

Second Edition

PERSONAL FINANCIAL PLANNING

Lewis J. Altfest

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Hill
Education

Personal Financial Planning

The McGraw-Hill/Irwin Series in Finance, Insurance, and Real Estate

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Principles of Corporate Finance

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White

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Investments

Tenth Edition

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Tenth Edition

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Fifth Edition

Kapoor, Dlabay, Hughes, and Hart

Personal Finance

Eleventh Edition

Walker and Walker
Personal Finance: Building Your Future

Second Edition

Second Edition

Personal Financial Planning

Lewis J. Altfest, Ph.D.
Pace University





PERSONAL FINANCIAL PLANNING, SECOND EDITION

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To my wife, Karen. Her success as a financial planner after receiving a Ph.D. in an unrelated field made her inputs particularly valuable in constructing this text and its second edition. Perhaps more importantly, through her ability to balance a career and dedication to our children and the quality of our lives together, she created an environment that made this book possible.

About the Author

Lewis J. Altfest, Ph.D., CFP, CFA, CPA, PFS

Lewis J. Altfest has balanced a career in financial planning and investing with one as an associate professor of finance. He began as an accountant working for a then “Big 8” accounting firm and became a Certified Public Accountant. After some shorter-lived ventures, he joined the Wall Street firm of Wertheim and Co. in its investment research department. He held similar positions with Lehman Brothers and Lord Abbett & Co.

At Lord Abbett & Co., an investment management firm, he rose to become Director of Investment Research, Chief of Long Range Strategy, and a general partner of the firm. At the same time, he began seriously pursuing a Ph.D. and teaching part-time. It was at Lord Abbett that Lewis Altfest decided to focus on helping individuals instead of institutions. He wanted to become the “*Consumer Reports* of Financial Planning,” that is, to provide unbiased financial and investment advice and to dedicate himself to instructing students and the public on financial matters.

In 1982, he established a financial planning and investments firm along with another individual and in 1983 incorporated a firm performing activities by himself. At about the same time, he joined the faculty of Pace University as Associate Professor of Finance.

His wife, Karen C. Altfest, joined him in business shortly thereafter (his son some 20 years later), and together they have established a nationally recognized multi-person financial and investment advisory firm, Altfest Personal Wealth Management Inc., located in New York City.

Dr. Altfest has been active in financial planning industry matters for over 30 years, interacting with other planners nationwide, and has been an original member and a member of the board of directors of the National Association of Personal Financial Advisors and served on the board of directors of the IAFP New York Chapter, the predecessor of the Financial Planning Association, and on the board of the Educational Foundation of NAPFA as well. He was named one of NAPFA’s 30 most influential advisors in 2013.

Over the past 30+ years, Dr. Altfest has been named to Best Planners in the United States lists by *Money* magazine, *Worth Magazine*, *Mutual Funds Magazine*, and *Medical Economics*. Over the past 10 years and again in 2014 *Barron’s* named Dr. Altfest one of the “Top 100 Independent Financial Advisors in the Nation.” In 2014, he was inducted into *Research* magazine’s Hall of Fame, and Dr. Altfest’s firm was named by *Financial Times* magazine as one of the Top 300. In 2014, he received The Best Practices Award Recognizing Altfest Personal Wealth Management as a Best Managed Firm by *Investment News*. He has been included among Bloomberg’s “Top Wealth Managers.” He was also awarded the Lifetime Achievement Award by *Financial Planning* magazine.

At Pace University, he has been active in many pursuits, including serving on the University’s employee benefits committee, chairing the Lubin School’s Graduate Division tenure committee, and chairing the finance department’s recruitment and tenure committees. He has published academic research papers in financial planning and investing and has two other books, *Introduction to Business* (Harper and Row), and *Lew Altfest Answers Almost All Your Questions about Money* (McGraw-Hill), which he co-authored with his wife.

Dr. Altfest participates in many professional and academic associations today, including the FPA, NAPFA, CFA Institute, and AICPA, and is an original member of the Academy of Financial Services. His advice and research have been quoted in such media as *The New York Times*, *The Wall Street Journal*, *Newsweek*, *US News and World Report*, *Fortune*, *BusinessWeek*, *Money Financial Advisor*, *Financial Planning*, *Investment News*,

Bloomberg Wealth Manager, and *Bottom Line*, and he has written a monthly column for *Medical Economics* for over a decade. He has appeared on CBS, ABC, NBC, CNN, CNBC, and others. For his role in the development of the financial planning profession, the Business and Economics Alumni Society of the City College of New York chose Dr. Altfest as their 2006 Career Achievement Award recipient. Baruch College, the then undergraduate division of City College of New York, provided him with the Alumnus of Distinction Award in 2012. He has been named an Alumnus of the Year by CUNY Graduate Center Alumni Association, where he received his Ph.D. degree.

You can catch him on Saturdays and Sundays relaxing on the deck of his weekend home, alternately doing work, talking to Karen, and gazing at the birds in the treetops, which one of his clients assured him would add years to his life.

Preface

GOALS OF THE BOOK

Personal Financial Planning is designed to be used for the study of personal finance and financial planning from a planner's perspective. This text goes beyond the traditional personal finance texts to teach students how to do actual financial planning and integrates the theory and practice of personal finance.

This book incorporates a theory of personal financial planning that demonstrates the similarities and differences between personal and business finance and integrates the entire body of financial material presented. It is intended to utilize the theoretical contributions over the past half-century, particularly modern portfolio theory, to elevate the level of presentation. At the same time, its goal is to remain easy to understand and useful in real life.

Instructors of education courses, whether for general or CFP® certification preparation purposes, may consider the text's practical combination of planning facts, analysis, and frequent step-by-step instructions attractive. Experienced financial planners and other professionals looking for a one-volume reference to the planning field from a practitioner's perspective, or who may be considering pursuing the Certified Financial Planner™ (CFP®) certification should also find the book appealing. Those who would like to plan their own financial future in a comprehensive way also should find the text informative.

THEMES

This text is unified by a few themes. One is that the household resembles a business and can profitably use its financial techniques. Another is that decisions for the household, for you, include all operations and all assets and obligations. In other words, decisions are ultimately made on an integrated basis. Whether we are engaged in investment activities or mapping retirement plans, we are performing household operations that fall under personal financial planning's mandate.

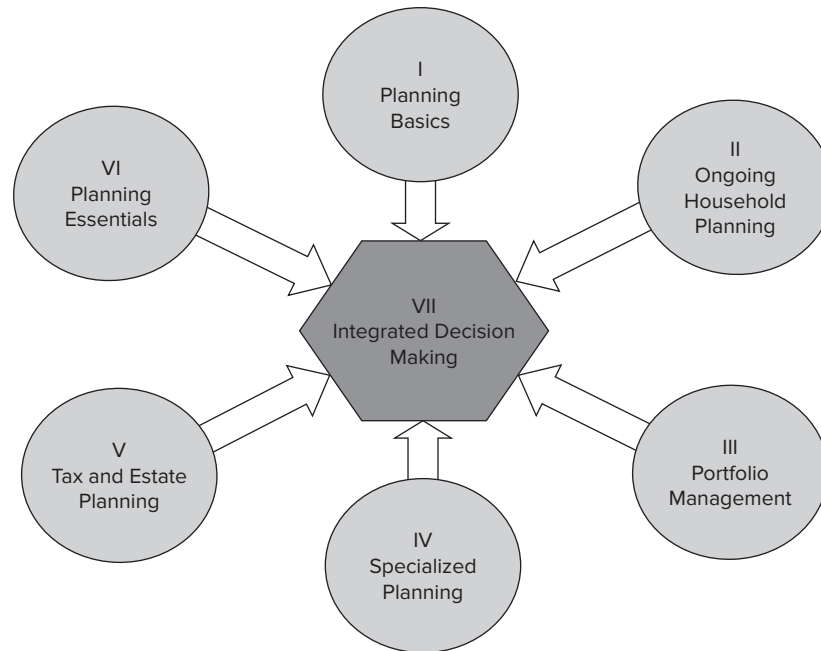
Our personal financial planning objective is effective household operations that we achieve through logical, businesslike financial procedures. Households whose activities are financially efficient have the foundation for personal goal achievement. This approach is covered in more detail in Chapter 4.

ORGANIZATION

In keeping with its practical emphasis, *Personal Financial Planning* is largely ordered around the parts of a financial plan. Its parts all funnel into the final section, Integrated Decision Making. The approach is illustrated in Figure A.

Many of the chapters that require active planning use a full or modified process-oriented approach that takes the student through the methodology point by point. This approach not only provides an easy-to-follow structure; it also better prepares financial planning majors for more advanced material to come.

FIGURE A
Sections of the Book



Content

Personal financial planning is an unusually broad discipline that requires knowledge of topics ranging from mathematics to human interaction. Not coincidentally, there is an introductory chapter in Part One that presents virtually all the mathematical material needed in simple fashion with solved examples for each step. It is a feature of the book that all new concepts are followed by examples using generic calculator solutions where possible and Excel-based solutions in the text and on the website.

The human side of the process, which is often overlooked, is presented in Chapter 3 in the sections that stress communications and goal setting. Human actions are expanded on in a separate chapter, “Behavioral Financial Planning” (Chapter 18), which presents the latest thinking on the topic. Practical examples of its contributions are given in each major area of personal financial planning.

In keeping with the practical nature of the text there is a final chapter, “Completing the Process,” that truly explores the finishing process. To the author’s knowledge, this is the only textbook to cover PFP integration and overall decision making in detail. The chapter could have been called simply “Completing the Financial Plan.” However, it essentially does more, indicating how certain tools and practices demonstrate the comprehensive nature of PFP and improve the completion process. It is this integration that requires overall decision making that differentiates personal financial planning from personal finance and from other professions that offer financial advice.

Personal finance and investments courses alike tend to treat financial investments as the centerpiece of investment material. There are other assets, namely human-related and real assets, that importantly enter into decision making. In Chapter 8, “Household Investments,” these investments, often given less emphasis, are described and analyzed in detail.

The text has one review chapter in Part Six, “Planning Essentials.” Chapter 16, “Stocks, Bonds, and Mutual Funds,” provides those without a proper background, or students in need of a review, with a quick upgrading in usable knowledge in investment categories. Included is descriptive material on stocks, bonds, mutual funds, and exchange-traded funds.

Normal Financial Coursework and CFP® Preparation

Current or possible future CFP® candidates can receive credit toward CFP® requirements in a regular financial planning course.¹ *Personal Financial Planning* provides all the specific material necessary to comply with CFP® required content areas. It is an appropriate method of presentation for all students, not just financial planning majors. Its emphasis on practical material, theory, case study analysis, and “how to do it approach” provides a broader experience for both one-time students and those headed for CFP® status.

Professors who desire further descriptive coverage, including those who prefer enhanced CFP® certification preparation information, will find special chapters for that purpose as well. Suggested syllabi and outlines are provided for classes: 1) intended solely for students interested in a CFP® and 2) for combined regular survey and CFP® students. This will accommodate all students interested in applying for CFP® credit as detailed in the Instructor’s Manual found on the book’s website.

FEATURES

There are a number of features throughout the chapters to help bring the text material to life.

- **Chapter Goals**

The goals of each chapter are stated at the beginning of that chapter. They are most often expressed in action-oriented terms to emphasize the usefulness of the material in daily situations.

- **Dan and Laura Opening Case**

A key feature is the use of a single case study that is developed throughout the text. Each chapter starts with a relevant sentence or two from that chapter’s event. Significantly at chapter’s end, Dan and Laura’s day-to-day problems are stated and answered from a financial planning practitioner’s point of view. This ongoing case study also reviews the chapter’s material and places it in a broader context. The case permits the student to understand how the chapter’s material can be applied to real-life situations and experience the information-gathering process as a professional interviewer would. Reviewers have said that this case study, which is deeper than a typical academic one, is more interesting and closer to a student’s own experiences.

- **Real-Life Planning**

Almost every chapter starts with a minicase called “Real-Life Planning.” It sets the stage for the educational material to follow. Students have found these “stories,” largely based on the author’s own experiences with clients and told in a nontechnical manner, an interesting, easy-to-relate-to way to begin the chapter.²

- **Key Terms**

Key words are presented in boldface to highlight terms and concepts that are emphasized.

- **Practical Comments**

Practical Comments are often used to underscore the situations in which real human actions differ from the way the book tells you it should be done. These highlighted

¹ The course must comply with coverage of CFP® required areas. If it does the student can receive credit toward eligibility for the exam and the CFP® within a normal academic curriculum without it being taken through a CFP® Board-Registered Program. “The CFP® Board will consider granting credit toward the educational course work requirement for CFP® certification if: 1. You can submit documentation that you have successfully completed equivalent approved upper division level college or university coursework at a regionally accredited college or university . . .” See CFP® Board education requirement for further details—<http://www.cfp.net/become-a-cfp-professional/cfp-certification-requirements/education-requirement>.

² Certain material has been altered in part to protect the identities of the people who are discussed.

boxes' recommendations, given to meet the issues at hand, carry the tone of a financial planner who has dealt extensively with these circumstances.

- **Tables and Figures**

Tables and figures have been placed throughout the text. Wherever useful, the tables have presented a summary of factual material in an easy-to-refer-to manner.

- **Examples**

As we mentioned, there are many examples given, particularly in mathematical and more-difficult-to-describe concepts. Special efforts are made to provide an answer for every type of problem, often including an explanation of why a particular step is taken.

- **Excel and Calculator Examples**

Excel is explained and solutions are given for all appropriate problems in the appendix to the text and on the website. In addition, calculator solutions are provided on a generic pictorial basis in the body of the text where possible, thereby allowing any financial calculator to be used to solve those problems. Where problems are more complex, key-strokes of two leading calculators, the HP12C and the TI BAII Plus, are illustrated right in the example.

- **Comprehensive Financial Plan**

An actual comprehensive financial plan is provided on the website. It is based on the Dan and Laura case study presented by chapter, but this time in a more compact manner after final decisions have been made. Students should gain an appreciation for how an actual financial plan looks and, together with chapter presentations, how it is developed.

There are many end-of-chapter study tools to be used for self-study and/or homework:

- **Chapter Summary**

The salient points of the chapter are placed here. Together with the goals section and key terms, it can guide the student into a better understanding of the chapter's points.

- **Key Terms List with Page References**

This feature provides in one place a useful compendium of important terms introduced in the text.

- **Websites**

Selected websites indicate where additional information can be obtained.

- **Questions and Problems**

A select list of questions is presented representing a mixture of factual and evaluative matters. The problems stress mathematical computation as a practical exercise of the chapter's numerical material.

- **CFP® Certification Examination Questions**

A broad list of former CFP® certification examination questions is provided. These demonstrate selected areas of emphasis for those contemplating taking the exam. They also present many practical questions that require students to demonstrate knowledge of the chapter's topics.

- **Case Application and Questions**

There is a second case study, called Case Application, that is similar in approach to the first one about Dan and Laura. However, instead of having a solution given in the text, this one is to be prepared and submitted by the student and/or discussed in class.

- **Student Financial Plan**

Instructors who wish to schedule a term project for students doing a financial plan for "clients" can do so. In my experience of over 30 years teaching PFP to matriculating

undergraduate and graduate students, this assignment is very popular. The knowledge derived from the two case studies in each chapter and the full financial plan on the website enable students to prepare their plans well.

There are also a Glossary and Suggested Readings at the end of the book.

CHANGES IN SECOND EDITION

This book goes beyond the presentation of basic facts to teach people how to perform personal financial planning. Since the first edition, the field has become more sophisticated both from the standpoint of the professionals who offer PFP and the consumers who increasingly desire broader and deeper knowledge from their financial advisors. At the same time, the public and many students want practical information presented in easy-to-understand terms that don't speak down to them. Feedback on the first edition indicated that students felt the book was easy to read. The second edition, as described below, adds new sections and text material that significantly enhances the ease of understanding, practicality, and further relatability to college students and provides a lively new Life Cycle Planning section. It also has a subtle new summary of many chapters done in a partly narrative style.

College Age Case Study and Overall Chapter Review

A new third case study, called "College Student Case Study and Review: Amy and John," has two purposes. The first is to provide college-age undergraduate and graduate students, many of whom have not yet established their own households, with issues and interests they can relate to. It presents Amy and John as students with varying challenges and gives instructions on how to overcome them in appropriate chapters. The second purpose is to present a summary of these chapters, whether used as an introduction to or summation of the key points in the text. This partly narrative summary is set in a simpler and less formal style. Those looking for a simple placing together of the major ideas of the chapter irrespective of their ages should find this case study highly useful.

Professional Advice

This new boxed section presented in many chapters adds more news you can use. It presents recommendations on how to resolve common problems people encounter. It is based on the author's more than 30 years of experience as a practitioner helping literally thousands of people.

Life Cycle Planning

This new section placed at the end of most chapters takes the reader through age-related issues ranging from college days to post retirement. It is presented in an action-oriented style from a practitioner's standpoint. Its approach is intended to be concise and informal.

New Real Estate Chapter

It is clear that interest in real estate, whether it be the home or independent properties, has grown sharply in recent periods. This new Chapter 9, "Real Estate and Other Assets," presents a simplified description of the topic. It also provides a brief description of other alternatives to stocks and bonds.

Revision of Capital Needs Analysis Chapter

Chapter 17, "Capital Needs Analysis," presents the traditional answer to calculating the amount needed to bring about a comfortable retirement. A new, simpler method for calculating that amount is also given.

Modification of Financial Investments Chapter

Chapter 10, “Financial Investments,” shifts practical step-by-step information on selecting investments and constructing a portfolio using mutual funds from the background investments in Chapter 16 and simplifies other technical information. It also provides more attention to exchange-traded funds (ETFs), which have grown more popular in recent years.

Updating Financial Planning

Taxes, economic circumstances, retirement planning, investments, and insurance alternatives are among the areas that have changed since the first edition. Taken together, the financial planning field has grown in numbers and sophistication. These new factors have been reflected in the second edition throughout the book.

SUPPLEMENTS

Online Learning Center

www.mhhe.com/altfest2e

The Online Learning Center contains the following assets, which are password-protected for instructors only:

- *Instructor’s Manual*. Includes solutions for end-of-chapter questions, problems, and case studies.
- *Test bank*. Word files containing 30–40 questions, including true-false, multiple choice, and essays, prepared by Aron Gottesman, Associate Professor of Finance, Pace University.
- *PowerPoint slides*. PowerPoint slides for each chapter to use in classroom lecture settings, created by Aron Gottesman, Associate Professor of Finance, Pace University.

New Second Edition Instructor Material:

- Detailed course syllabus including recommended chapter coverage by individual class session provided by type of student (undergraduate, graduate finance major, non-finance major, CFP® prep, combined regular survey and CFP® prep, simpler approach, adult education).
- Comments and suggestions on introducing and conveying material is given by chapter. The comments are based on the author’s more than 30 years of teaching the course.
- Adjustments to test bank and PowerPoint slides done by author.

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My personal thanks to all academic reviewers. Each contributed importantly to the final copy. Their knowledge of the material and understanding of what it takes to communicate it effectively significantly enhanced the book.

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Inside Information

Henry Wendel, CFP®

Wendel Financial Planner &

Investment Advisor

I would like to thank my colleagues at Pace University who assisted me by providing constructive suggestions, including Michael Szenberg, Ron Filante, Aron Gottesman, Qi Lu, Jouahn Nam, Alan Tucker, and P. V. Viswanath. I am also grateful to my graduate assistants over the term of this project. One in particular stands out. Oktay Veliev not only was extremely helpful in production aspects treating the book as if it were his own but was responsible for many of the creative diagrams and software examples.

Finally, I am grateful to members of my professional staff. Ekta Patel, Dawn Brown, and Michael Prendergast were of material assistance as were administrative staff members Helen Cummings and Marina Marsillo. However, three others stand out. The first is Karen C. Altfest, who provided a strong contribution in overall advice and chapter reviews. The second is Paul Palazzo, who made a major contribution to the case study and helped in several other areas. Lastly, I want to thank Dr. Abe Fenster for his constructive suggestions, pedagogy, and continuing support in the strategy and execution of this book.

The second edition benefited importantly from Andrew Altfest, whose assistance in all areas of the book was very valuable. I also received a material contribution from the analytical and updating skills of Don Korn. In addition, members of my professional staff reviewed and made suggestions including Paul Palazzo. Significant contributions were made by Dawn Brown, Boyan Doytchinov, Brett Fry, Steven Cadoff, and Brendan McEwan. Dr. Abe Fenster continued his high level support in the revised edition that was in total very important. Harvey Goldfarb of All Risk Insurance was a huge help with the life insurance example and data, as was Alex Smith of Ashton Benefits with health insurance as well and Richard Rothberg of Cooley LLP was invaluable with the Estate Planning chapter. Finally, thanks for editorial assistance to Prateeksha Sabhani, Yisroel Zylberberg, and Matthew Suchow, all of whom made substantive improvements to the book.

It is my hope that this book will contribute to the further development of personal financial planning and enhance the stature of the discipline, the instructors who teach the course, the professionals who practice its fundamentals, as well as motivate students in its career possibilities.

Lewis J. Altfest
(*LJA@Altfest.com*)

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3. Beginning the Planning Process

In this part, Planning Basics, you will learn the preliminaries necessary to perform personal financial planning. Chapter 1 is an overview of the entire PFP process and details the segments of a financial plan. It also introduces a case study that we will develop throughout the book. Unlike many other case studies you may have come across, this one provides the solutions using the facts developed by a financial planning practitioner.

Chapter 2 examines the time value of money, one of the basic ideas in finance. It provides virtually all the mathematical techniques you will need to perform the calculations required throughout the book. Chapter 3 begins the planning process with what can be called its initial stages. These include goal setting, data gathering, and understanding how to communicate with others.

With an understanding of these topics, these topics under your belt, you will be prepared for the financial planning activities that lie ahead.

Chapter One

Introduction to Personal Financial Planning

Chapter Goals

This chapter will enable you to:

- Understand what personal financial planning (PFP) is and how it works.
- Place goals at the head of the PFP process.
- Become familiar with PFP's financial and personal frameworks.
- Understand the specific role of financial planning and the financial plan as a comprehensive integrated process.

Dan and Laura, both age 35, were recently married. Each works, Dan as a systems engineer and Laura as a teacher. They want to make major decisions concerning their lives, and they have questions about the cost and the timing of having children, purchasing a house, and maintaining a “great” lifestyle. They have heard that personal financial planning might be helpful. Dan and Laura know little about finance and nothing about planning, so they made an appointment with a financial planner to find out about it. Their questions are basic: What is personal financial planning? How can it help us achieve our goals? Can we do financial planning ourselves? Their immediate concern is the debt they are accumulating. (To be continued at chapter's end.)

Real-Life Planning

Maria stepped into the advisor's office looking awkward. She appeared to be unsure that she belonged there. Maria wasn't the advisor's typical client. She was a young messenger for a national package delivery firm who had occasionally delivered items to the advisor's previous office location. She arrived in her uniform without an appointment. Her face showed that she was troubled by something and needed an answer right then.

The advisor ushered her into his office, offered her a soft drink, and discussed some things they had in common. When she seemed more at ease, he asked why she had come. She said her husband was thinking of purchasing a second house and renting it out. She, on the other hand, was against doing this. It would require almost all of their nonretirement savings for just the down payment and they would have to take on significant additional mortgage debt. She said she could not stop thinking that if this investment soured, it could ruin their savings, expose their existing investment in their home to risk, and, most

importantly, jeopardize their plans to raise a family. Maria said that the dispute was seriously affecting their relationship and she and her husband fought constantly over this outlay. She asked the advisor what he thought of the investment for them.

The advisor did some data gathering. He found that both husband and wife had full-time jobs that provided moderate sources of income. They seemed to have sound financial operations that generated significant savings each year, and they had accumulated a decent sum. Both liked their work and had opportunities to advance and raise their income. They planned on working until full retirement in their existing jobs even if the government pushed back the retirement age for full Social Security.

They had no debt outstanding except for their mortgage. Their employer covered their health insurance and other benefits, and they had purchased additional life insurance on their own. Like many young people, they hadn't gotten around to making a will.

Their goals were not complex. They wanted to start a family within a few years and to continue what was from the advisor's perspective a relatively modest but comfortable lifestyle. Maria said they didn't want to worry about their financial future.

The advisor then focused on the real estate investment. He asked her the purchase cost of what turned out to be another house in their neighborhood. A quick calculation indicated they could make a significant annual sum by renting it out after expenses, including interest on debt borrowed and maintenance costs. The advisor asked whether she was confident of the figures, and she said that she knew both projected rental income and costs. Her husband was handy and would supervise the project. The advisor asked about the outlook for the neighborhood and was told it was one for people with modest incomes but was becoming popular with younger, more affluent urban dwellers.

The advisor then thought about what he wanted to say to Maria. Often his recommendations incorporated two factors, a blend of what was financially best and, whenever feasible, what the client's preferred alternative was. In this case, he believed there was no conflict between the two approaches. The husband was not an irrational risk taker. Purchase of the house made financial sense. What remained were Maria's concerns.

The advisor decided to find out whether Maria had a low tolerance for risk or just needed some advice and support in an area she feared. Despite not having enough notice to analyze the situation in greater depth, he told her that while any investment contained risk, this investment seemed sound. If her figures and appraisal were correct, her husband should be commended for his enterprising thoughts. The investment income from the property could replenish their savings fairly quickly. Moreover, it could bring them closer to realizing their financial goals.

The smile that broke out on her face and her more relaxed manner told the advisor that all she needed was some confidence in the idea. He gave her the names of some mutual funds to invest in when their cash was re-established and advised her to make an appointment with a lawyer to draw up a will within two weeks. He told her to review the real estate investment and her savings each year after it was bought. The advisor declined any money for this "engagement." He said the satisfaction he got from being helpful was pay enough.

As he accompanied her out, the advisor realized that he had performed the major steps in the financial planning process. Both he and Maria had established that the planning scope was to discuss the real estate investment. However, in order to make proper recommendations, he had to gather data, establish goals, and analyze a broad range of information.

In fact, in the space of a very short time he had composed a kind of financial checkup with selected elements of a mini-financial plan for someone with a fairly simple financial life. He had concluded that the couple was on the right financial path. He made some recommendations and included some implementation steps that extended the original scope. The whole process was completed over a moderately longer than normal lunch period, just in time for his next scheduled client.

OVERVIEW

Personal financial planning (PFP) is a practical activity whose objective is to help achieve your goals. This chapter provides an introduction to it and begins with a look at the overall planning setting including why PFP is important, its history, and its placement within the finance field.

The chapter moves on to the heart of planning, describing the fixed process that is used to increase the chance for reaching the objective. The planning process is what defines the profession of personal financial planning. The financial plan itself is discussed with an emphasis on its comprehensive integrated approach.

Finally, the chapter discusses financial planning as a career and the practice standards to which planners must adhere.

Thereafter, the Dan and Laura financial plan is introduced, which will serve as a unified case study for each chapter in the book. You should find it useful in helping you understand how actual planning is performed.

Knowing how financial planning operates as described in this chapter will serve as a useful backdrop for the information and techniques to be introduced throughout the book. More importantly, knowledge of this information and utilization of the PFP process should result in better decision making and improvement in outcomes. In other words, it can provide material help in achieving the goals you set out.

WHY IS FINANCIAL PLANNING IMPORTANT?

Financial planning is important because we live in a fast-paced world in which an ever-increasing number of financial alternatives are presented to us. At the same time, information through all kinds of media, including the Internet, is available to help us make selections. Making wise decisions enables us to achieve our goals. Financial planning, which includes gaining insight into the efficient way to perform a task and then handling it in a logical, disciplined way, enables us to further our objectives.

Personal financial planning has become even more important in the twenty-first century because of the extraordinary events that have already transpired. For many people, owning a home has been and continues to be a keystone of their personal finances. Home prices soared at an unprecedented rate in the early years of this century, yet lenders made it all too easy to buy high-priced homes by offering easy credit. When the housing bubble burst, many homeowners learned a new expression—*under water*—meaning that they owed more than their home was worth. Knowledge of sound savings and borrowing strategies could have helped.

In addition, retirement planning is an increasingly important area of personal finance, yet stock market shocks have temporarily, and in some cases permanently, affected retirement portfolios including two major declines in 2000 and 2008. In order to confidently prepare for retirement, workers must develop prudent investment strategies that are another component of personal financial planning.

Understanding personal financial planning and being comfortable with our own planning efforts have important benefits for society as well. They allow us to dedicate our full efforts to the job at hand at work. They also may make us more effective at that job because the household and the business approach many problems in the same way, and many personal financial planning techniques are useful in work-related situations.

THE HISTORY OF PERSONAL FINANCIAL PLANNING

Personal financial planning (PFP) has existed for many years. Until well into the twentieth century, however, it was generally restricted to very wealthy people who were advised by

Professional Advice Use of This Book

This book is intended to go beyond an introduction to personal finance facts to provide you with the tools to analyze and plan for your own financial future. It is written by a college professor who is also a professional financial advisor with hundreds of clients and more than \$1 billion in assets under management. Visualizing yourself as a financial planner

can be useful even if you are also the only client. This should help you better understand finance including business finance. It can provide you with knowledge that will serve you throughout your life whether you remain the planner's sole client or become a part- or full-time professional.

their lawyers, accountants, registered representatives, insurance agents, investment advisors, or bankers.

Around 1970, these services began expanding to a larger population. Many middle-class people had the discretionary income and desire to seek help with the growing complexity of financial instruments and services. The new personal financial planners developed as professionals who could provide solutions to a range of financial problems and coordinate the activities of their clients' other advisors.

Established in 1972, *Money* magazine and later a wide variety of additional publications and other media helped inform the broad population in financial planning matters and in the usefulness of consulting financial planners.

CHARACTERISTICS OF FINANCE

In this and the following two sections, we will place PFP within an overall setting in the finance field. **Finance** deals with the management of funds, among other money issues. Individual businesses and government all have concerns over use of funds. We can say that finance is a practical field of study that is based principally on cash flow. **Cash flow** is the amount of money made available for use. Finance is concerned with such variables as

1. **Markets.** Places where tangible goods and financial instruments such as stocks and bonds are bought and sold.
2. **Capital.** The real, financial, and human-related assets that are generated by individuals and organizations or bought and sold in the marketplace.
3. **Market structures.** The economic operations of the business, the government, and the household that facilitate the purchase and sale of items.
4. **Market value.** The market-established worth of a product or a financial instrument.
5. **Fair value.** The inherent worth of nonmarketable assets based on cash flow, risk, and the time value of money principles.
6. **Cash flow.** The economic operation of the organization based on the cash it generates.
7. **Risk.** The uncertainty of outcomes.
8. **Investments.** Placing cash flow into assets designed to improve an organization or to provide future funds for consumption.

In an academic program, finance is generally broken down into courses on personal finance and business finance, with second-level courses such as investments analysis and portfolio management, capital markets, and capital budgeting. We will discuss all items above as they pertain to personal finance and personal financial planning. Let's begin with personal finance.

PERSONAL FINANCE

Personal finance can be defined as the study of how people develop the cash flows necessary to support their operations and provide for their well-being. **Household finance**, the subject of Chapter 4, is the study of how a household and the people in it develop the cash flows necessary to support operations and provide for the well-being of its members.

Basic finance tools such as the time value of money, cash flow analysis, investment models of behavior, and risk analysis form the backbone of personal finance and PFP. These tools are discussed in this and subsequent chapters. As you will see, a wide variety of other disciplines have a significant role in the practice of personal finance and PFP. Some of these are listed next.

Discipline	Explanation
Microeconomics	The study of single units in the economy. It helps us understand how people and households allocate scarce resources.
Macroeconomics	A broad study of the functioning of the entire economy or a major section of it. Economic conditions often have a strong influence on household actions.
Accounting ¹	System of recording and analyzing financial transactions. It helps organize and analyze financial data in a logical way.
Law	The entire body of rules, practice and customs. They serve as a benchmark of correct rules and regulations for PFP.
Taxation	The imposition of taxes to obtain revenues. Taxes are a key factor in decision making for virtually all parts of PFP.
Mathematics	The science of numbers and their operations. Mathematics helps develop logical thinking and forms the quantitative basis for efficient decision making.
Statistics	A means of collecting relevant data. The examination of accumulated statistics helps establish or verify proposed PFP actions.
Business	A purposeful commercial activity. As will be established in Chapter 4, household operations resemble a business in many respects.
Psychology	The study of mind and behavior. Psychology can provide one input into appropriate human actions.
Sociology	The analysis of the behavior of groups of humans. Along with psychology it helps in understanding how people act as distinct from how they should act.

¹ Modified from *Webster's Ninth New Collegiate Dictionary* (Springfield, MA: Merriam-Webster Inc, 1988).

PERSONAL FINANCIAL PLANNING

Personal financial planning can be thought of as the analysis and decision-making extension of personal finance. Basically, PFP must satisfy four broad categories of personal-finance decisions: consumption and savings, investments, financing, and risk management.

PERSONAL FINANCIAL PLANNING PROCESS

Personal financial planning can be defined as the method by which people anticipate and plot their future actions to reach their goals. When we engage in financial planning, it is usually to solve a problem or to structure a plan for the future. In either case, we go through the following steps of the decision-making process:

1. Establish the Scope of the Activity

Establishing the scope answers the question: How broad an area are we analyzing? For financial planning practitioners, the scope defines the specific services that they will

provide.² For example, are they concentrating on saving money for a down payment on a home, or are they examining the entire financial planning process?

2. Gather the Data and Identify Goals

In order to solve the problem as financial planning practitioners, we must gather certain information. We accumulate data on household financial assets and information on income and expenditures. In addition, we develop information on limiting factors such as health, time available, and tolerance for risk.

A person or household can have many types of goals at any point in time. Goals that arise from values differ by household. The underlying goal, however, is to have the highest standard of living possible. The time devoted to work and types of leisure activities and expenditures will vary with each individual.

3. Compile and Analyze the Data

We funnel the data received into the balance sheet, the statement of assets and liabilities, the cash flow statement, which provides the household cash revenues and expenses/outlays, and any other statements that are relevant. After that is done, we proceed to analyze the statements and establish the client's overall financial position. What are the resources that are available? For example, does the balance sheet suggest a safe level of borrowing or does the household have a high level of debt? If there is a great deal of debt, does the cash flow indicate that paying it off may be a problem in the future? All major parts of financial planning are considered and any special needs included.

Practical Comment Why People Seek Financial Planners

Most people focus on financial planning for themselves because they have a particular problem or goal in mind. As financial planners are aware, few clients come in asking for a review of their finances or a financial plan. Just as most patients, particularly younger ones, come to a doctor with a

symptom rather than for a check-up, we can say that most clients come to a planner with a "financial hurt."

Some of the most common reasons for the visit and the broad categories of financial planning they fall into are

Reason	Principal Category
1. Inability to save properly.	Consuming and saving
2. Need to resolve a debt problem.	Financing
3. Desire to retire comfortably on time.	Consuming and saving*
4. Desire to improve investment returns.	Investing
5. Discomfort with present risk profile.	Managing risk
6. Beset by economic turmoil	Setting new goals and objectives

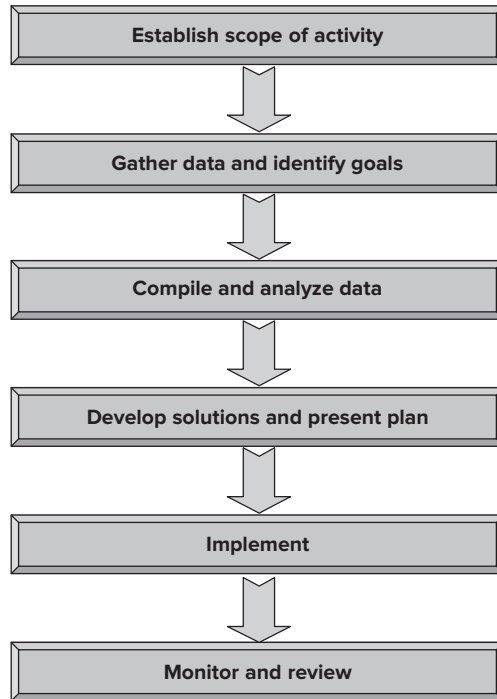
* Incorporates other areas as well.

The financial hurt and the category it falls into give rise to a financial planning process for solving it. Often other financial categories are drawn into the process. The result is that, the single financial hurt

frequently results in a more comprehensive look at the person or household. The financial planning process and the financial plan that often provides the solution for the "hurt" is presented here.

² When a financial planner is involved, according to the Practice Standards established by the CFP Board, this scope would include the range of services to be provided, how the planner is compensated, how long services will be provided, and so forth. Instead of terming this first step "Establish the Scope of the Activity," the CFP Board calls it "Establishing and Defining the Client-Planner Relationship."

FIGURE 1.1
Personal Financial
Planning Process



4. Develop Solutions and Present the Plan

There are often many different ways to solve a problem. There are hosts of products that are available and many alternative services or practices to call on. For example, if the client's goal is to save more money, this can be done simply by placing more money in a savings account, purchasing a whole life insurance policy instead of a term one, or buying a bigger house with a larger mortgage whose payment of principal each month could be considered a form of saving.

The best solution is usually the one that solves the problem at the lowest cost. In the case of the savings problem mentioned, the lowest-cost solution, assuming it is followed, would probably be simply to make regular deposits into a savings account.

5. Implement

Implementation is the action step. It is taking the best solution and putting it into practice. Although this may sound simple, for many people it is difficult to accomplish. This may be due to simple inertia or the action steps may be painful to carry out (saving money, for example).

6. Monitor and Review Periodically

All planning procedures are subject to change. Incomes change, life situations change—some people get married, some of them get divorced, and many have children. In addition, individual goals may need to be altered as a person ages. The environment we live in changes as well. Therefore, all planning procedures must be monitored for material changes and reviewed periodically to ensure they remain up to date. This process is summarized in Figure 1.1.

THE FINANCIAL PLAN

The **financial plan** is a structure through which you can establish and integrate all your goals and needs. It, therefore, can be the practical embodiment of the financial planning process and the tool to assist in implementing the process. The financial plan may take the form of a detailed written document—particularly if you consult a financial practitioner. It is then

often referred to as a **comprehensive financial plan**. Alternatively, it could be summarized on a single sheet of paper, even written on the back of an envelope, or could exist just in the head of the person in charge of the household's financial affairs. The key decision is a commitment to the financial planning process, including its analytical component. In other words, the financial plan is an organizational tool that can aid in financial planning.

Parts of the Plan

The plan can be separated into 11 parts, each of which is explained briefly next.

1. *Establishing goals.* **Establishing goals** involves deciding on your priorities not only for living not only today but also for the rest of your life. It is the reason the plan is made. Therefore, all the other parts of the plan follow this one. We describe goals more fully in Chapter 3.
2. *Analyzing financial statements.* **Financial statements** provide a current picture of your financial condition. They present the resources that are available to fund your goals. Financial statements include a balance sheet, a cash flow statement, and other relevant statements.
3. *Cash flow planning.* In **cash flow planning**, household income and expenditures and other cash flows are compiled and analyzed. The goal is to plan income and expense flows so that work, cost of living, savings and investment, and financing issues interact in an optimal way to provide the highest returns possible.
4. *Tax planning.* **Tax planning** is the practice of attempting to minimize unnecessary tax payments to the government. It is done by applying allowable tax deductions, credits, and other forms of tax benefits.
5. *Investment planning.* Through **investments**, you enable your net cash flows to grow as rapidly as possible, subject to your tolerance for risk. Generally households have a portfolio of human, real (ones you can touch), and financial assets to consider in the investment process.
6. *Risk management.* The objective of **risk management** is to control the level of risk and consequently of loss for each significant household asset and for the entire portfolio of assets. It involves implementing certain risk-modifying practices and considering products such as insurance.

Practical Comment Elements of a Financial Plan

In common usage, the public sometimes views a financial plan as a written document to identify their needs and the solution to them, not as a rigorously defined document. As we have noted, most people come to a financial planner for a solution to one or two problems, not for a comprehensive solution. Consequently, people may consider, for example, an investment review or a retirement plan as a financial plan. A financial plan has a defined minimum scope, which is detailed in this section. As discussed, when prepared by a financial planner, the document is often referred to as a comprehensive financial plan.

The use and form of this document will vary considerably among financial planners. Some use it to

form the basis of an ongoing relationship. Others employ it at the end of an extended process of looking at client activities. Some make it a highly detailed document; others summarize it in a few pages. Unless any planning document is geared to a specific client and deals with all relevant factors of the client's financial life, it will not be as useful as it could be. Said differently, whether engaging in financial planning orally, in summary form, in a segmented plan—one that focuses on just one or a few areas—or in a comprehensive financial plan, the key is to incorporate all the relevant client factors and gear recommendations to the individual needs of the client.