Personal Finance

Turning Money into Wealth

7th Edition

Arthur J. Keown

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Seventh Edition

Arthur J. Keown

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

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Acknowledgments of third-party content appear on the appropriate page within the text.

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Library of Congress Cataloging-in-Publication Data

Keown, Arthur J.
Personal finance : turning money into wealth / Arthur J. Keown.
—Seventh edition.
pages cm.—(The Prentice Hall series in finance)
Includes index.
ISBN 978-0-13-385643-9—ISBN 0-13-385643-7
1. Finance, Personal. 2. Investments. I. Title.
HG179.K47 2015
332.024'01—dc23
2014041821

10 9 8 7 6 5 4 3 2 1

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ISBN-10: 0-13-385643-7
ISBN-13: 978-0-13-385643-9

About the Author

Arthur J. Keown is the R. B. Pamplin Professor of Finance at Virginia Polytechnic Institute and State University. He received his bachelor's degree from Ohio Wesleyan University, his MBA from the University of Michigan, and his doctorate from Indiana University. An award-winning teacher, he is a member of the Academy of Teaching Excellence at Virginia Tech, he has received five Certificates of Teaching Excellence, the W. E. Wine Award for Teaching Excellence, and the Alumni Teaching Excellence Award, and in 1999 he received the Outstanding Faculty Award from the State of Virginia. Professor Keown is widely published in academic journals. His work has appeared in *Journal of Finance, Journal of Financial Economics, Journal of Financial and Quantitative Analysis, Journal of Financial Research, Journal of Banking and Finance, Financial Management, Journal of Portfolio Management*, and many others. Two of his books are widely used in college finance classes all over the country—*Financial Management* and *Foundations of Finance: The Logic and Practice of Financial Management.* Professor Keown is a Fellow of Decision Sciences Institute and served as Department Head for twelve years. In addition, he has served as the co-editor of both the *Journal of Financial Research* and the Financial Management Association's *Survey and Synthesis Series.* He was recently inducted into Ohio Wesleyan's Athletic Hall of Fame for wrestling. His daughter and son are both married and live in Madison, Wisconsin, and Denver, Colorado, while he and his wife live in Blacksburg, Virginia, where he collects original art from *Mad* magazine.

Brief Contents

Contents

Preface

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

New to the Seventh Edition

Since the last edition of *Personal Finance: Turning Money into Wealth*, a lot has changed in the world of personal finance, and much of this is driven by the economic turmoil resulting from the recent crash of the financial markets and the worst downturn in the economy since the Great Depression. While employment has recovered, many individuals left the workforce because they were unable to find jobs; interest rates are at all-time lows; housing prices dropped and then recovered, but not evenly; consumer debt (including mortgage debt) reached $11.5 trillion, more than doubling since 2000; and student loans have continued to rise at an alarming rate and now top $1 trillion, with over 11 percent of those student loan balances over 90 days delinquent or in default. While the Federal Reserve and the government have made a number of changes aimed at bringing about stability in the financial markets, the economy has had a difficult time regaining its footing. If that wasn't enough in the way of changes, the Affordable Care Act is just now phasing in with all kinds of implications and changes. As you will see, the entire book is updated to reflect the recent changes in the area of financial planning, including tax changes, new laws, the ever-changing investments landscape, weakness in the labor markets, the explosion of student loans, and credit card challenges facing graduating students, as well as other changes in the world of personal finance. In short, because of these continuous and fast-paced changes occurring in the personal finance landscape, little remains exactly as it was in the previous edition. Some of the more dramatic changes to the new edition include the following revisions.

- **Dramatically Expanded Coverage of Student Loans and Paying for College, Now Covering Almost Half of Chapter 7.** The chapter's new title, "Student and Consumer Loans: The Role of Planned Borrowing," reflects the complete and extensive coverage of student loans and paying for college. This chapter helps students understand the consequences of their choice of school and choice of major course of study; grasp what costs are involved (including tuition and living expenses); and learn how to borrow less and borrow smarter, manage their money while on campus, and, eventually, repay their loans without sacrificing financial goals. In addition, this chapter gives students an in-depth look at the world of student loans to help untangle the complexities and jargon associated with them and facilitate good decision-making practices.

- **New Coverage of Behavioral Finance in Every Chapter.** At the end of each chapter, there is a new section titled "Behavioral Insights—Principle 9: Mind Games, Your Financial Personality, and Your Money." These insights serve not only to highlight how behavioral biases can sabotage financial well-being but also to demonstrate how an understanding of these biases can be used to avoid destructive financial behavior. In addition, we discuss how recognizing these behavioral biases can lead to better financial decisions. For example, acknowledgment of the psychological/behavioral patterns or mind games that come into play when making financial decisions may help students avoid excessive credit card and student loan debt, save more for retirement, and make better investment decisions now and in the future.
- **Introduction of an Action Plan for Life with the Reintroduction of Chapter 17: "Financial Life Events—Fitting the Pieces Together."** This chapter ties the book together by looking at ten financial life events: getting started, marriage, buying a home, having a child, unexpected money (inheritances and bonuses), major illnesses, caring for an elderly parent, retiring, death of a spouse, and divorce. The presentation of each financial life event offers a blueprint of how to deal with that life event, referring students back to appropriate chapters in the book where warranted. In effect, this chapter answers the questions many students have at the end of the course: What do I do next? What do I do if/when something happens? This is followed by a discussion of 12 key decisions that lead to financial success.
- **A New Action Plan in Every Chapter.** Every chapter ends with a call for action in the form of a new section titled "Action Plan—Principle 10: Just Do It!" This section provides students with very specific suggestions on what they should do now based on the chapter's topic. This template for action gives them a place to start and has been purposely made specific enough to actually result in a change in behavior or an action that increases financial well-being.
- **Coverage of Investing Is Simplified and Completely Revised Under a "Need-to-Know" Philosophy, with the Discussions of Investment Basics (Formerly Chapter 11) and Securities Markets (Formerly Chapter 12) Combined.** Material is simplified and combined, thereby allowing for the two chapters to be consolidated without any loss of relevant material. The other chapters dealing with investing are also dramatically revised, with an emphasis on the intuitive rather than the mathematical. For example, the mathematical presentation for the value of a share of common stock has been dropped, while SWOT analysis has been added, stressing the fact that before investors put their money down and purchase a stock, they should be able to answer these questions:
    - Value: Is this a good price for this stock?
    - Quality: Is this firm in a position that will allow it to be profitable into the future?
    - Strengths and Weaknesses: What are this firm's strengths and weaknesses, and are they likely to get better or worse?
    - Threats and Opportunities: What are this firm's threats and opportunities, and are they likely to get better or worse?
- **Introduction of Author Videos Throughout the Book.** Calculator Clues and other calculations throughout the book are accompanied by author videos that present the calculations in a very deliberate and intuitive way, thereby allowing students to easily master the material. The videos provide an alternative method for not only mastering difficult material but also enjoying the type of learning experience that provides a long-lasting impact.

- **Continued Coverage of Lessons from the Recent Economic Downturn and the Uneven Recovery.** The opening chapter provides new coverage on the lessons learned from the recent economic downturn; the stock market and real estate crash and recovery; the loss of jobs, with many of those jobs disappearing permanently; the absence of growth in real wages; the financial stress experienced by many as they realized they didn't have enough saved in their emergency funds; and the prolonged and very uneven recovery. This coverage is included throughout the book where appropriate, including in Chapters 1, 5, 7, 8, 11, 12, and 17.
- **Increased Emphasis on the Use of the Internet and Apps for Smartphones.** This edition continues to increase emphasis on the use of apps for smartphones and the best of the Internet where appropriate. For example, the Mint.com and Level Money apps are easily installed on a smartphone and are both introduced and described when discussing budgeting and record keeping. Both apps make tedious tasks easy—and, if you can imagine, fun. Apps and the best of personal finance Web sites on the Internet are also introduced when discussing credit cards, student loans, insurance, investments, and retirement planning.
- **Complete Redesign of the End-of-Chapter Material to More Closely Match the Learning Objectives.** The summary presentation is redesigned to align with the chapter's learning objectives. In addition to a summary of the material covered under each learning objective, key terms are defined within each learning objective.

Hallmarks of *Personal Finance: Turning Money into Wealth*

- **The Ten Principles of Personal Finance—**Each chapter of the text touches back on the ten principles introduced in Chapter 1 and shows how to apply these principles to particular situations.
- **The Personal Finance Workbook—**A companion workbook is available for this text. It contains tear-out worksheets that provide a step-by-step analysis of many of the personal finance decisions examined in the book. Instructors can assign them as homework or use them to guide students through actual decisions. Icons in the text indicate content areas, as well as cases and problems, that utilize the worksheets. Every worksheet is also available electronically at the Instructor's Resource Center at **http://www.pearsonhighered.com/irc**. The workbook also includes **Your Financial Plan**, which guides students through a series of exercises that utilize the worksheets (available in the workbook and at the Instructor's Resource Center) and will generate a very basic financial plan to explore where students are today, where they want to be in the future, and what they need to do to get there. Finally, the workbook includes a section on how to use a financial calculator.
- **Easy-to-Follow Advice—**The proactive checklists, which appear throughout the text, serve as useful learning tools for students. These boxes identify areas of concern and propose questions to ask when buying a car, getting insurance, and investing in mutual funds, as well as performing other personal finance tasks.
- **MyFinanceLab—**MyFinanceLab, a fully integrated online homework and tutorial system, enables students to complete problems and receive immediate feedback and help. See the inside front cover for details.

Other Points of Distinction

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

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

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

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

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

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

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

Author Videos Author videos help students master difficult material while ensuring that the material provides a long-lasting impact. To this end, when Calculator Clues and other mathematical topics are presented in the book, they are accompanied by videos that present the calculations in a very deliberate and intuitive way. These videos are identified in the text with MyFinanceLab Video and can be accessed in MyFinanceLab at **http://www.myfinancelab.com**.

Major Content Updates

Chapter 1 New and updated content is provided to help students understand the financial impact of having children. Similarly, a new look is taken at the financial implications of students choice of a college major. The section "Lessons from the

Recent Economic Downturn" details Americans' continued vulnerability as they try to regain their financial footing even as the economy continues to recover. In addition, the new Behavioral Insights section looks at "mental accounting," or the tendency many people have to separate money into different mental accounts, or buckets, each with a different purpose, often for illogical reasons and with detrimental effects on their financial life. Finally, the new Action Plan feature gives specific advice that can be put into play.

Chapter 2 This chapter begins with a new introduction that focuses on Max and Caroline, two financially struggling characters from the TV show *2 Broke Girls*. The sitcom portrays their financial struggles as they inch their way toward their goal of starting a cupcake business. As each episode ends, the total amount they have saved appears on the screen. The statistics in the chapter have been updated, and two smartphone apps, Level Money and Mint.com, are introduced to help students with the processes of budgeting and record keeping. The topic of record keeping is rewritten to reflect the ease with which records can now be stored electronically. The new Behavioral Insights section takes a look at the impact of behavioral traits on our ability to save and budget. Finally, the chapter closes with an Action Plan to help students successfully put a budget in place.

Chapter 3 A new section in Chapter 3 examines how interest rates and time work together in compounding, illustrating the importance of saving earlier and the impact one or two percentage points can have on savings. The new Behavioral Insights section explores difficulties in saving arising from behavioral biases, along with ways to overcome those biases. The chapter closes with an Action Plan for putting an understanding of the time value of money to work by effectively saving.

Chapter 4 The tax chapter is streamlined to keep students focused on the main points. In addition, this chapter is fully revised to reflect all changes in the tax laws since the previous edition. The new Behavioral Insights section reviews tax refunds and how behavioral traits get in the way of saving those refunds. Finally, a simple Action Plan is provided that will make preparing for tax season easier for students.

Chapter 5 This chapter begins with a new introduction that looks at the value of an emergency fund, focusing on Haley and Luke Dunphy from the TV series *Modern Family*. Returns and recent changes in liquid assets are updated, and the new Behavioral Insights section looks at the behavioral biases faced when saving for an emergency. Finally, the Action Plan provides easy-to-implement tips on how to manage cash, paving the way to more financial control.

Chapter 6 This chapter is revised to reflect the recent changes to credit cards and the calculation of credit scores. The new Behavioral Insights section looks at how the behavioral trait of "mental accounting" can impact credit card spending. Finally, an Action Plan is laid out to help students and new graduates gain a strong credit score.

Chapter 7 This chapter now focuses on student loans and has been renamed "Student and Consumer Loans: The Role of Planned Borrowing." The chapter opener also reflects the expanded coverage of paying for college and student loans, featuring the fictional cast of *Glee* and the challenges they will face in paying for college. The new section on student loans and paying for college looks at the choice of schools and majors; how to borrow less and borrow smarter; paying for college and the different student loan options available; how federal and private student loans differ; managing money while in college; and the different repayment choices that are available. The new Behavioral Insights section looks at both the "endowment effect" and the behavioral struggles students face when making student loan decisions. The Action Plan sets in place a strategy for managing and paying off student loans. Finally, a new case focuses on student loans.

Chapter 8 A new introduction opens Chapter 8 with a look at the houses owned by television characters Phil and Claire Dunphy from *Modern Family* and Leslie Knope from *Parks and Recreation*. This chapter has been updated and revised to reflect changes that occurred during the economic downturn, and the Behavioral Insights section looks at the concept of "fuzzy math" and how the way prices are presented impacts a buyer's view of whether something is a good deal or not, which in turn can lead to poor buying decisions. The Action Plan looks at things to consider when buying a car or a house.

Chapter 9 This chapter is updated to reflect the extensive changes that have resulted from the passage of the Affordable Care Act, much of which went into effect in 2014. Topics include buying an individual insurance policy, the different options available under the Affordable Care Act, and the ramifications of not purchasing health insurance. In addition, the coverage of Medicare is simplified in order to make it more meaningful to students. The Behavioral Insights section looks at "anchoring" and the behavioral tactics used by some life insurance salespeople. Finally, the Action Plan gives direction on how to make life and health insurance decisions.

Chapter 10 Chapter 10 begins with a new introduction that looks at insurance problems faced by the character Crosby Braverman on the television show *Parenthood*. Updated and revised, Chapter 10 reflects changes in property and liability insurance since the previous edition, and the new Behavioral Insights coverage looks at insurance policy riders and how a behavioral trait called "integrated losses" makes adding options and riders to purchases seem logical when it isn't necessarily so. It also explains the concept of "representational bias," which can result in the purchase of unneeded insurance. Finally, the chapter closes with an Action Plan detailing what to consider when buying insurance.

Chapter 11 Chapters 11 and 12 from the previous edition are combined, simplified, and shortened to make the material both more relevant and more intuitive. In effect, a need-to-know approach is taken to the material in this newly revamped chapter. Coverage of the securities markets is revised to reflect the fact that most transactions are now made electronically. In addition, the chapter now reflects the current state of the financial markets. The new Behavioral Insights section introduces and explores several of the common behavioral biases that affect investors, including overconfidence, disposition, house money, loss and then risk aversion, and herd behavior effects. Finally, the new Action Plan gives students advice on how to approach investing.

Chapter 12 This chapter is updated to reflect the current state of the stock market, and it is also simplified by the removal of nonessential mathematics. While the mathematical approach to the valuation of common stock is dropped, SWOT, a more intuitive approach to understanding companies that students might want to invest in, is introduced. The new Behavioral Insights section explores several behavioral biases, including status quo bias, herd behavior, and loss aversion. The new Action Plan provides direction to students on improving their chances when investing in stocks.

Chapter 13 This chapter examines the bond market during the current time of extraordinarily low interest rates. The new Behavioral Insights section explores some of the behavioral biases that interfere with attempts to diversify effectively. The new Action Plan sets out a path to improve students' chances when investing in bonds.

Chapter 14 This chapter is updated to reflect new mutual fund sources available on the Web and the most recent academic research on mutual funds and performance. The new Behavioral Insights section looks at how patterns can interfere with choosing a mutual fund and how to choose mutual funds that will perform the best. The new Action Plan sets out a strategy for investing in mutual funds.

Chapter 15 This chapter now includes the latest information on retirement planning and corporate pension funds, as well as the increased difficulties that Americans face in meeting their retirement goals. The new Behavioral Insights section examines the behavioral biases of procrastination, choice overload, and inertia and the effects these biases have on reaching retirement goals. The Action Plan gives strategies and reinforces the reality that saving for retirement is real, is important, and needs to start now.

Chapter 16 The new introduction in Chapter 16 discusses the untimely death of James Gandolfini, who played Tony Soprano on the HBO series *The Sopranos*, and the shortcomings of his will. The chapter then reviews the current state of the federal estate tax laws. The new Behavioral Insights section looks at issues that prevent people from taking the steps necessary to do effective estate planning. Finally, the Action Plan summarizes important tasks involved in estate planning.

Chapter 17 This chapter ties together all of the topics covered in the book. We examine ten common financial life events and show students that the subject matter they studied in this course will prepare them for the resulting financial implications of these life events. In addition, a step-by-step game plan is set out to provide direction in successfully dealing with each financial life event. The chapter also ties together the coverage of debt, a topic that was discussed in a number of different chapters, looking at the trap of too much debt and the keys to successful debt management. The new Behavioral Insights section looks at the Prince Charming bias and examines the scholarly research on how to change financial behavior. The Final Action Plan pulls together a number of the concepts examined in earlier chapters and sets out instructions for a successful financial life. Students are assured that they "now know enough to put a financial plan in play, keep more of what you have, and really start your successful path toward 'Turning Money into Wealth.'"

For Instructors

Instructor's Resource Center **Register. Redeem. Log in.** **http://www.pearsonhighered.com/irc** is the Web site where instructors can download, in a digital format, a variety of print, media, and presentation resources that are available with this text. For most texts, resources such as Blackboard, WebCT, and Course Compass are also available for course management platforms.

It Gets Better. Once you register, you will not have additional forms to fill out or multiple usernames and passwords to remember in order to access new titles and/or editions. As a registered faculty member, you can log in directly to download resource files and receive immediate access and instructions for installing course management content to your campus server.

Need Help? Our dedicated technical support team is ready to assist instructors with questions about the media supplements that accompany this text. Visit **http://247pearsoned.custhelp.com/** for answers to frequently asked questions and toll-free user support phone numbers.

The following supplements are available to adopting instructors. Detailed descriptions of these supplements are provided at the Instructor's Resource Center:

- Instructor's Manual—Prepared by Sonya Britt of Kansas State University. The Instructor's Manual contains many features to aid with the navigation of this rich text. Among the features included for each chapter are a brief overview of the chapter's content (Chapter Summary); insight into how the chapter integrates with the other chapters in that part and the entire text (Chapter Context); a teaching outline of the concepts and terms to assist with chapter reviews (Chapter Outline); an explanation of the principles in the order they appear in the chapter (Applicable Principles); a sampling of projects that can be assigned as in-class group activities or as homework to increase the applied understanding of key concepts from the chapter (Suggested Projects); and sample solutions for all end-of-chapter questions, problems, and cases.

- Test Bank—Prepared by Oscar Solis of Virginia Tech and checked for accuracy by Thomas Krueger of Texas A&M University—Kingsville. The Test Bank for each chapter contains approximately 50–75 questions consisting of short-answer vocabulary, true/false, multiple-choice, and scenario-based questions.
- TestGen—The computerized TestGen package allows instructors to customize, save, and generate classroom tests. The TestGen program permits instructors to edit, add, or delete questions from the Test Bank, analyze test results, and organize a database of test and student results. This software allows for extensive flexibility and ease of use. It provides many options for organizing and displaying tests, along with search and sort features. Instructors can download the software and the Test Banks from the Instructor's Resource Center (**http://www.pearsonhighered.com/irc**).
- Instructor PowerPoint® slides—Prepared by Sonya Britt of Kansas State University. The PowerPoint slides provide the instructor with individual lecture outlines to accompany the text. The slides include many of the figures and tables from the text. Instructors can use these lecture notes as is or can easily modify the notes to reflect specific presentation needs.

For Students

Personal Finance Workbook The first section of this workbook is made up of a set of worksheets that provide you with the opportunity to answer problems from the book and develop and implement your own financial plan. References to the worksheets can be found throughout the text. The second section of this workbook contains Your Financial Plan, which guides you through a series of exercises that utilize the worksheets (also available online) and electronic calculators (found on **http://www.myfinancelab.com**). The third section contains step-by-step calculator keystrokes to help you calculate important personal finance formulas.

MyFinanceLab *Personal Finance*, Seventh Edition, is also available with MyFinanceLab. MyFinanceLab, a fully integrated homework and tutorial system, solves one of the biggest teaching problems in finance courses: providing students with unlimited practice homework problems along with a structured blueprint for studying the material. MyFinanceLab offers:

- Textbook problems online
- Algorithmically generated values for more practice
- Partial credit
- Personalized study plans
- Extra help for students
- Online gradebook

Selected end-of-chapter problems from the Problems and Activities and the Discussion Cases, as well as additional bonus problems that provide assessment and practice opportunities, are available in MyFinanceLab.

Acknowledgments

I gratefully acknowledge the assistance, support, and encouragement of those individuals who have contributed to *Personal Finance: Turning Money into Wealth.* Specifically, I wish to recognize the extremely helpful insights provided by many of my colleagues. For their careful comments and helpful reviews of this edition, I would like to thank:

Howard Davidoff, Brooklyn College
Caitlin DeSoye, Bentley University and University of New Hampshire
Robert B. McCalla, University of Wisconsin–Madison
James E. Parco, Colorado College
Clarence Rose, Radford University
Oscar J. Solis, Virginia Tech
Kevin Sullivan, Virginia Tech
Sam E. Veit, University of Wisconsin–Madison

I would also like to thank those who have provided very helpful insights in past editions. For their comments and reviews, I would like to thank:

Allen Arnold, University of Central Oklahoma
Mike Barry, Boston College
Karin Bonding, University of Virginia
Craig Bythewood, Florida Southern College
Ronald J. Cereola, James Madison University
Stephen Chambers, Johnson County Community College
Lynda S. Clark, Maple Woods Community College
Michael Collins, University of Wisconsin–Madison
Bobbie D. Corbett, Northern Virginia Community College
Charles P. Corcoran, University of Wisconsin–River Falls
Julie Cumbie, University of Central Oklahoma
Kathy J. Daruty, Los Angeles Pierce College
Richard A. Deus, Sacramento City College
Yuhong Fan, Weber State University
Beverly Fuller, Portland State University
Caroline S. Fulmer, University of Alabama
Michael Gordinier, Washington University in St. Louis
Ramon Griffin, Metropolitan State College of Denver
Jack Griggs, Abilene Christian University
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Katherine Kocher, University of Central Oklahoma
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Karen Korins, University of Northern Colorado

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Thomas Krueger, Texas A&M University–Kingsville
Karen Lahey, University of Akron
Frances Lawrence, Louisiana State University
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Abbas Mamoozadeh, Slippery Rock University of Pennsylvania
James A. Milanese, University of North Carolina, Greensboro
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Sally Wells, Columbia College
Alex White, Virginia Tech
Martha A. Zenns, Jamestown Community College

I would like to thank a wonderful group of people at Pearson Education. I must thank the Vice President of Business Publishing, Donna Battista, who has provided leadership from the top and has kept all the parts moving. Donna has transformed the finance list at Pearson, making it the best in the industry, and in doing so has helped make this book live up to its potential. I would also like to thank Kate Fernandes, my editor, who has been great to work with. Under Kate's guidance, I believe we have produced the finest possible textbook and supplements package. Kate is truly creative, insightful, and demanding—never settling for anything but the best. I also thank Meredith Gertz and Kathryn Dinovo, who served as the project manager and program manager, respectively, on this revision. They have been great to work with, continuously offering insights and direction and often serving as sounding boards for revisions and new ideas. Meredith and Kathryn were fun to work with, always keeping me on task. It seemed that a day did not go by when I didn't call one of them for advice or help on something. Meredith also saw the book through a complex production process and kept it all on schedule, while maintaining extremely high quality. In addition, I owe a debt of gratitude to Jeff Holcomb, Team Lead, Project

Management, who made this a much better book. Miguel Leonarte, who worked on MyFinanceLab, also deserves a word of thanks for making MyFinanceLab flow so seamlessly with the book. He has continued to refine and improve MyFinanceLab, and as a result of his efforts, it has become a learning tool without equal.

I should also thank Paul Donnelly and David Cohen. Paul is a past editor and good friend, without whom this project would never have been started. Dave once served as the developmental editor and helped mold this book into a text that is fun to read. My thanks also go to Heidi Allgair of Cenveo® Publisher Services, who oversaw the extended production team.

My appreciation to the people at Pearson would be incomplete without mention of the highly professional Pearson field sales staff and their managers. In my opinion, they are the best in the business, and I am honored to work with them. In particular, I must single out Bill Beville, retired national editorial advisor. He is one of the most dogged and delightful people I have ever met. Bill pursued me relentlessly until I agreed to do this book. I will always owe Bill a debt of gratitude. Bill, I'm glad you're on my side.

I also owe a great debt to Sonya Britt, an assistant professor of family studies and human services at Kansas State University and founding president of the Financial Therapy Association. In addition to preparing the PowerPoint slides and revising the Instructor's Manual, Sonya oversaw the revision of the end-of-chapter material. In doing so, she went well beyond the call of duty by refining, revising, and simplifying the end-of-chapter material and thereby greatly improving it. Her efforts made a meaningful impact on the book—strengthening it and making it more user friendly—and, as a result, she has improved the student experience. In addition, Sonya was always there to provide advice and opinions, which greatly improved this edition of the book. Moreover, she's one of the nicest and hardest-working individuals I have ever worked with. I am hoping this is a relationship that will carry on long into the future.

I must also thank Oscar Solis at Virginia Tech. He not only prepared the Test Bank but also provided excellent insights into the behavioral aspects of personal finance that were incorporated into the book.

I also express sincere gratitude to the accuracy checkers who meticulously reviewed the Seventh Edition. Thomas Kreuger at Texas A&M University–Kingsville reviewed both the textbook and the Instructor's Manual; Alan Wolk at the University of Georgia reviewed the Test Bank.

Finally, I must extend my thanks to my friend and colleague Ruth Lytton. While her role on this edition was limited, her efforts in the past helped produce the outstanding cases and end-of-chapter material currently in the book. Because she is a perfectionist and an award-winning teacher, her efforts result in a pedagogy that works. When working with Ruth, I am constantly in awe of her effortless grasp of the many aspects of personal finance and of her ability to make complex concepts accessible to any student. She is truly one of the "gifted ones." Her suggestions and insights made a profound impact on the book, from start to finish, and greatly added to its value.

In past editions, Derek Klock joined Ruth in working on the case and end-of-chapter material. Derek is exceptional! If you can think of a trait you would like a coworker to have, Derek has it. On top of all that, he is one of the nicest people I have ever had the opportunity to work with.

As a final word, I express my sincere thanks to those using *Personal Finance: Turning Money into Wealth* in the classroom. I thank you for making me a part of your team.

Arthur J. Keown

PART 1

Financial Planning

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

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

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

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

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

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

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

CHAPTER 1

The Financial Planning Process

Learning Objectives

LO1	**Explain** why personal financial planning is so important.	**Facing Financial Challenges**
LO2	**Describe** the five basic steps of personal financial planning.	**The Personal Financial Planning Process**
LO3	**Set** your financial goals.	**Establishing Your Financial Goals**
LO4	**Explain** how career management and education can determine your income level.	**Thinking About Your Career**
LO5	**Explain** the personal finance lessons learned in the recent economic downturn.	**Lessons from the Recent Economic Downturn**
LO6	**List** ten principles of personal finance.	**Ten Principles of Personal Finance**

After nine years, the popular TV sitcom *How I Met Your Mother* came to a close. It is widely agreed that the strength of the show was that the audience could intimately relate to so many of the story lines affecting the five main characters. Marshall and Lily play the part of the loving, but somewhat goofy, married couple. Marshall is a young lawyer and Lily is a kindergarten teacher, who, along with their friends, Robin, Ted, and Barney, get into some improbable predicaments, but the financial problems they face are, unfortunately, all too realistic.

Marshall has his law degree, is loaded with student loan debt, and has to make a decision whether to take his low-paying dream job with the nonprofit NRDC or a

high-paying job with an evil law firm. It's a choice of money versus his dream, and he ends up taking the money. Meanwhile, Lily is back at their apartment with girlfriend Robin, looking over some of her new purchases. Robin asks, "How can you afford such expensive clothes?" The answer is, as you might expect, on credit, and apparently Lily has a lot of debt. As Robin says, "Lily, you have debt the size of Mount Waddington!" "Waddington?" Lily responds. "It's the tallest mountain in Canada. It's like 4,000 meters high," Robin explains. "Meters?" Lily responds—apparently Lily knows about as much about meters as she does about personal finance.

Clever and improbable plot line? Not really. Unfortunately, personal financial problems and their avoidance are all too common. It's much easier to postpone dealing with money problems than to confront them. In fact, Lily said she was intending to take care of her credit card debt just as soon as she finished furnishing their apartment. As Robin responded, "You should be on a reality show."

How much do you know about personal finance? Hopefully more than Lily, but probably not enough. That's pretty much how it is for everyone until they've made a real effort to learn about personal finance. When did Marshall find out about Lily's credit card problems? Not until a few seasons later when they found their dream home and the loan officer informed them that their approved interest rate would be 18%!

Being financially secure involves more than just making money—life will be easier when you learn to balance what you make with what you spend. Unfortunately, financial planning is not something that comes naturally to most people. This text will provide you with the know-how to avoid financial pitfalls and to achieve your financial goals, whether they include a new car, a vacation home, or early retirement. In addition to providing the necessary tools and techniques for managing your personal finances, you will learn the logic behind them, allowing you to understand why they work. To make life a little easier, you will be introduced to ten basic principles that reinforce this underlying logic. If you understand these principles, you are well on your way to successful financial planning. It's just too bad Lily didn't take this class.

LO1 Explain why personal financial planning is so important.

Facing Financial Challenges

How big are the financial challenges you face? You may be gaining an appreciation for the cost of college. College tuition and fees at a private school average around $29,056 per year; at a public school, the average is $8,655 per year. Add to this the cost of housing and food, textbooks and computer equipment, and the "essentials"—a mini-refrigerator, a parking permit, lots of change for the laundry, a bit more cash to cover library fines, and late-night pizza money. How do most students finance the cost of college? The answer is, by borrowing.

Today, the typical grad with loans—and that's about half of all college students—will leave college with both a diploma and about $29,000 in student loans, and according to a recent Fidelity survey, if you add in credit card, personal, and family loans, student debt climbs to over $35,000—and many students are far more in debt than that. Take, for example, Sheri Springs-Phillips, who was written about in the *Wall Street Journal.* She's a neurology resident at Loyola University Medical Center. On her 11-year journey from the South Side of Chicago to becoming a doctor, she piled up $102,000 in debt. Although her friends think she's got it made, she worries about the $2,500 monthly loan payments that begin when she finishes her residency. Fortunately, Sheri is an exception, but just the average level of debt can be daunting. However, with a solid financial plan, even this level of debt is manageable.

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

STOP & THINK

Why do people *need* to make a financial plan? Because it's always easier to spend than to save. According to a survey by Thrivent Financial, more than half of nonretired adult Americans have less than $10,000 saved for retirement. On top of that, 54 percent said they've never tried to determine how much money they will need to save for retirement. How do you see yourself in retirement? Now, do you think you need a plan?

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

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

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

expenses for which you'll have to plan ahead financially. Financial planning will help you map out a strategy to pay for a house by the beach or a trip around the world.

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

The Personal Financial Planning Process

LO2 Describe the five basic steps of personal financial planning.

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

Step 1: Evaluate Your Financial Health

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

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

Step 2: Define Your Financial Goals

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

STOP & THINK

According to a recent Retirement Confidence Survey, retirement was the number one savings goal for Americans. It was listed 3½ times more often by those surveyed than the number two savings goal, which was a child's or grandchild's education. But while Americans feel retirement savings are important, they don't seem to be making much progress saving. That same survey showed that 54 percent of all workers had saved less than $25,000 (not including the value of their primary residence) and 63 percent of Americans aged 55 and older have less than $100,000 in savings. Only 30 percent of those in this 55-and-older group have an annual income of more than $25,000; 45 percent have an annual income of less than $15,000! And these figures include Social Security benefits! Retirement is only one of many reasons financial planning is so important. As Carl Sandburg once wrote, "Nothing happens unless first a dream." Why do you think goals are so important?

Step 3: Develop a Plan of Action

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

Flexibility Remember when we mentioned planning for the unplanned? That's what flexibility is all about. Your financial plan must be flexible enough to respond to changes in your life and unexpected events, such as losing your job or rear-ending the Honda in front of you. An investment plan that doesn't allow you to access your money until you retire doesn't do you much good when you suddenly get fired for using your office computer to play 2048, BioShock, or the Stanley Parable.

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

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

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

STOP & THINK

It's much easier to be satisfied if you think of working toward goals rather than working toward becoming "rich." That goes back to Ecclesiastes 5:10, "He that loveth silver shall not be satisfied with silver." What do you think this means?

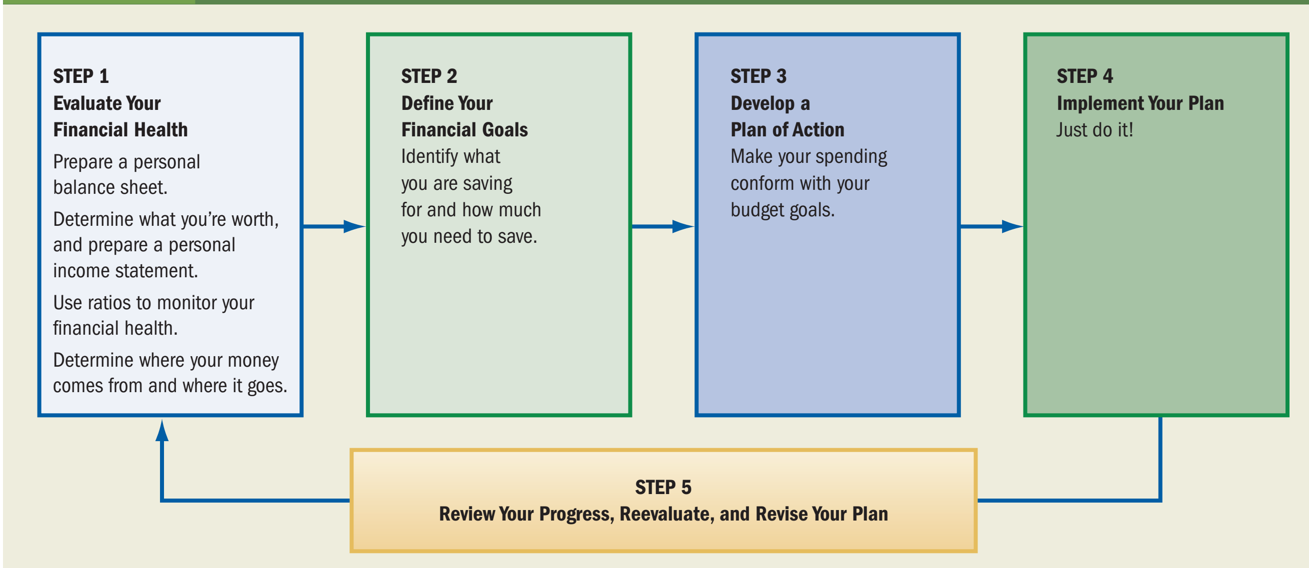
Minimization of Taxes Finally, your financial plan must take taxes into account. Keep in mind that a chunk of your earnings goes to the government, so if you need to earn \$1,000 from an investment, make sure it yields \$1,000 *after taxes.* While you want to pay as little in tax as possible, your goal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

Step 4: Implement Your Plan

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

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

FIGURE 1.1 The Budgeting and Planning Process



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

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

Figure 1.1 summarizes these five basic steps to financial planning.

Establishing Your Financial Goals

LO3 Set your financial goals.

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

WORKSHEET 1

Figure 1.2 is a worksheet that lists examples of short-term, intermediate-, and long-term goals. You can use it to determine your own objectives. In setting your goals, be as specific as possible. Rather than aiming to "save money," state the purpose of your saving efforts, such as buying a car, and determine exactly how much you want saved by what time. Also, be realistic. Your goals should reflect your financial and life situations. It's a bit unrealistic to plan for a $100,000 Porsche on an income of $15,000 a year.

Once you've set up a list of goals, you need to rank them. Prioritizing goals may make you realize that some of your goals are simply unrealistic, and you may need to reevaluate them. However, once you have your final goals in place, they become the cornerstone of your personal financial plan, serving as a guide to action and a benchmark for assessing the effectiveness of the plan.

FIGURE 1.2 Personal Financial Goals Worksheet

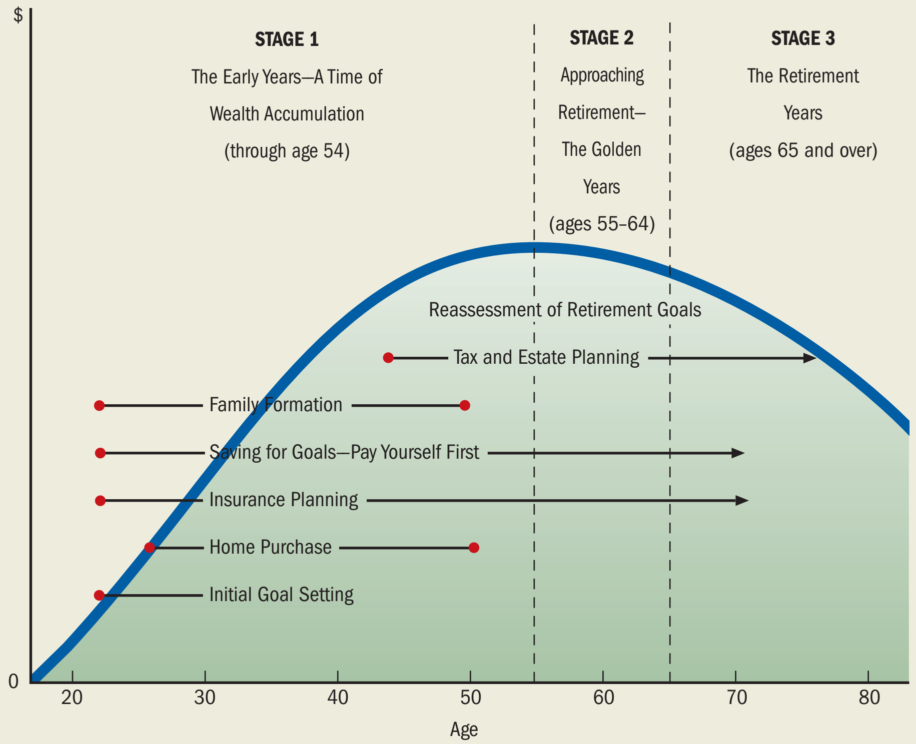
Goal	Priority Level	Desired Achievement Date	Anticipated Cost
Short-Term Goals (less than 1 year)			
Accumulate Emergency Funds Equal to 3 Months' Living Expenses	________	________	________
Pay Off Outstanding Bills	________	________	________
Pay Off Outstanding Credit Cards	________	________	________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

The Life Cycle of Financial Planning

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

The first 17 or 18 years of our lives tend to involve negative income (and you thought it was only you). You can think of this as the "prenatal" stage of your financial life cycle. During this period, most people are in school and still depend on their parents to pay the bills. After high school, you may get a job, or attend college, or do both. Regardless, once your education is completed, your financial life cycle may begin in earnest. This first stage can be decades long and centers on the accumulation of wealth. For most people, this period continues through their mid-50s. During this time, goal setting, insurance, home buying, and family formation get the spotlight in terms of planning.

FIGURE 1.3 A Typical Individual's Financial Life Cycle



Complications:

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

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

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

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

Think of the financial life cycle in terms of a family life cycle. Consider a couple that marries in their 20s or 30s, has kids shortly thereafter, spends the next 18 or 20 years raising the kids and putting them through college, and then settles down as a couple again when the kids move out to form their own families. Obviously, a typical individual's experiences don't fit everyone perfectly. Today, with more single-parent families and more young people postponing marriage, it simply isn't reasonable to refer to any family experience as typical. However, regardless of how unusual your life is, you'll be surprised at how much it has in common with a typical financial life cycle.

The early years are different for everyone. For many people, however, the biggest investment of a lifetime, purchasing a home, occurs during these early years. With a