Billingsley • Gitman • Joehnk 14e

personal Financial Planning

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14e

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Personal Financial Planning, Fourteenth Edition
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For Bonnie, Lauren, and Evan
RSB

For our children:
Zachary, Jessica, and Caren
LJG

For Colwyn,
Grace, and Rhett
MDJ

Brief Contents

Contents


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Preface

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

So many questions about managing our personal finances—and the stakes are so high! *Personal Financial Planning*, 14th edition, provides a framework for answering these questions and more. Careful planning allows us to best adapt to changes in the financial environment and the associated changes in our own lives. This book provides tools for preparing personal financial plans that serve as road maps for achieving goals. It emphasizes the dynamics of the financial planning process by considering the impact of life changes—birth, marriage, divorce, job and career, and death.

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

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

ORGANIZATION OF THE BOOK

Personal Financial Planning is divided into six parts. Part 1 presents the foundations of personal financial planning, beginning with the financial planning process and then covering financial statements and budgets and also taxes. Part 2 concerns the management of basic assets, including cash and savings instruments, automobiles, and housing. Part 3 covers credit management, including the various types of open account borrowing and consumer loans. Part 4 deals with managing insurance needs and considers life insurance, health care insurance, and property insurance. Part 5 covers investments—including stocks, bonds, mutual funds, ETFs, and real estate—and how to make transactions in securities markets. Part 6 is devoted to retirement and estate planning.

Pedagogy

Each chapter opens with six learning goals that link the material covered to specific learning outcomes and anchor the text's *integrated learning system*. The learning goal numbers are tied to major chapter headings and restated and reviewed point by point in the end-of-chapter summary. New to the 14th edition, each chapter also opens with a series of statements presented as *Financial Fact or Fantasy* in the related chapter material. Each statement is critically evaluated as fact or fantasy in the context of the relevant material. Then, at the end of each of the major sections, *Test Yourself* questions allow readers to reinforce their understanding of the material before moving on to the next section. As students read through the chapters, these *Test Yourself* questions allow them to test their understanding of the material in each section. Students can find the answers to the *Test Yourself* questions on the book's companion website by going to www.cengagebrain.com and searching for this book by its author or ISBN, and then adding it to the dashboard. They're also found in the instructor's manual. Also new to the 14th edition, at the end of select chapters is a summary of all key financial relationships along with a problem set illustrating their application.

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

Major Changes in the 14th Edition

The 14th edition has been thoroughly updated to consider the most up-to-date techniques of contemporary personal financial planning. We emphasize that the key principles of personal financial planning remain valid: save, diversify your investments, watch your expenditures, and borrow carefully. This edition reflects feedback from past users, practicing financial planners, finance industry experts, students, and our own research. It provides helpful new approaches, expanded coverage in certain areas, streamlined coverage in others, and enhanced pedagogy anchored by a state-of-the-art integrated learning system. The basic organizational structure, topical coverage, superior readability, and useful instructional aids that marked the success of the first 13 editions have been retained and extended. Important changes in this edition are described below, first as general changes and then as specific chapter-by-chapter changes.

General Changes and Hallmark Features

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

Coverage" (Chapter 9), "Wade Saves on His Car Insurance" (Chapter 10), "Trey and April Get Serious About Their Retirement Asset Allocation" (Chapter 11), "Landon and Kirsten Like High Flying Stocks" (Chapter 12), "Virginia Finds a Simple Retirement Investment Plan" (Chapter 13), "Carl and Brian's Different Approaches to a Traditional IRA" (Chapter 14), and "The (Un)intended Effects of Corbin's Beneficiary Designations" (Chapter 15).

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

Specific Chapter-by-Chapter Changes and Summaries

Because instructors often like to know where new material appears, the significant changes that have been made in the 14th edition are summarized next.

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

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

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

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

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

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

Chapter 7 on using consumer loans, analyzes the benefits and uses of consumer credit for both single-payment and installment loans. The discussion concentrates on the key issues surrounding loan provisions, finance charges, and other credit considerations. There are suggested questions to ask before you loan money to family and friends, a discussion about 0 percent annual percentage rate (APR) loans and their potential limitations, and a discussion of what lenders are looking at when you submit a loan application—your credit report, debt history, employment history, and savings.

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

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

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

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

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

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

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

Chapter 15 on preserving your estate, has been updated to reflect the most recent estate tax laws and tax rates. The chapter discusses online estate planning resources, the details of choosing a suitable guardian for minor children in case of death, tips for writing a will, reasons to use a trust, and a feature about recognizing and overcoming aversion to ambiguity in estate planning.

SUPPLEMENTARY MATERIALS

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

Instructor Supplements

CengageNOW

CengageNOW is a powerful course management and online homework tool that provides robust instructor control and customization to optimize the student learning experience and meet desired outcomes. CengageNOW offers:

- Auto-graded homework (static and algorithmic varieties), a test bank, and an eBook, all in one resource.
- Easy-to-use course management options offering flexibility and continuity from one semester to another.
- New! Expanded post-submission feedback explains each problem to students. The instructor decides when this solution is delivered to the students. The 14th edition of *Personal Financial Planning* is the first to offer post-submission feedback to students using CengageNOW.
- The most robust and flexible assignment options in the industry.
- The ability to analyze student work from the gradebook and generate reports on learning outcomes. Each problem is tagged to Business Program (AACSB) and Bloom's Taxonomy outcomes so that you can measure student performance.
- Contact your sales representative for more details if you are interested in offering CengageNOW to your students.

Instructor's Manual and Test Bank

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

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

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

Testing with Cognero

Cengage Learning Testing Powered by Cognero is a flexible, online system that allows you to author, edit, and manage test bank content, create multiple test versions in an instant, and deliver tests from your LMS, in your classroom or through CengageNOW.

Microsoft PowerPoint®

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

STUDENT SUPPLEMENTS

Interactive Worksheets

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

ACKNOWLEDGMENTS

In addition to the many individuals who made significant contributions to this book by their expertise, classroom experience, guidance, general advice, and reassurance, we also appreciate the students and faculty who used the book and provided valuable feedback, confirming our conviction that a truly teachable personal financial planning text could be developed.

Of course, we are indebted to all the academicians and practitioners who have created the body of knowledge contained in this text. We particularly wish to thank several people who gave the most significant help in developing and revising it. They include Professor John Brozovsky, CPA, of VirginiaTech, for assistance in the chapter on taxes; Professor Sam Hicks, CPA, of VirginiaTech, for his thorough review of the entire book; Thomas C. Via Jr., CLU, for his help in the chapters on life and property insurance; Kent Dodge for his help in the chapter on health insurance; Professor Hongbok Lee, of Western Illinois University, for helpful observations, and Marlene Bellamy of Writeline Associates for her help with the real estate material.

Cengage Learning shared our objective of producing a truly teachable text and relied on the experience and advice of numerous excellent reviewers for the 14th edition:

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About the Authors

Randall S. Billingsley is a finance professor at VirginiaTech. He received his bachelor's degree in economics from Texas Tech University and received both an M.S. in economics and a Ph.D. in finance from Texas A&M University. Professor Billingsley holds the Chartered Financial Analyst (CFA), Financial Risk Manager (FRM), and Certified Rate of Return Analyst (CRRA) professional designations. An award-winning teacher at the undergraduate and graduate levels, his research, consulting, and teaching focus on investment analysis and issues relevant to practicing financial advisors. Formerly a vice president at the Association for Investment Management and Research (now the CFA Institute), Professor Billingsley's published equity valuation case study of Merck & Company was assigned reading in the CFA curriculum for several years. In 2006 the Wharton School published his book, *Understanding Arbitrage: An Intuitive Approach to Financial Analysis*. In addition, his research has been published in refereed journals that include the *Journal of Portfolio Management*, the *Journal of Banking and Finance*, *Financial Management*, the *Journal of Financial Research*, and the *Journal of Futures Markets*. Professor Billingsley advises the Student-Managed Endowment for Educational Development (SEED) at Virginia Tech, which manages an equity portfolio of about $5 million on behalf of the Virginia Tech Foundation.

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

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

His other major textbooks include *Fundamentals of Investing*, 12th edition, which is co-authored with Scott B. Smart and Michael D. Joehnk; and *Principles of Managerial Finance*, 7th Brief edition, and *Principles of Managerial Finance*, 14th edition, both co-authored with Chad J. Zutter.

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

Michael D. Joehnk is an emeritus professor of finance at Arizona State University (ASU). In addition to his academic appointments at ASU, Professor Joehnk spent a year (1999) as a visiting professor of finance at the University of Otago in New Zealand. He received his bachelor's and Ph.D. degrees from the University of Arizona and his M.B.A. from Arizona State University. A Chartered Financial Analyst (CFA), he has served as a member of the Candidate Curriculum Committee and of the Council of Examiners of the Institute of Chartered Financial Analysts. He has also served as a director of the Phoenix Society of Financial Analysts and as secretary-treasurer of the Western Finance Association, and he was elected to two terms as a vice-president of the Financial Management Association. Professor Joehnk is the author or co-author of some 50 articles, five books, and numerous monographs. His articles have appeared in *Financial Management*, the *Journal of Finance*, the *Journal of Bank Research*, the *Journal of Portfolio Management*, the *Journal of Consumer Affairs*, the *Journal of Financial and Quantitative Analysis*, the *AAII Journal,* the *Journal of Financial Research*, the *Bell Journal of Economics*, the *Daily Bond Buyer*, *Financial Planner,* and other publications.

In addition to co-authoring several books with Lawrence J. Gitman, Professor Joehnk was the author of a highly successful paperback trade book, *Investing for Safety's Sake*. In addition, Dr. Joehnk was the editor of *Institutional Asset Allocation*, which was sponsored by the Institute of Chartered Financial Analysts and published by Dow Jones–Irwin. He also was a contributor to the *Handbook for Fixed Income Securities* and to *Investing and Risk Management*, volume 1 of the Library of Investment Banking. In addition, he served a six-year term as executive co-editor of the *Journal of Financial Research*. He and his wife live in Flagstaff, Arizona, where they enjoy hiking and other activities in the nearby mountains and canyons.

PART 1

Foundations of Financial Planning

CHAPTERS

CHAPTER 1

Understanding the Financial Planning Process

LEARNING GOALS

LG1 Identify the benefits of using personal financial planning techniques to manage your finances.

LG2 Describe the personal financial planning process and define your goals.

LG3 Explain the life cycle of financial plans, their role in achieving your financial goals, how to deal with special planning concerns, and the use of professional financial planners.

LG4 Examine the economic environment's influence on personal financial planning.

LG5 Evaluate the impact of age, education, and geographic location on personal income.

LG6 Understand the importance of career choices and their relationship to personal financial planning.

How Will This Affect Me?

The heart of financial planning is making sure your values line up with how you spend and save. That means knowing where you are financially and planning on how to get where you want to be in the future no matter what life throws at you. For example, how should your plan handle the projection that Social Security costs may exceed revenues by 2037? And what if the government decides to raise tax rates to help cover the federal deficit? An informed financial plan should reflect such uncertainties and more.

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

Financial Fact or Fantasy?

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

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

1-1 THE REWARDS OF SOUND FINANCIAL PLANNING

LG1

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

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

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

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

FINANCIAL PLANNING TIPS

Be SMART in Planning Your Financial Goals

Success is most likely if your goals are:

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

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

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

Realistic: Am I willing and able to do this?

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

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

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

1-1a Improving Your Standard of Living

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

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

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

So our quality of life is closely tied to our standard of living. Although other factors—geographic location, public facilities, local cost of living, pollution, traffic, and population density—also affect quality of life, wealth is commonly viewed as a key determinant. Material items such as a house, car, and clothing, as well as money available for health care, education, art, music, travel, and entertainment, all contribute to our quality of life. Of course, many so-called wealthy people live "plain" lives, choosing to save, invest, or support philanthropic organizations with their money rather than indulge themselves with luxuries.

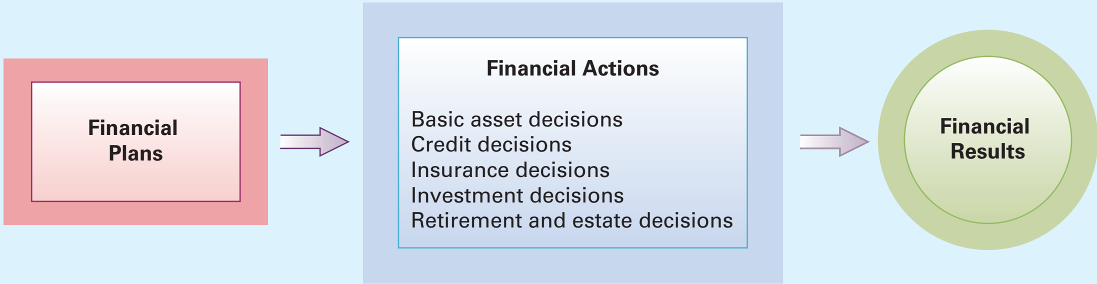
Financial Fact or Fantasy?

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

One trend with a profound effect on our standard of living is the *two-income family*. What was relatively rare in the early 1970s has become commonplace today, and the incomes of millions of families have risen sharply as a result. About 75 percent

EXHIBIT 1.1 **Organizational Planning Model**

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



of married adults say that they and their mate share all their money, while some partners admit to having a secret stash of cash. Two incomes buy more, but they also require greater responsibility to manage the money wisely.

1-1b Spending Money Wisely

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

Current Needs

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

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

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

Future Needs

A carefully developed financial plan should set aside a portion of current income for deferred, future spending. Placing these funds in various savings and investment vehicles allows you to generate a return on your funds until you need them. For example, you may want to build up a retirement fund to maintain a desirable

FINANCIAL PLANNING TIPS

Ways to Save More Money

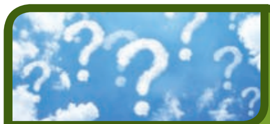
You can save more money by being purposeful in your spending.

- **Cook at home more.** Ease your way in by cooking at home at least once a week.
- **Make rather than buy your coffee.** While a latte is great, we all know that it's an expensive habit. Don't stop cold—just skip it as often as you can and make your coffee at home instead.
- **Take your lunch to work.** Lunch with coworkers may be the norm and a wise way to build helpful relationships. So it may not be practical to take your lunch all of the time. But it will save you money to take your lunch at least occasionally.
- **Avoid late fees by paying your bills on time.** You can have many bills like utilities paid automatically so there is no reason to pay late fees.
- **Avoid ATM fees.** Many banks do not waive ATM withdrawal fees. Be sure to use ATMs that do not charge a fee.
- **Avoid using credit cards with an annual fee.** The number of no-fee cards with reward plans makes it unnecessary to pay an annual fee.
- **Disconnect the landline phone.** You may do just fine with you mobile phones and no landline, which would save you some money.
- **Borrow books from the library and don't buy them.** Library cards are free and the book and media selection is usually up-to-date.
- **Don't buy bottled water, bottle your own.** Buy bottled water only occasionally just so you can get the bottle to fill with your own water.
- **Drive your car a long time.** Keep your car until the repair costs and questionable reliability make it necessary to find a replacement.

Source: Adapted from Sam Baker of GradMoneyMatters.com, republished June 19, 2011, http://www.dumblittleman.com/2008/01/30-easy-ways-to-save-money-and-no-you.html, accessed July 2015.

standard of living in your later years. Instead of spending the money now, you defer actual spending until the future when you retire. Nearly 35 percent of Americans say retirement planning is their most pressing financial concern. Other examples of deferred spending include saving for a child's education, a primary residence or vacation home, a major acquisition (such as a car or home entertainment center), or even a vacation.

The portion of current income we commit to future needs depends on how much we earn and also on our average propensity to consume. About two-thirds of affluent Americans say they need at least $5 million to feel rich. The more we earn and the less we devote to current spending, the more we can commit to meeting future needs. In any case, some portion of current income should be set aside regularly for future use. This practice creates good saving habits.



Financial Fact or Fantasy?

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

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

1-1c Accumulating Wealth

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

EXHIBIT 1.2 The Average American, Financially Speaking

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

	Income and Assets
What Do We Earn? (*median*)	
All families	$ 46,700
What Are We Worth? (*median*)	
All families	81,200
Home Ownership (*median*)	
Value of primary residence	170,000
Mortgage on primary residence	115,000
How Much Savings Do We Have? (*median*)	80,000
Pooled investment funds (excluding money market)	27,000
Individual stocks	94,500
Bonds	20,100
Bank accounts/CDs	
Retirement accounts	59,000

Source: Adapted from Jesse Bricker, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Kevin B. Moore, John Sabelhaus, Jeffrey Thompson, and Richard A.Windle, "Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances," Board of Governors of the Federal Reserve System, Washington, DC, (October 24, 2014, data is for 2013), http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf, Tables 1–4, accessed July 2015.

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

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

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

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

TEST YOURSELF

1-1 What is a *standard of living*? What factors affect the quality of life?

1-2 Are consumption patterns related to quality of life? Explain.

1-3 What is *average propensity to consume*? Is it possible for two people with very different incomes to have the same average propensity to consume? Why?

1-4 Discuss the various forms in which wealth can be accumulated.

1-2 THE PERSONAL FINANCIAL PLANNING PROCESS

LG2

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

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

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

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

Behavior Matters

Practicing Financial Self-Awareness

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

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

Then ask yourself two critically important questions:

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

Source: Adapted from Carl Richards, "Practicing Radical Self-Awareness," Behaviorgap.com. http://us2.campaign-archive1.com/?u=23ce2ac179e8158f7583c4e3f&id=86f42577bc&e=b50e826a9e, accessed July 2015.

EXHIBIT 1.3 The Six-Step Financial Planning Process

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

1. Define financial goals.
2. Develop financial plans and strategies to achieve goals.
3. Implement financial plans and strategies.
4. Periodically develop and implement budgets to monitor and control progress toward goals.
5. Use financial statements to evaluate results of plans and budgets, taking corrective action as required.
6. Redefine goals and revise plans and strategies as personal circumstances change.

1-2a Steps in the Financial Planning Process

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

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

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

1-2b Defining Your Financial Goals

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

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