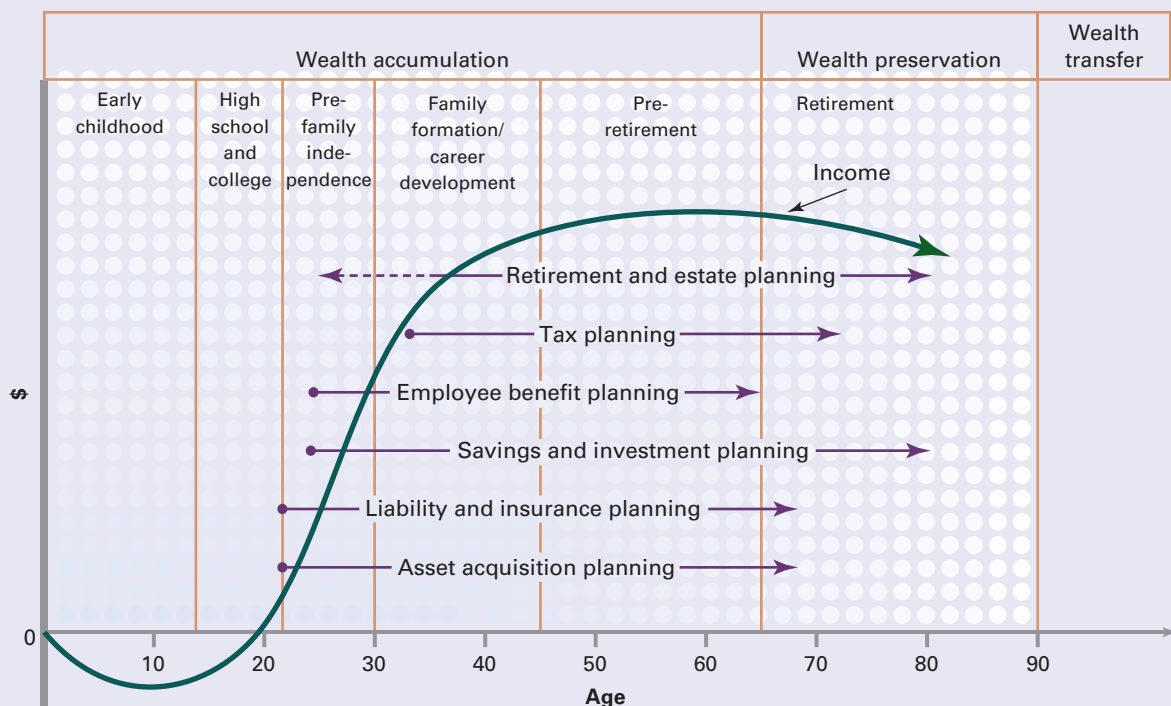
As we pass from one stage of maturation to the next, our patterns of income, home ownership, and debt also change. From early childhood, when we rely on our parents for support, to early adulthood, when we hold our first jobs and start our families, we can see a noticeable change in income patterns. For example, those in the pre-retirement 45–64 age group tend to have higher income than those younger than age 45. Thus, as our emphasis in life changes, so do the kinds of financial plans we need to pursue.

Today, new career strategies—planned and unplanned job changes—are common and may require that financial plans be revised. Many young people focus on their

EXHIBIT 1.7

The Personal Financial Planning Life Cycle

As you move through life and your income and living cost patterns change, you'll typically have to pursue a variety of financial plans. For instance, after graduating from college, your focus likely will be on buying a car and a house, and you'll be concerned about health and automobile insurance to protect against loss.



careers and building a financial base before marrying and having children. The families of women who interrupt their careers to stay home with their children, whether for 6 months or 6 years, will experience periods of reduced income. A divorce, a spouse's death, or remarriage can also drastically change your financial circumstances. Many people in their 40s and 50s find themselves in the “sandwich generation,” supporting their elderly parents while still raising their own children and paying for college. And some people must cope with reduced income due to jobs lost because of corporate downsizing or early retirement. We'll look at these and other special planning concerns next.

1-3b Plans to Achieve Your Financial Goals

As discussed earlier, financial goals can range from short-term goals such as saving for a new stereo to long-term goals such as saving enough to start your own business. Reaching your particular goals requires different types of financial planning. Let's take a brief look at what each major plan category includes.

Asset Acquisition Planning

One of the first categories of financial planning is asset acquisition. We accumulate *assets*—things we own—throughout our lives. These include *liquid assets* (cash, savings accounts, and money market funds) used to pay everyday expenses, *investments* (stocks, bonds, and mutual funds) acquired to earn a return, *personal property* (movable property such as automobiles, household furnishings, appliances, clothing, jewelry, home electronics, and similar items), and *real property* (immovable property; land and anything fixed to it, such as a house). Chapters 4 and 5 focus on important considerations for managing liquid assets and other major assets such as automobiles and housing.

Liability and Insurance Planning

Another category of financial planning is liability planning. A *liability* is something we owe, which is measured by the amount of debt we incur. We create liabilities by borrowing money. By the time most of us graduate from college, we have debts of some sort: education loans, car loans, credit card balances, and so on. Our borrowing needs typically increase as we acquire other assets such as a home, furnishings, and appliances. Whatever the source of credit, such transactions have one thing in common: *the debt must be repaid at some future time*. How we manage our debt burden is just as important as how we manage our assets. Managing credit effectively requires careful planning, which is covered in Chapters 6 and 7.

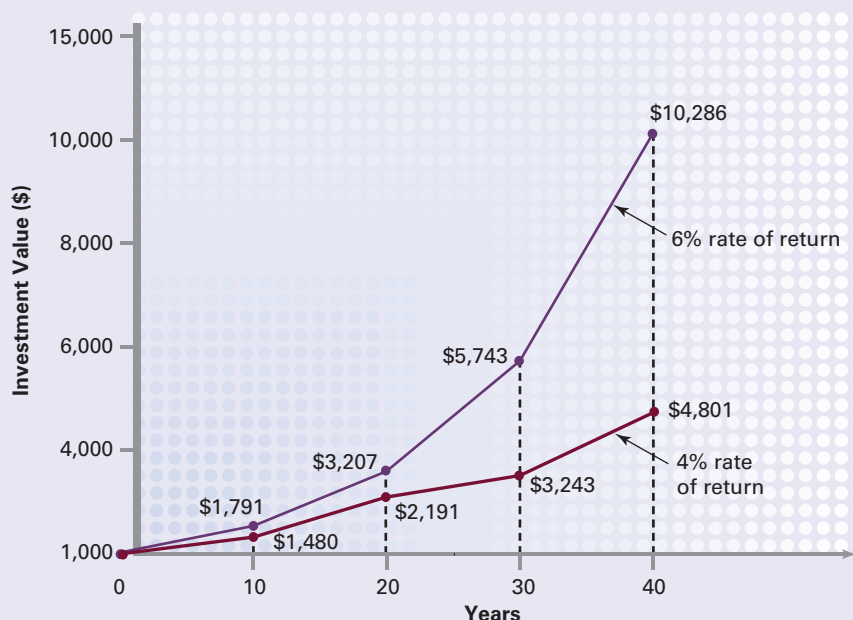
Obtaining adequate *insurance coverage* is also essential. Like borrowing money, obtaining insurance is generally introduced relatively early in our life cycle (usually in the family formation stage). Insurance is a way to reduce financial risk and protect both income (life, health, and disability insurance) and assets (property and liability insurance). Most consumers regard insurance as absolutely essential—and for good reason. One serious illness or accident can wipe out everything you have accumulated over many years of hard work. But having the wrong amount of insurance can be costly. We'll examine how to manage your insurance needs in Chapters 8, 9 and 10.

Savings and Investment Planning

As your income begins to increase, so does the importance of savings and investment planning. Initially, people save to establish an emergency fund for meeting unexpected expenses. Eventually, however, they devote greater attention to investing excess income as a means of accumulating wealth, either for major expenditures (such as a child's college education) or for retirement. Individuals build wealth through savings and the subsequent investing of funds in various investment vehicles: common or preferred stocks, government or corporate bonds, mutual funds, real estate, and so on. The higher the returns on the investment of excess funds, the greater wealth they accumulate.

Exhibit 1.8 shows the impact of alternative rates of return on accumulated wealth. The graph shows that if you had \$1,000 today and could keep it invested at

Four percent or 6 percent: How big a deal is a 2 percent difference? The deal is more than twice the money over a 40-year period! Through the power of compound interest, a higher return means dramatically more money as time goes on.



4 percent, then you would accumulate a considerable sum of money over time. For example, at the end of 40 years, you'd have about \$4,801 from your original \$1,000. Earning a higher rate of return provides even greater rewards. Some might assume that earning, say, only 2 percentage points more (i.e., 6 percent rather than 4 percent) would not matter much. But it certainly would! Observe that if you could earn 6 percent over the 40 years, then you'd accumulate \$10,286, or *more than twice as much* as you'd accumulate at 4 percent. This powerful observation is important to keep in mind when comparing competing investment and savings alternatives.

As we'll explore in Part 5 on managing investments, seemingly small differences in various investment management fees can translate into significant differences in net investment returns over long periods of time. The length of time you keep your money invested is just as important as the rate of return you earn on your investments. You can accumulate more than twice as much capital by investing for 40 rather than 30 years with either rate of return (4 percent or 6 percent). This is the magic of compound interest, which explains why it's so important to create strong savings and investment habits early in life. We'll examine compounding more fully in Chapter 2, savings in Chapter 4, and investments in Chapters 11, 12, and 13.

Employee Benefit Planning

Your employer may offer a wide variety of employee benefit plans, especially if you work for a large firm. These could include life, health, and disability insurance; tuition reimbursement programs for continuing education; pension and profit-sharing plans, and 401(k) retirement plans; flexible spending accounts for child care and health care expenses; stock options; sick leave, personal time, and vacation days; and miscellaneous benefits such as employee discounts and subsidized meals or parking. Employee benefit plans are described more fully in later chapters.

Financial Fact or Fantasy?

Over the long run, gaining only an extra percent or two on an investment makes little difference in the amount of earnings generated.

Fantasy: Gaining an extra percent or two on an investment's return can make a tremendous difference—often thousands of dollars—that increases the longer the investment is held.



Managing your employee benefit plans and coordinating them with your other plans are an important part of the overall financial planning process. For example, tax-deferred retirement plans and flexible spending accounts offer tax advantages. Some retirement plans allow you to borrow against them. Employer-sponsored insurance programs may need to be supplemented with personal policies. In addition, in today's volatile labor market, you can no longer assume that you'll be working at the same company for many years. If you change jobs, your new company may not offer the same benefits. Your personal financial plans should include contingency plans to replace employer-provided benefits as required. We'll discuss employee benefits in greater detail in Chapters 2 (planning); 3 (taxes); 8, 9, and 10 (insurance); and 14 (retirement).

Tax Planning

Despite all the talk about tax reform, our tax code remains highly complex. Income can be taxed as active (ordinary), portfolio (investment), passive, tax-free, or tax-deferred. Then there

are tax shelters, which use various aspects of the tax code (such as depreciation expenses) to legitimately reduce an investor's tax liability. Tax planning considers all these factors and more. It involves looking at your current and projected earnings and then developing strategies that will defer and minimize taxes. Tax plans are closely tied to investment plans and will often specify certain investment strategies. Although tax planning is most common among individuals with high incomes, people with lower incomes can also obtain sizable savings. We'll examine taxes and tax planning in Chapter 3.

Retirement and Estate Planning

While you're still working, you should be managing your finances to attain those goals you feel are important after you retire. These might include maintaining your standard of living, extensive travel, visiting children, frequent dining at better restaurants, and perhaps a vacation home or boat. Retirement planning should begin long before you retire. Most people don't start thinking about retirement until well into their 40s or 50s. This is unfortunate, because it usually results in a substantially reduced level of retirement income. The sooner you start, the better off you'll be. Take, for instance, the individual retirement account (IRA), whereby certain wage earners were allowed to invest up to \$7,000 per year in 2019. We'll look at IRAs and other aspects of retirement planning in Chapter 14.

EXAMPLE: The Sooner You Start an IRA, the Better

If you start investing for retirement at age 40 and put only \$2,000 a year in an IRA earning 5 percent for 25 years, you will have \$95,454 at age 65. However, if you start the same retirement plan 10 years earlier at age 30, you'll have \$180,641 at age 65!

Accumulating assets to enjoy in retirement is only part of the long-term financial planning process. As people grow older, they must also consider how they can most effectively pass their wealth on to their heirs, an activity known as *estate planning*. We'll examine this complex subject—which includes such topics as wills, trusts, and the effects of gift and estate taxes—in Chapter 15.

1-3c Special Planning Concerns

Students may not spend much time on financial planning. Yet the sooner you start, the better prepared you'll be to adapt your plans to changing personal circumstances. Such changes include changing or losing a job, relocating to a new state, getting



Busting Common Financial Planner Myths

- **Myth 1: My finances aren't complicated—I can do this on my own.** While most people can likely pay down credit cards, set up an IRA, and do some basic investing, professionals can handle the nuances of financial planning better. Your finances may well be more complicated than you realize. For example, many parents with young kids realize they need to buy life insurance. But they often overlook disability insurance, which covers some lost income if one or both parents are unable to work. Professionals are more likely to keep the big picture in mind and second opinions can be helpful.
- **Myth 2: Only the rich need financial planners.** Financial planning is needed by all who want to set money goals and design a plan to achieve those goals. Many people wrongly assume that a good financial planner will charge more than they can afford. In fact, there are planner who work with younger people and price-sensitive families under fixed-fee or hourly arrangements.
- **Myth 3: Financial planners provide only investing advice.** While investing advice is important, many planners can provide good advice on broad areas that include insurance, estate and retirement planning, and budgeting.
- **Myth 4: Once I've hired a financial planner, I'm good to go for life.** A good planner will help you get your finances organized and help you monitor them. But you do the heavy-lifting of contributing more to your 401(k) plan, changing your withholding taxes when needed, and deciding whom to name as insurance and investment account beneficiaries. A good financial planner listens to the client over the entire financial life cycle and provides accountability.
- **Myth 5: Credentials don't matter much.** Not true. You want a planner who has passed rigorous certification exams that require him or her to apply financial skills to practical situations. For example, holders of the Certified Financial Planner (CFP®) designation pass comprehensive exams on investment management, insurance, tax planning, employee benefits, and retirement and estate planners. And holders of the Chartered Financial Analyst (CFA®) designation have passed three levels of exam on comprehensive investment management. Looking over a group of well-trained planners and investment advisors for the best personal fit is the way to go.

Source: Adapted from LearnVest, "6 Common Myths About Financial Planning—Busted," https://www.huffpost.com/entry/6-common-myths-about-fina_b_6670090?guccounter=1, accessed January 2020.

married, having children, being in a serious accident, getting a chronic illness, losing a spouse through divorce or death, retiring, or taking responsibility for dependent parents. These and other stressful events are “financial shocks” that require reevaluation of your financial goals and plans.

It is important not to rush to make major financial decisions at these times, when you're most vulnerable. Postpone any action until you have had time to recover from the event and evaluate all your options carefully. This can be difficult because some financial salespeople will rush to contact you in these circumstances. For example, when you have a child, you will find that insurance agents, financial planners, and stockbrokers actively encourage you to buy insurance and start investing in a college fund. Although these are valid objectives, don't be pushed into any expensive decisions. People who get large sums of money—from severance packages, retirement benefits, or insurance policies when a loved one dies—are also likely to hear from financial salespeople eager to help them invest the funds. This is another time to wait. Face it—some professionals may have a greater interest in selling their own products than advising you on the best strategy for your needs.

Managing Two Incomes

Did you know that the earnings of the average dual-income family will add up to more than \$1 million over the wage earners' lives? Today, two-income couples account for two-thirds of U.S. households and many depend on the second income to make ends meet. For others, it provides financial security and a way to afford "extras." Often, however, a second income doesn't add as much as expected to the bottom line. Higher expenses such as child care, taxes, clothing, dry cleaning, transportation, and lunches may consume a large part of the second paycheck. And two-income families tend to spend what they earn rather than save it.

When Valeria Ramirez was offered a job as a credit analyst, she and her husband, Derek, filled out Worksheet 1.2 to assess the net monthly income from her paycheck, both with and without the impact of employer-paid benefits. Valeria had been staying home with their three children, but now two were in school all day. The couple listed only those expenses that *directly related to the second job* and made sure not to include personal expenses that would exist even without the second job. Valeria's job offer included good employer-paid benefits, with a better health insurance plan than the one Derek's employer offered. Taking these benefits and the job-related expenses into account, the Ramirez family's net monthly income would increase by \$3,440 a month, or \$41,280 a year. Without benefits, this amount drops to \$1,808, or \$21,696 a year. These numbers provided the information that the Ramirez family needed to discuss the pros and cons of Valeria's job offer. They took into account not just the higher total income and out-of-pocket costs but also the intangible costs (additional demands on their lives, less time with family, and higher stress) and benefits (career development, job satisfaction, and sense of worth). They decided that the timing was right and agreed that they'd use the second income to increase their college savings accounts and build up their other investments. This would provide greater financial security in these uncertain times if Derek were laid off from his research job at a biotechnology company.

Like the Ramirez family, partners in two-income households need to approach discussions on financial matters with an open mind and be willing to compromise. Spouses need to decide together how to allocate income to household expenses, family financial goals, and personal spending goals. Will you use a second income to meet basic expenses, afford a more luxurious lifestyle, save for a special vacation, or invest in retirement accounts? You may need to try several money management strategies to find the one that works best for you. Some couples place all income into a single joint account. Others have each spouse contribute *equal* amounts into a joint account to pay bills, but retain individual discretion over remaining income. Still others contribute a *proportional* share of each income to finance joint expenses and goals. In any case, both spouses should have money of their own to spend without accountability.

Managing Employee Benefits

As we've already discussed, if you hold a full-time job, then your employer probably provides various employee benefits, ranging from health and life insurance to pension plans. As we saw when analyzing the Ramirez family's case, these benefits can have a major financial impact on family income. Most American families depend solely on employer-sponsored group plans for their health insurance coverage and also for a big piece of their life insurance coverage and retirement needs.

Today's well-defined employee benefits packages cover a full spectrum of benefits that may include:

- Health and life insurance
- Disability insurance
- Long-term care insurance
- Pension and profit-sharing plans
- Supplemental retirement programs, such as 401(k) plans
- Dental and vision care
- Child care, elder care, and educational assistance programs
- Subsidized employee food services

Use this worksheet to estimate the contribution of a second paycheck. Without the employer-paid benefits of \$1,632 (line 2), the Ramirez family would realize a net monthly income of \$1,808 (line 1 – line 3); with those benefits, their net monthly income would be \$3,440 (line 4).

| Second Income Analysis | |
|--|----------------------------------|
| Name(s) | <u>Valeria and Derek Ramirez</u> |
| Date | <u>December 27, 2020</u> |
| MONTHLY CASH INCOME | |
| Gross pay | <u>\$5,000</u> |
| Pretax employer contributions (401(k) plans, dependent-care reimbursement account(s)) | <u>400</u> |
| Additional job-related income (bonuses, overtime, commissions) | <u>0</u> |
| (1) Total Cash Income | <u>\$5,400</u> |
| EMPLOYER-PAID BENEFITS | |
| Health insurance | <u>\$550</u> |
| Life insurance | <u>100</u> |
| Pension contributions | <u>600</u> |
| Thrift-plan contributions | <u>0</u> |
| Social Security | <u>382</u> |
| Profit sharing | <u>0</u> |
| Other deferred compensation | <u>0</u> |
| (2) Total Benefits | <u>\$1,632</u> |
| MONTHLY JOB-RELATED EXPENSES | |
| Federal income tax | <u>\$1,500</u> |
| Social Security tax | <u>382</u> |
| State income tax | <u>250</u> |
| Child care | <u>640</u> |
| Clothing; personal care; dry cleaning | <u>400</u> |
| Meals away from home | <u>200</u> |
| Public transportation | <u>0</u> |
| Auto-related expenses (gas, parking, maintenance) | <u>220</u> |
| Other | <u>0</u> |
| (3) Total Expenses | <u>\$3,592</u> |
| (4) Net Income (Deficit) = Total Cash Income | <u>\$3,440</u> |
| + Total Benefits | |
| - Total Expenses | |

Each company's benefit package is different. Some companies and industries are known for generous benefit plans; others offer far less attractive packages. In general, large firms can afford more benefits than small ones can. Because employee benefits can increase your total compensation by 30 percent or more, you should thoroughly investigate your employee benefits to choose those appropriate for your personal situation. Be sure to coordinate your benefits with your partner's to avoid

flexible-benefit (cafeteria) plans

A type of employee benefit plan wherein the employer allocates a certain amount of money and then the employee “spends” that money for benefits selected from a menu covering everything from child care to health and life insurance to retirement benefits.

paying for duplicate coverage. Companies change their benefit packages often and today are shifting more costs to employees. Although an employer may pay for some benefits in full, typically employees pay for part of the cost of group health insurance, supplemental life insurance, long-term care insurance, and participation in voluntary retirement programs.

Due to the prevalence of two-income families and an increasingly diverse workforce, many employers today are replacing traditional programs, where the company sets the type and amounts of benefits, with **flexible-benefit (cafeteria) plans**. In flexible-benefit programs, the employer allocates a certain amount of money to each employee and then lets the employee “spend” that money for benefits that suit his or her age, marital status, number of dependent children, level of income, and so on. These plans usually cover everything from child care to retirement benefits, offer several levels of health and life insurance coverage, and have some limits on the minimum and maximum amounts of coverage. Within these constraints, you can select the benefits that do you the most good. In some plans, you can even take part of the benefits in the form of more take-home pay or extra vacation time!

Managing Your Finances in Tough Economic Times

Tough economic times can be due to broad macroeconomic trends like a recession, or they can be brought on by more personal, local developments. The effects of recessions and financial crises divide people into three groups: (1) those who are directly and severely hurt through job loss, (2) those who are marginally hurt by reduced income, and (3) those who are not directly hurt. If you are in either of the first two groups, you must make significant lifestyle changes to reduce spending. Even if you are in the last group, a recession affects you indirectly. For example, retirement accounts typically drop in value and financial plans must be revised. And everyone’s expectations are at least temporarily affected, which causes most people to be more cautious about their expenditures during a recession or crisis.

The financial crisis of 2007-2008 and the subsequent long period of high unemployment was a macroeconomic challenge of historic global proportions. It drives home the benefits of having a sound financial plan—and dramatized the cost of not having one. The precipitous decline in stock and home prices and the many people laid off from their jobs made everyone think a lot more about financial planning in general and how to survive a financial crisis in particular. Although we all hope that such broad crises will be rare, it is important to plan for a possible recurrence. All of the financial planning principles explained in this book remained valid during the recent global financial crisis and should continue to serve us well in any future similar situations.

So how do you best plan to survive a broad-based financial crisis? First, you remind yourself of the key principles of financial planning presented in this book:

- Spend less than you earn.
- Keep investing so your money continues to work toward your goals.
- Know where you are and plan for the unexpected. You cannot know where you are financially unless you carefully, and frequently, update your family’s budget. And it is important to set aside money for an emergency fund. As discussed earlier in this chapter, you should set aside enough cash to last at least 6 months.

Second, don’t panic when financial markets crash. This means that you shouldn’t try to time the market by buying when the experts say it’s at a low or by selling when they say it’s at a high. Continue to invest for the long-term but keep in mind how close you are to achieving your financial objectives. For example, if you pull all of your money out of the stock market when it has fallen, you will not be positioned to take advantage of its eventual recovery. Part 5 of the book focuses on investment management.

Do It Now

Start Building an Emergency Fund

What would happen if you lost your job, got hurt, or had an unexpected big expense? Even if you're not making much money now, you could start building an emergency fund by putting aside even \$10 a month. As this chapter points out, your goal is to eventually set aside enough to last at least 6 months. Considering the risk of not doing so, **you can do it now.**

You can take specific actions in your day-to-day life to deal effectively with a financial crisis or recession. Consider the following ways to manage expenses in times of stress:

- Postpone large expenses. For example, hold on to your old car rather than buying a new one. And you could wait on that new refrigerator or big-screen TV.
- Cut back on the number of times you eat out.
- Take your vacation at or around home.
- If you rely mostly on a cell phone, consider canceling your landline phone.
- Cancel nonessential magazine subscriptions.

Recessions and financial crises can be challenging. A financial plan that considers such contingencies will help you weather the storm.

Adapting to Other Major Life Changes

Economic hardships are not always the result of adverse macroeconomic developments. Even in the best of times, people can lose their job or face other hardships. Situations that require special consideration include changes in marital status and the need to support grown children or elderly relatives. Marriage, divorce, or the death of a spouse results in the need to revise financial plans and money management strategies.

As we mentioned previously, couples should discuss their money attitudes and financial goals and decide how to manage joint financial affairs *before* they get married. Take an inventory of your financial assets and liabilities, including savings and checking accounts; credit card accounts and outstanding bills; auto, health, and life insurance policies; and investment portfolios. You may want to eliminate some credit cards. Too many cards can hurt your credit rating, and most people need only one or two. Each partner should have a card in his or her name to establish a credit record. Compare employee benefit plans to figure out the lowest-cost source of health insurance coverage, and coordinate other benefits. Change the beneficiary on your life insurance policies as desired. Adjust withholding amounts as necessary based on your new filing category.

In the event of divorce, income may decrease because alimony and child-support payments may cause one salary to be divided between two households. Single parents may have to stretch limited financial resources further to meet added expenses such as child care. Remarriage brings additional financial considerations, including decisions involving children from prior marriages and managing the assets that each spouse brings to the marriage. Some couples develop a prenuptial contract that outlines their agreement on financial matters, such as the control of assets, their disposition in event of death or divorce, and other important money issues.

The death of a spouse is another change that greatly affects financial planning. The surviving spouse is typically faced with decisions on how to receive and invest life insurance proceeds and manage other assets. In families where the deceased made



FINANCIAL PLANNING TIPS

Planning for Important Life Events

Just like you, financial plans go through stages and must adapt to changes over your lifetime. Here are some of the critical life events that may make you reconsider and possibly revise an existing financial plan:

- **Marriage.** Finances must be merged, and there may be a need for life insurance.
- **Children.** It's time to start a college savings plan and revise your budget accordingly. A will is needed that makes provisions for guardianship if both parents die while the children are minors.
- **Divorce.** Financial plans based on two incomes are no longer applicable. Revised plans must reflect any property settlements, alimony, and/or child support.
- **Moving into middle age.** Although having started a savings and investing plan early in life should be paying off, the number of working years is declining, along with future earning ability. The shorter horizon implies that you may want to take less risk and keep less money in the stock market. While the greater safety is appealing, the reduced expected returns are also sobering. In addition, this could be the time to consider long-term-care insurance for possible use in retirement.

- **Death of a parent.** The estate must be settled, and you may need help managing a possible inheritance.
- **Retirement.** If you set it up right, your financial plan generated the amount needed to fund your retirement fully. During retirement, you will try to preserve your capital, relying as much as possible on the income generated by your investments to fund your living expenses. Investment risk should be reduced greatly and inflation risk must be managed. Money can be withdrawn from tax-deferred retirement accounts beginning at age 59 1/2 without penalty, but taxes will be due. If retired, you *must* start taking out such money at age 70 1/2 at a rate that is based on the average life expectancy for that age. The risk of increases in future tax rates can be managed, in part, with Roth IRAs, which are retirement accounts where your original contributions are not tax-deductible. However, there is no requirement that you take out the money and it is not taxed when you do. Estate planning and long-term care issues must also be addressed.

most of the financial decisions with little or no involvement of the surviving spouse, the survivor may be overwhelmed by the need to take on financial responsibilities. Advance planning can minimize many of these problems.

Couples should regularly review all aspects of their finances. Each spouse should understand what is owned and owed, participate in formulating financial goals and investment strategies, and fully understand estate plans (covered in detail in Chapter 15).

1-3d Technology in Financial Planning

Using personal computers and the Internet streamlines the number crunching and information gathering involved in budgeting, tax planning, and investment management. Many reasonably priced, user-friendly programs are available for personal financial planning and money management, including the popular Microsoft Money and Quicken packages. And the number of free and reasonably priced online and smart-phone apps for this purpose continues to grow at an amazing rate.

The Internet puts a wealth of financial information literally at your fingertips. Comprehensive sites that consistently get good reviews include Yahoo! Finance (<http://finance.yahoo.com>), Microsoft's MSN MoneyCentral (<http://moneycentral.msn.com>), and Intuit's Quicken.com (<http://www.quicken.com>). Where applicable, we'll point out ways to use the computer and Internet resources to simplify and reduce the time required to manage your personal finances.

professional financial planners

An individual or firm that helps clients establish financial goals and develop and implement financial plans to achieve those goals.

1-3e Using Professional Financial Planners

Does developing your own financial plans seem like an overwhelming task? Help is at hand! **Professional financial planners** will guide you through establishing goals, plan preparation, and the increasingly complex maze of financial products and investment opportunities. This field has experienced tremendous growth, and there are now more than 300,000 financial planners in the United States.

Financial planners offer a wide range of services, including preparing comprehensive financial plans that evaluate a client's total personal financial situation or abbreviated plans focusing on a specific concern, such as managing a client's assets and investments and retirement planning. Where once only the wealthy used professional planners, now financial firms such as H&R Block's Financial Advisors and the Personal Advisors of Ameriprise Financial compete for the business of middle-income people as well.

Why do people turn to financial advisors? Surveys indicate that retirement needs motivated 50 percent, while 23 percent were unhappy with the results of trying to manage their own finances. Estate and inheritance planning caused another 13 percent to seek help; saving for college and tax issues were also mentioned as reasons.

1-3f Types of Planners

Most financial planners fall into one of two categories based on how they are paid: commissions or fees. *Commission-based planners* earn commissions on the financial products they sell, whereas *fee-only planners* charge fees based on the complexity of the plan they prepare. Many financial planners take a hybrid approach and charge fees and collect commissions on products they sell, offering lower fees if you make product transactions through them.

Insurance salespeople and securities brokers who continue to sell the same financial products (life insurance, stocks, bonds, mutual funds, and annuities) often now call themselves "financial planners." Other advisors work for large, established financial institutions that recognize the enormous potential in the field and compete with the best financial planners. Still others work in small firms, promising high-quality advice for a flat fee or an hourly rate. Regardless of their affiliation, full-service financial planners help their clients articulate their long- and short-term financial goals, systematically plan for their financial needs, and help implement various aspects of the plans. Exhibit 1.9 provides a guide to some of the different planning designations.

In addition to one-on-one financial planning services, some institutions offer computerized financial plans. Merrill Lynch/Bank of America, Ameriprise Financial, T. Rowe Price, and other major investment firms provide these computerized plans on the Internet to help clients develop plans to save for college or retirement, reduce taxes, or restructure investment portfolios.

Personal finance programs such as Quicken and Microsoft Money also have a financial planning component that can help you set a path to your goals and do tax and retirement planning. As you'll see in later chapters, some Internet sites provide planning advice on one topic, such as taxes, insurance, or estate planning. Although these plans are relatively inexpensive or even free, they are somewhat impersonal. However, they are a good solution for those who need help getting started and for do-it-yourself planners who want some guidance.

The cost of financial planning services depends on the type of planner, the complexity of your financial situation, and the services you want. The cost may be well worth the benefits, especially for people who have neither the time, inclination, discipline, nor expertise to plan on their own. Remember, however, that the best advice is worthless if you're not willing to change your financial habits.

Confused about what the letters after a financial advisor's name signify? Here's a summary of the most common certifications so you can choose the one that best suits your needs.

| Credential | Description | Internet Address |
|--|---|---|
| Chartered Financial Analyst (CFA®) | Focuses primarily on securities analysis not financial planning | http://www.cfainstitute.org |
| Certified Financial Planner (CFP®) | Requires a comprehensive education in financial planning | http://www.cfp.net |
| Chartered Financial Consultant (ChFC) | Financial planning designation for insurance agents | http://www.theamericancollege.edu/ |
| Certified Trust & Financial Advisor (CTFA) | Estate planning and trusts expertise, found mostly in the banking industry | http://aba.com/ICB/CTFA.htm |
| Personal Financial Specialist (PFS) | Comprehensive planning credential only for CPAs | http://www.pfp.aicpa.org |
| Chartered Life Underwriter (CLU) | Insurance agent designation, often accompanied by the ChFC credential | http://www.theamericancollege.edu |
| Certified Investment Management Analyst | Consulting designation for professional investment managers | http://www.imca.org/ |
| Registered Financial Associate (RFA) | Designation granted only to recent graduates of an approved academic curriculum in financial services | http://www.iarfc.org |

Source: Adapted from <https://www.finra.org/investors/professional-designations>, accessed January 2020.

1-3g Choosing a Financial Planner

Planners who have completed the required course of study and earned the Certified Financial Planner (CFP®) or Chartered Financial Consultant (ChFC) designation are often a better choice than the many self-proclaimed “financial planners.” Of course, CPAs, attorneys, investment managers, and other professionals without such certifications in many instances also provide sound financial planning advice.

Unlike accounting and law, the field is still largely unregulated, and almost anyone can call himself or herself a financial planner. Most financial planners are honest and reputable, but there have been cases of fraudulent practice. So it's critical to thoroughly check out a potential financial advisor—and preferably to interview two or three.

The way a planner is paid—commissions, fees, or both—should be one of your major concerns. Obviously, you need to be aware of potential conflicts of interest when using a planner with ties to a brokerage firm, insurance company, or bank. Many planners now provide clients with disclosure forms outlining fees and commissions for various transactions. In addition to asking questions of the planner, you should also check with your state securities department and the Securities and Exchange Commission (for planners registered to sell securities). Ask if the planner has any pending lawsuits, complaints by state or federal regulators, personal bankruptcies, or convictions for investment-related crimes. However, even these agencies may not have accurate or current information; simply being properly registered and having no record of disciplinary actions don't guarantee that an advisor's track record is good. You may also want to research the planner's reputation in the local financial community. Clearly, you should do your homework before engaging the services of a professional financial planner.



Finding the Best Financial Planner

When interviewing a prospective financial advisor, you should be aware of potential conflicts of interest:

- **How is the advisor compensated?** Financial advisors can be compensated by product sale commissions and/or by client-paid fees. Client-paid fees can include an hourly fee, an annual retainer, a fee that is based on the amount invested with the advisor, or a flat fee for each service provided. Some advisors are paid using a combination of commissions and fees.
- **Conflicts of interest.** While most advisors are honest, opportunities for conflicts of interest abound. Advisors who get a commission have an incentive to sell you the products that generate the most money for them, but those are not necessarily the best products for you. Advisors who are paid an hourly fee have an incentive to add hours to your bill. And advisors who earn a fee based on the amount of assets under management tend to encourage you to invest more with them.
- **Good questions to ask.** Ask a prospective advisor how he or she is compensated. If an advisor receives commissions, ask for a description of the commissions on their products. Alternatively, ask a fee-paid advisor for a schedule of fees for each type of service provided. It would be helpful to use the questionnaire provided on the National Association of Personal Financial Advisors (NAPFA) website, www.napfa.org. It has good questions to ask when interviewing a prospective advisor and provides a form that your advisor can use to disclose the commissions he or she receives.

TEST YOURSELF

- 1-9** What types of financial planning concerns does a complete set of financial plans cover?
- 1-10** Discuss the relationship of life-cycle considerations to personal financial planning. What are some factors to consider when revising financial plans to reflect changes in the life cycle?
- 1-11** Cooper Bryant's investments over the past several years have not lived up to his full return expectations. He is not particularly concerned, however, because his return is only about 2 percentage points below his expectations. Do you have any advice for Cooper?
- 1-12** Describe employee benefit and tax planning. How do they fit into the financial planning framework?
- 1-13** "There's no sense in worrying about retirement until you reach middle age." Discuss this point of view.
- 1-14** Discuss briefly how the following situations affect personal financial planning:
- a. Being part of a dual-income couple
 - b. Major life changes, such as marriage or divorce
 - c. Death of a spouse
- 1-15** What is a *professional financial planner*? Does it make any difference whether the financial planner earns money from commissions made on products sold as opposed to the fees he or she charges?

1-4 THE PLANNING ENVIRONMENT

LG4

Financial planning takes place in a dynamic economic environment created by the actions of government, business, and consumers. Your purchase, saving, investment, and retirement plans and decisions are influenced by both the present and future state of the economy. Understanding the economic environment will allow you to make better financial decisions.

Consider that a strong economy can lead to high returns in the stock market, which in turn can positively affect your investment and retirement programs. The economy also affects the interest rates you pay on your mortgage and credit cards as well as those you earn on savings accounts and bonds. Periods of high inflation can lead to rapid price increases that make it difficult to make ends meet. Here we look at two important aspects of the planning environment: the major financial planning players and the economy.

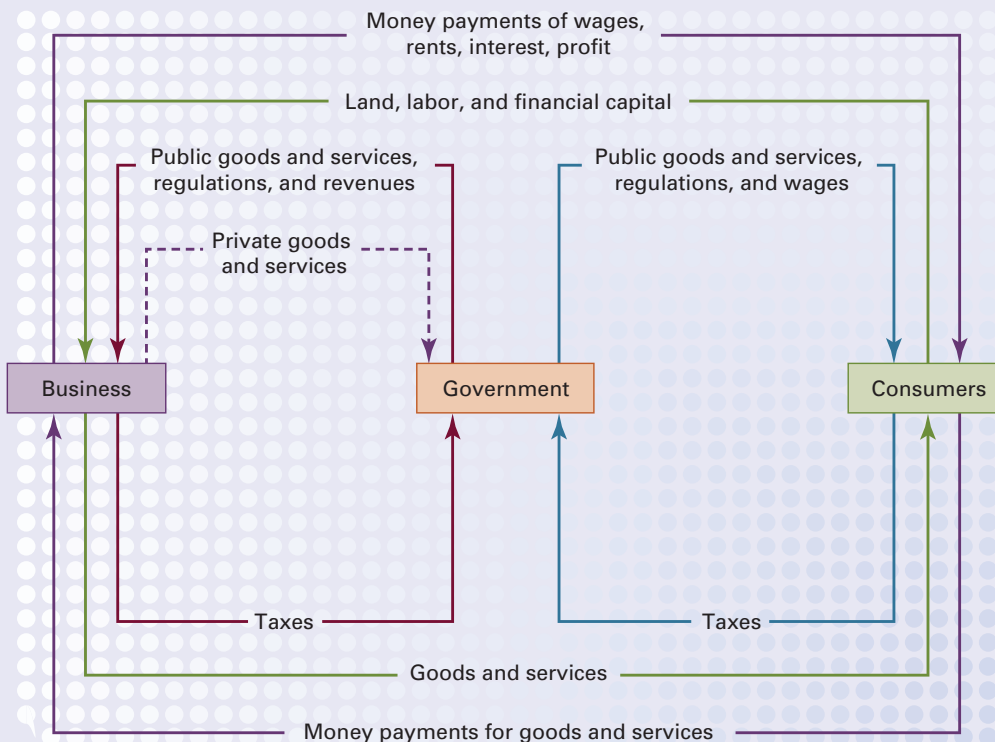
1-4a The Players

The financial planning environment contains various interrelated groups of players, each attempting to fulfill certain goals. Although their objectives are not necessarily incompatible, they do impose some constraints on one another. There are three vital groups: government, business, and consumers. Exhibit 1.10 shows the relationships among these groups.

EXHIBIT 1.10

The Financial Planning Environment

Government, business, and consumers are the major players in our economic system. They interact with one another to produce the environment in which we carry out our financial plans.



Government

Federal, state, and local governments provide us with many essential public goods and services, such as police and fire protection, national defense, highways, public education, and health care. The federal government plays a major role in regulating economic activity. Government is also a customer of business and an employer of consumers, so it's a source of revenue for business and of wages for consumers. The two major constraints from the perspective of personal financial planning are taxation and regulation.

Taxation The federal government levies taxes on income, state governments levy taxes on sales and income, and local governments levy taxes primarily on real estate and personal property. The largest tax bite for consumers is federal income taxes, which are *progressive* in that (up to a point) the greater the taxable income, the higher the tax rate. Changes in tax rates and procedures will increase or decrease the amount of income consumers have to spend, so you should factor the effects of taxes into your personal money management activities. Because of tax structure constraints and the potential magnitude of taxes, financial decisions should be evaluated on an after-tax basis. Taxes are discussed in Chapter 3.

Regulation Federal, state, and local governments place many regulations on activities that affect consumers and businesses. Aimed at protecting the consumer from fraudulent and undesirable actions by sellers and lenders, these regulations require certain types of businesses to have licenses, maintain specified hygiene standards, adequately disclose financial charges, and warrant their goods and services. Other laws protect sellers from adverse activities such as shoplifting and nonpayment for services rendered. Decisions related to achieving personal financial goals should consider the legal requirements that protect consumers and those that constrain their activities.

Business

As Exhibit 1.10 shows, business provides consumers with goods and services and, in return, receives payment in the form of money. Firms must hire labor and use land and financial capital (economists call these *factors of production*) to produce these goods and services. In return, firms pay out wages, rents, interest, and profits to the various factors of production. Thus, businesses are an important part of the circular flow of income that sustains our free enterprise system. In general, they create a competitive environment in which consumers may select from an array of goods and services. As noted previously, all businesses are limited in some way by federal, state, and local laws.

Consumers

The consumer is the central player in the financial planning environment. Consumer choices ultimately determine the kinds of goods and services that businesses will provide. The consumer's choice of whether to spend or save also has a direct impact on present and future circular flows of money. Cutbacks in consumer spending are usually associated with a decline in economic activity, whereas increases in consumer spending help the economy to recover.

Consumers are often thought to have free choices in the marketplace, but they must operate in an environment that includes government and business. Although they can affect these parties by voting and by their purchasing actions, consumers need lobbyists and consumer groups in order to have a significant impact. The individual consumer should not expect to change government or business and instead plan transactions within the existing financial environment.

gross domestic product (GDP)

The total of all goods and services produced in a country; used to monitor economic growth.

1-4b The Economy

Our economy is influenced by interactions among government, business, and consumers, as well as by world economic conditions. Through specific policy decisions, the government's goal is to manage the economy to provide economic stability and a high level of employment. Government decisions have a major impact on the economic and financial planning environment. The federal government's *monetary policy*—programs for controlling the amount of money in circulation (the money supply)—is used to stimulate or moderate economic growth. For example, increases in the money supply tend to lower interest rates. This typically leads to a higher level of consumer and business borrowing and spending that increases overall economic activity. The reverse is also true. Reducing the money supply raises interest rates, which reduces consumer and business borrowing and spending and thus slows economic activity. The historically low interest rates in the wake of the financial crisis of 2007–2008 and beyond reflect efforts by the Federal Reserve (Fed) to bolster the sagging economy and decrease unemployment.

The government's other principal tool for managing the economy is *fiscal policy*—its programs of spending and taxation. Increased spending for social services, education, defense, and other programs stimulates the economy, while decreased spending slows economic activity. Increasing taxes, on the other hand, gives businesses and individuals less to spend and, as a result, negatively affects economic activity. Conversely, decreasing taxes stimulates the economy. The importance of fiscal policy is illustrated by the government's massive spending to stimulate the U.S. economy in 2008 and 2009 as a way to address the greatest financial crisis since the Great Depression of the 1930s in the United States.

Economic Cycles

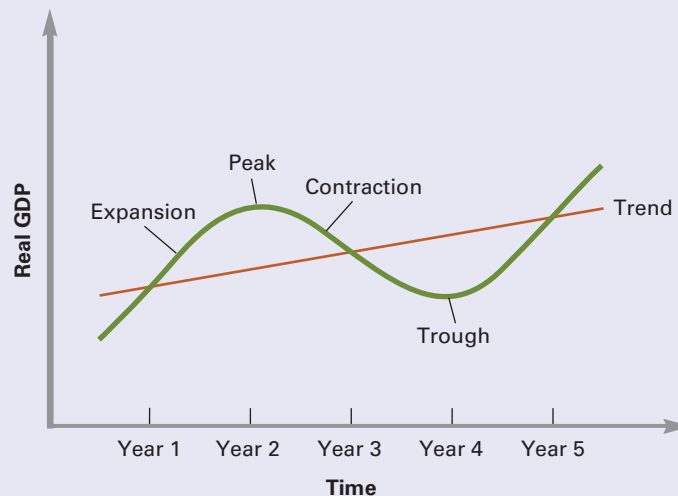
Although the government uses monetary and fiscal policy to manage the economy and provide economic stability, the level of economic activity changes constantly. The upward and downward movement creates *economic cycles* (also called *business cycles*), which vary in length and in extent. An economic cycle typically contains four stages: *expansion*, *peak*, *contraction*, and *trough*.

Exhibit 1.11 shows how each of these stages relates to real (inflation-adjusted) **gross domestic product (GDP)**, which is an important indicator of economic activity.

EXHIBIT 1.11

The Business Cycle

The business cycle consists of four stages: expansion, peak, contraction, and trough.



Source: Adapted from William Boyes and Michael Melvin, *Economics*, 8th ed. (Cengage, 2011), p. 35.

expansion

The phase of the economic cycle when levels of employment and production are high and the economy is growing, generally accompanied by rising prices for goods and services.

peak

The phase of the economic cycle when an expansion ends and a contraction begins.

contraction

The phase of the economic cycle when real GDP falls.

trough

The phase of the economic cycle when a contraction ends and an expansion begins.

inflation

A state of the economy in which the general price level is increasing.

consumer price index (CPI)

A measure of inflation based on changes in the cost of consumer goods and services.

The stronger the economy, the higher the levels of real GDP and employment. During an **expansion**, real GDP increases until it hits a **peak**, which usually signals the end of the expansion and the beginning of a **contraction**. During a contraction (also known as a *recession*), real GDP falls into a **trough**, which is the end of a contraction and the beginning of an expansion. For about 75 years, the government has been reasonably successful in keeping the economy out of a depression, although we have experienced periods of rapid expansion and high inflation, followed by periods of deep recession. And some would argue that the financial crisis of 2007–2008 came close to precipitating a depression.

Economic growth is measured by changes in GDP, the total of all goods and services produced within the country. The broadest measure of economic activity, GDP is reported quarterly and is used to compare trends in national output. A rising GDP means that the economy is growing. The *rate* of GDP growth is also important. Although the long-term trend in nominal GDP typically is positive, the annual rate of GDP growth varies widely. For example, while quarterly nominal GDP grew an average of about 6.5 percent between 1950 and mid-2019, its minimum value was –3.06 percent and its maximum value was 19.66 percent. And quarterly real GDP only grew about 3.2 percent over that time period, with a minimum of –3.9 percent and a maximum of 13.4 percent. Another important measure of economic health is the *unemployment rate*. The swings in unemployment from one phase of the cycle to the next can be substantial. For example, between 1950 and mid-2019, the civilian unemployment rate fluctuated between a low of 2.9 percent and a high of 9.7 percent. In addition to GDP growth and the unemployment rate, numerous economic statistics such as inflation, interest rates, bank failures, corporate profits, taxes, and government deficits directly and profoundly affect our financial well-being. These factors affect our financial plans: our level of income, investment returns, interest earned and paid, taxes paid, and prices paid for goods and services we buy.

Inflation, Prices, and Planning

As we've discussed, our economy is based on the exchange of goods and services between businesses and their customers—consumers, government, and other businesses—for a medium of exchange called money. The mechanism that facilitates this exchange is a system of *prices*. Technically speaking, the price of something is *the amount of money the seller is willing to accept in exchange for a given quantity of some good or service*—for instance, \$3 for a pound of meat or \$10 for an hour of work. The economy is said to be experiencing a period of **inflation** when the general level of prices *increases* over time. The most common measure of inflation, the **consumer price index (CPI)**, is based on changes in the cost of consumer goods and services. At times, the rate of inflation has been substantial. In 1980, for instance, prices went up by 13.5 percent. Fortunately, inflation has dropped dramatically in this country, and the annual rate of inflation has remained below 5 percent every year since 1983, except in 1990, when it was 5.4 percent. While there was mild deflation of –0.40 percent after the financial crisis in 2007–2008, inflation moved up to about 3.2 percent in 2011 and was between 0.10 and 2.1 percent for the next few years.

Inflation is of vital concern to financial planning. It affects not only what we pay for our goods and services but also what we earn in our jobs. Inflation tends to give an illusion of something that doesn't exist. That is, though we seem to be making more money, we really aren't. As prices rise, we need more income because our purchasing power—the amount of goods and services each dollar buys at a given time—declines. So be sure to look at what you earn in terms of its purchasing power, not just in absolute dollars.