PERSONAL $ FINANCE

SEVENTH EDITION

JEFF MADURA

Prepare, Apply, Confirm and Develop Employability Skills with MyLab Finance

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*Source: 2017 Student Survey, n 4703

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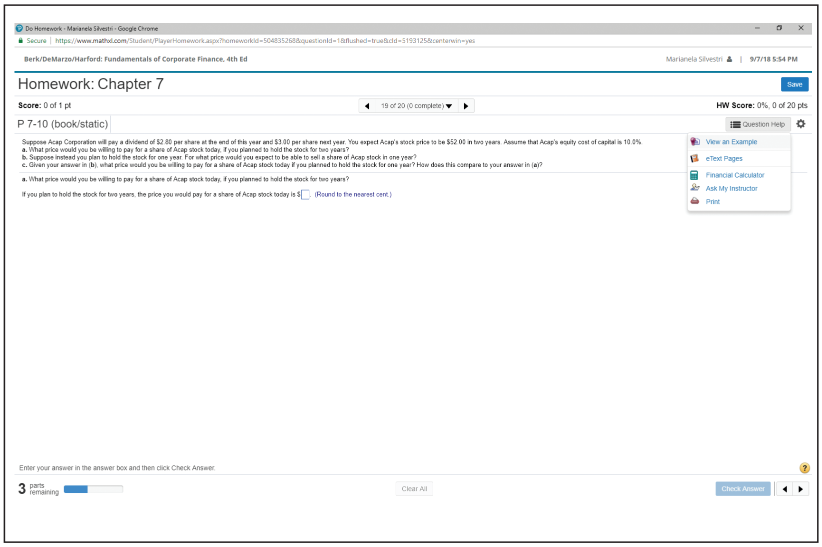

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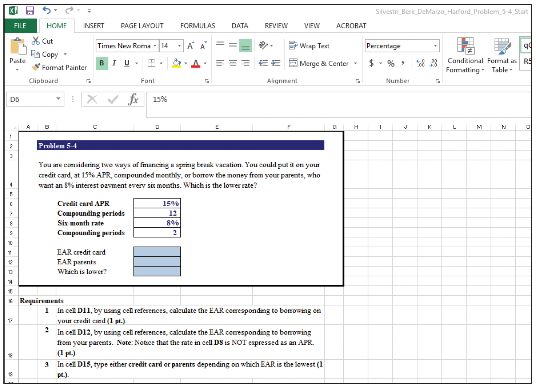

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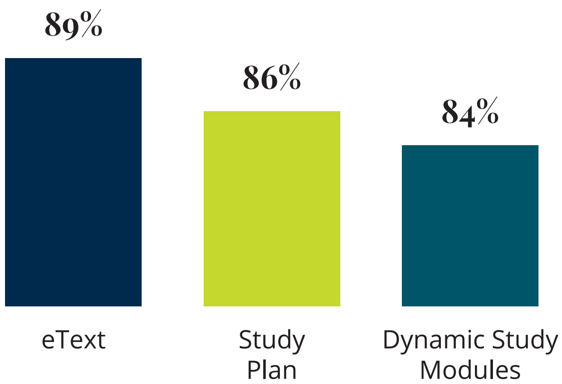

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85%

of students would tell their instructor to keep using MyLab Finance

For additional details visit: www.pearson.com/mylab/finance

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Seventh Edition

JEFF MADURA
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Pearson

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DEDICATION

This text is dedicated to *Best Friends Animal Society* in Kanab, Utah, for its commitment to, compassion for, and care of more than 1,500 animals, many of which were previously homeless. Best Friends has established an ambitious campaign to save all healthy dogs and cats in the United States by 2025 (prevent healthy cats and dogs from being euthanized due to excessive population).

Most of the royalties the author receives from this edition of the text will be invested in a fund that will ultimately be donated to Best Friends Animal Society and other humane societies. In the last several years, this fund donated more than $400,000 to Best Friends to support a new healthcare facility for Best Friends, sponsor a Public Broadcasting Service (PBS) documentary on the efforts of Best Friends to help animal societies, and to save misplaced dogs during Hurricane Harvey in Houston during 2017. This fund has also donated more than $100,000 to other animal care societies, including Friends of Greyhounds (Sunrise, FL), Florida Humane Society (Pompano Beach, FL), Greyhound Pets of America in Central Florida (Melbourne, FL), Tri-County Humane Society (Boca Raton, FL), and Doris Day Animal League (Washington, DC).

BRIEF CONTENTS

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PART 1 TOOLS FOR FINANCIAL PLANNING

PART 3 PERSONAL FINANCING

PREFACE

New to the Seventh Edition

All chapters have been updated to present complete and current coverage at the time of publication. The key changes in the Seventh Edition of *Personal Finance* include the following:

- The Stephanie Spratt running examples throughout all chapters account for present economic conditions and the most recent tax law changes.
- The Sampsons case has been revised to ensure consistency throughout the text, and incorporates the most recent tax law changes.
- The Brad Brooks case has been revised to ensure consistency throughout the text, and incorporates the most recent tax law changes.
- The Building Your Own Financial Plan feature includes new applications and templates that enable students to easily create their own financial plan.
- Chapter 1, "Overview of a Financial Plan," contains more information about how to select a college (or graduate school), a major, and an occupation. It also provides updated salary information about occupations and explains how to implement a financial plan to accomplish financial goals.
- Chapter 4, "Using Tax Concepts for Planning," has been completely rewritten to account for the new tax law changes. This chapter is written in very simple terms, and offers clear guidance for students to estimate their own taxes if they take the standard deduction.
- Chapter 5, "Banking and Interest Rates," contains more discussion on the online payment process for paying bills.
- Chapter 6, "Managing Your Money," uses lower interest rates to reflect current conditions.
- Chapter 7, "Assessing and Selecting Your Credit," contains more discussion of improving your credit score, and prevention of identity theft.
- Chapter 8, "Managing Your Credit," contains more discussion of credit cards.
- Chapter 9, "Personal Loans," contains more discussion of loan consolidations and student loans.
- Chapter 10, "Purchasing and Financing a Home," illustrates how the recent tax law changes have reduced the potential tax benefits of owning a home.
- Chapter 17, "Investing in Mutual Funds," includes much more information about exchange-traded funds (ETFs) because of their popularity.
- Chapter 19, "Retirement Planning," contains updated information on all the different retirement plans that are available because many of the rules, such as the maximum allowable contribution per year, have changed.

Solving Teaching and Learning Challenges

Ask yourself these financial questions:

- Should you buy a new car or lease a car?
- How much can you borrow?
- Which bank offers the best services to satisfy your needs?
- How can you avoid identity theft?
- Under what conditions should you use a credit card or a debit card?
- Do you have enough insurance?
- Will you be able to retire while still young?

This textbook allows you to address these and other related financial dilemmas. It also guides you to create a financial plan for yourself. This textbook gives you the opportunity to develop the skills that can improve your financial position over time. To do this, it incorporates Internet-based resources along with many examples, problems, and ongoing case studies, all of which focus on providing students with hands-on practice applying financial concepts.

The quantitative side of financial planning intimidates many students. This book simplifies the mathematics of personal finance by explaining the underlying logic. Formulas and calculations are explained in the text and then illustrated in examples. Examples that can be solved using a financial calculator are depicted with a calculator illustration. Students are referred to Web sites with online calculators whenever pertinent. The Financial Planning Problems provide students with ample opportunity to practice applying math-based concepts.

The key components of a financial plan are introduced in Chapter 1. The balance of the text is organized into the following seven parts, which are keyed to the financial plan components introduced in Chapter 1, concluding with the synthesis of those components into a comprehensive financial plan in Chapter 21:

1. *Tools for Financial Planning* covers budgeting and tax planning.
2. *Managing Your Liquidity* covers banking, credit, and money management.
3. *Personal Financing* covers financing large purchases.
4. *Protecting Your Wealth* covers insurance planning.
5. *Personal Investing* covers a variety of investments and investing strategy.
6. *Retirement and Estate Planning* covers plans, strategies, and tax considerations related to retirement and estate planning.
7. *Synthesis of Financial Planning* covers the integration of the components into a comprehensive personal financial plan.

	Chapter 1	Overview of a Financial Plan
PART 1	**TOOLS FOR FINANCIAL PLANNING**	
	Chapter 2	Planning with Personal Financial Statements
	Chapter 3	Applying Time Value Concepts
	Chapter 4	Using Tax Concepts for Planning
PART 2	**MANAGING YOUR LIQUIDITY**	
	Chapter 5	Banking and Interest Rates
	Chapter 6	Managing Your Money
	Chapter 7	Assessing and Securing Your Credit
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PART 3	**PERSONAL FINANCING**	
	Chapter 9	Personal Loans
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PART 4	**PROTECTING YOUR WEALTH**	
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PART 5	**PERSONAL INVESTING**	
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	Chapter 17	Investing in Mutual Funds
	Chapter 18	Asset Allocation
PART 6	**RETIREMENT AND ESTATE PLANNING**	
	Chapter 19	Retirement Planning
	Chapter 20	Estate Planning
PART 7	**SYNTHESIS OF FINANCIAL PLANNING**	
	Chapter 21	Integrating the Components of a Financial Plan

To improve student results, we recommend pairing the text content with MyLab Finance, which is the teaching and learning platform that empowers you to reach every student. By combining trusted author content with digital tools and a flexible platform, MyLab personalizes the learning experience and will help your students learn and retain key course concepts while developing skills that future employers are seeking in their candidates. From Dynamic Study Modules to Financial Planning Spreadsheets, MyLab Finance helps you teach your course, your way. Learn more at www.pearson.com/mylab/finance.

The main solutions that this textbook and MyLab offers are as follows.

Building Your Own Financial Plan

The seventh edition of *Personal Finance* integrates the Building Your Own Financial Plan feature along with the case studies in each chapter, to help students create their own personalized plans for financial success.

Students learn by doing. After each chapter, they are prompted to apply the key concepts in order to make their own financial planning decisions. At the end of the course, students will have completed a financial plan that they can use beyond the school term.

BUILDING YOUR OWN FINANCIAL PLAN: Chapter 1 MyLab Finance

At the end of every chapter, you will be guided to apply specific chapter concepts in order to build your financial plan. Some of the concepts will allow you to assess your present financial status. Other concepts that might not be applicable to your present status will focus on your future financial status. By the end of the school term, you will have a complete financial plan that should serve as a useful guide for your future financial decisions.

Decision Making

Personal Finance's interactive approach incorporates Internet-based resources along with examples, problems, and ongoing case studies that help students make informed financial planning decisions.

FREE APPS for Personal Finance

Managing Your Budget in Real Time

Application:

The Mint Money Manager, Budget, and Personal Finance app (by Mint.com) sends you reminders about future bills that are due and helps you schedule the payment of your future bills. This allows you to ensure that you manage your cash outflows more effectively.

To Find It:

Search for the "Mint" app on your mobile device.

Free Apps for Personal Finance highlights useful apps students can download to their smartphones for free that apply to some of the key concepts covered in the chapter.

Financial Planning **ONLINE**

Go to:
www.irs.gov

To get:
Information about tax rates, tax forms, guidelines, and deadlines.

Financial Planning Online in every chapter highlights Internet resources for more information on a chapter topic. Each includes an Internet address and a description of what the Web site provides.

FINANCIAL PLANNING PROBLEMS

All Financial Planning Problems are available in MyLab Finance *at www.pearson.com/mylab/finance. A financial calculator is recommended for Problems 4, 9, 11, 12, 13, 15 and 16. The financial tables can be used to answer Problems 1, 2, 3, 5, 6, 7, 9, 10, and 13.*

1. **Future Value.** Kyle has $1,000 in cash received for high school graduation gifts from various relatives. He wants to invest it in a certificate of deposit (CD) so that he will have a down payment on a car when he graduates from college in five years. His bank will pay 1.5% per year, compounded annually, for the five-year CD. How much

account that averages a 5% annual return, what amount will be in the account in twenty years? How much will she have if the account earns 8% a year?

3. **Future Value.** Luis wants to know how much he will have available to spend on his trip to Belize in three years if he deposits $3,000 today at an annual interest rate of 2%.

Financial Planning Problems require students to demonstrate knowledge of mathematical concepts by performing computations to make well-informed personal finance decisions. All Financial Planning Problems are available in MyLab Finance.

FINANCIAL PLANNING ONLINE EXERCISES

1. Go to the Web site www.consumer.gov, and go to the section on credit, loans, and debt.
   a. What are some ways that you can build your credit history?
   b. What type of information is contained in your credit report?
   c. What are some advantages of having "good credit"?
2. Review the information at www.ftc.gov about free credit reports.
   a. What is the only authorized source for free credit reports under federal law?
   b. How can you request a free credit report?
   c. Why should you review your credit report?

Financial Planning Online Exercises show students how to obtain, critically evaluate, and use Internet-based resources in making personal finance decisions.

EXAMPLE

Stephanie Spratt has $2,000 available to allocate to money market investments. She knows that she will need $400 to cover several small bills in the next week and may also need $600 in a month or so to pay for repairs on her car engine. She does not expect to need the other funds for at least one month. Her financial institution offers the following annualized yields on various money market instruments:

	Annualized Yield (%)
Checking account	0
Savings deposit	1.2
MMDA ($2,500 minimum balance)	2.0

A running example of a recent college graduate and new entrant into the workforce helps students apply concepts to real-life situations. Students are commonly faced with dilemmas similar to those Stephanie faces, such as how to control recreational spending or whether to buy or lease a car.

THE SAMPSONS—A CONTINUING CASE: Chapter 3

MyLab Finance

Dave and Sharon Sampson recently established a plan to save $300 per month (or $3,600 per year) for their children's education. Their oldest child is six years old and will begin college in twelve years. They will invest the $300 in a savings account that they expect will earn interest of about 2% per year over the next twelve years. The Sampsons wonder how much additional money they would accumulate if they could earn 5% per year on the savings account instead of 2%. They also wonder how their savings would accumulate if they could save $400 per month (or $4,800 per year) instead of $300 per month.

Build a financial plan for a family! As the parents of two children, Dave and Sharon Sampson face common financial dilemmas, having made few plans regarding their financial future and being eager to start saving toward a new car, their children's college education, and their retirement. Students apply chapter concepts to counsel the Sampsons on the accompanying online worksheets.

BRAD BROOKS—A Continuing Case: Part 1 MyLab Finance

Your friend Brad Brooks has no control of personal finances. Single and 30 years old, he has a good job at a technology company. His monthly disposable income is $4,000. Brad recently moved from his apartment where the rent was $1,400 per month to an expensive condo. His typical monthly expenses are as follows:

Rent at condo	$2,000
Car payment (balance on car loan $10,000; market value of car $15,000)	500
Utilities (gas, electric, Internet)	200
Smartphone	200

At the end of each part, students are prompted to **build a financial plan for their friend Brad Brooks** using the accompanying online worksheets. Brad has expensive tastes and a soaring credit card balance, and he needs their assistance to improve his financial condition.

Chapter 21 synthesizes all parts of the text to highlight the interrelationships among the components of a financial plan and presents a completed plan for Stephanie Spratt. It also contains a *Certified Financial Planner Exercise* that challenges students to offer advice on how financial planning should be adjusted in response to a change in economic conditions.

Learning Tools

Banking and Interest Rates

chapter 5

When Shawna arrived on campus for her first year of college, she relied on an automated teller machine (ATM) to obtain cash for the many little necessities of college life (food, movies, and more food). It was only on a weekend trip back home, where she reviewed her latest bank statement, that Shawna became aware of a problem. Her bank statement showed thirty-nine separate charges for ATM fees. She had been charged $1.00 for each trip to an "out-of-network" ATM not owned by her bank. There was another $1.50 fee charged by the bank that owned the ATM, so each ATM visit created two charges. In addition, Shawna discovered that she had made five balance inquiries on "out-of-network" ATMs, and her bank charged $0.50 for each of them. Altogether, for her seventeen visits to the ATM, Shawna had accrued $42.50 in ATM fees and $2.50 in inquiry fees for a total of $45.00. Shocked at this discovery, Shawna found a bank that offered a mob would enable her to easily find no-fee ATMS. The mobile account balance at any time, so she will always be aware i

This chapter explains how to use a financial institution to m bank is an essential component of liquidity, whether you ar earning account or need a loan. You may choose a commer online bank. In each case it is important to know how well y

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Chapter Introductions
The opening of each chapter provides an interest-grabbing scenario that previews the chapter's content.

Learning Objectives
Corresponding to the main headings in each chapter, the list of learning objectives guides students through the material.

The objectives of this chapter are to:

- Provide a background on money management
- Describe the most popular money market investments
- Identify the risk associated with money market investments
- Explain how to manage the risk of your money market investments
- Explain how money management fits within your financial plan

EXAMPLE

While at the mall today, Lisa saw a pair of Italian shoes that she liked. The shoes were priced at $300 and were not on sale. Lisa did not have any cash with her, so she used her credit card to pay for the shoes. Lisa did not need the shoes but decided to buy them because she did not see anything else at the mall that she wanted. Before purchasing the shoes, Lisa used her smartphone and determined that she could purchase the same shoes online for $100 less, but she would have to wait several days for them to be delivered, and she wanted them now. Lisa was also aware that the shoe store periodically has 40% off sales, and she could likely buy the shoes at the sale price if she would be willing to wait. Lisa's purchase decision was primarily influenced by her desire for immediate satisfaction. She knew that she could have waited until the shoes were on sale, but she went to the mall intending to purchase something today. Lisa's purchase decision was especially easy because she used credit instead of cash. Thus, she was able to make the purchase and still has all her cash that she can use for other future purchases.

personal balance sheet
A summary of your assets (what you own), your liabilities (what you owe), and your net worth (assets minus liabilities).

liquid assets
Financial assets that can be easily sold without a loss in value.

household assets
Items normally owned by a household, such as a home, car, and furniture.

Marginal Glossary

Throughout the text, key terms and their definitions appear in the text margin where they are first introduced.

Explanation by Example

Practical examples applying concepts in realistic scenarios throughout chapters help cement student understanding.

PSYCHOLOGY of Personal Finance

Personal Consumption Behavior Most people's consumption behavior is affected by their income. For example, a two-income household tends to spend more money when both income earners are working full-time. Yet, people's consumption behavior varies substantially. At one extreme are people who spend their entire paycheck within a few days of receiving it, regardless of the size of the paycheck. Although this behavior is understandable for people who have low incomes, it is also a common practice for some people who have very large incomes. At the other extreme are "big savers" who minimize their spending and focus on saving for the future.

Psychology of Personal Finance

Personal finance behavior is influenced by psychology. For example, some spending decisions are made on impulse due to the desire for immediate satisfaction.

ECONOMIC IMPACT

How Your Future Financial Position Is Tied to the Economy Economic conditions affect the types of jobs that are available to you and the salary offered by each type of job. They also affect the price you pay for services such as rent, the value of assets (such as a home) that you own, and the return that you can earn on your investments.

Economic Impact

The Economic Impact logo identifies text that emphasizes how economic conditions can affect personal finance.

SUMMARY

Types of Financial Institutions. Depository institutions (commercial banks, savings institutions, and credit unions) accept deposits and provide loans. Nondepository institutions include insurance companies (which provide insurance), securities firms (which provide brokerage and other services), and investment companies (which offer mutual funds). Financial conglomerates offer a wide variety of these financial services so that

Summary

To aid in student study, the chapter summary presents the chapter's key points in paragraph form.

Activities and Assessments

REVIEW QUESTIONS

All Review Questions are available in MyLab Finance *at www.pearson.com/mylab/finance.*

1. **Time Value of Money.** What is the time value of money? How is it related to opportunity costs?
2. **Importance of the Time Value of Money.** List one reason why the time value of money is an important concept.

Review Questions
Test knowledge of material by comparing and contrasting concepts, interpreting financial quotations, and understanding how financial data can be used to make personal finance decisions. All Review Questions are available in MyLab Finance.

Ethical Dilemmas
Real-life ethical situations are presented along with questions to encourage students' critical thinking about ethics.

Ethical Dilemma. Jill just finished reconciling her account balance and discovered the bank made a $567 error in her favor. She double-checked her numbers and is certain the bank made an error, and the difference is not a miscalculation on her part. Jill knows the amount is miniscule to the bank's overall value but it would help her make a payment that is due this month. Should she just let the bank find the error and use the money until that time? Or, should she report it now?

WEB SEARCH EXERCISE

You can develop your personal finance skills by conducting an Internet search for related articles. Find a recent online article about personal finance that reinforces one or more concepts covered in this chapter. If your class has an online component, your professor may ask you to post your summary of the article there and provide a link to the article so that other students can access it. If your class is live, your professor may ask you to summarize your application of the article in class. Your professor may assign specific students to complete this assignment or may allow any student to do the assignment on a volunteer basis.

Web Search Exercises
This exercise directs students to conduct an online search for real-world events related to the key content of each chapter.

VIDEO EXERCISE: Investing in Money Markets

Go to one of the Web sites that contain video clips (such as www.youtube.com), and view some video clips about investing in money market securities. You can use search phrases such as "investing in money markets." Select one video clip on this topic that you would recommend for the other students in your class.

1. Provide the Web link for the video clip.
2. What do you think is the main point of this video clip?
3. How might you change your investment in money market securities after watching this video clip?

Video Exercises
This activity has students find a video on an important finance topic discussed in the chapter.

Psychology of Personal Finance Questions

At the end of every chapter is a section on the Psychology of Personal Finance that tests students' understanding of how psychological forces such as desire for immediate satisfaction can influence personal finance decisions.

PSYCHOLOGY OF PERSONAL FINANCE: Using Your Credit Cards

For many people, less pain is associated with using a credit card to make purchases than with using cash, even if the payments are the same. The use of the credit card almost feels like there is no payment, but the use of cash means that there is less cash available for other purchases. Therefore, spending decisions are made more carefully when using cash.

1. Describe your opinion on this topic. Do you feel less pain when using a credit card? Are your spending decisions made more carefully when you use cash as opposed to credit cards?
2. Read one practical article about how psychology affects the use of credit cards. You can easily retrieve possible articles by doing an online search using the terms "psychology" and "using credit cards." Summarize the main points of the article.

Financial Literacy Tests

A Financial Literacy Pre-Test is included just before Chapter 1. Answers are provided so that students can grade their performance. This test allows students to discover how much they do not know about personal finance and motivates them to develop their skills. A Financial Literacy Post-Test is provided immediately following Chapter 21. This test lets students discover how much they have learned after finishing the course. Answers are supplied so that students can easily assess their performance.

Financial Literacy POST-TEST

The following test will help you determine how much you learned about personal finance. It contains basic questions on material you learned from the text that can determine your ability to make proper financial planning decisions.

After taking the test, grade your performance based on the answers provided at the end of the test.

1. The ______ specifies the financial decisions that result from your personal financial planning.
   a. personal financial plan
   b. personal budget
   c. personal finance objective
   d. none of the above
2. When constructing a budget, it is helpful to use a personal cash flow statement, which measures a person's ______ and ______.
   a. cash inflows; cash outflows
   b. assets; expenses
   c. assets; liabilities
   d. none of the above
3. The time value of money implies that a dollar received today is worth ______ a dollar received tomorrow.
   a. more than
   b. the same as
   c. less than
   d. none of the above
4. Which of the following will not affect the amount of taxes you pay? (Assume that you itemize for tax purposes.)
   a. Purchasing a home that will be financed with a mortgage
   b. Contributing a portion of your salary to your retirement account
   c. Taking a third job to enhance your wealth
   d. All of the above will affect the amount of taxes you pay.
5. ______ are not a type of depository institution.
   a. Credit unions
   b. Savings institutions
   c. Commercial banks
   d. Securities firms
6. Individuals with short-term funds would probably not invest them in ______.
   a. CDs
   b. NOW accounts
   c. corporate bonds
   d. checking accounts
7. Credit cards that allow consumers to borrow up to a specified maximum amount are examples of ______.
   a. installment credit
   b. collateral-based credit
   c. noninstallment credit
   d. revolving open-end credit
8. When applying for a credit card, you will probably not be asked for information regarding ______.
   a. your cash inflows and outflows
   b. your capital
   c. your credit history
   d. your criminal record
9. When applying for a loan, borrowers will probably need to provide information regarding their ______.
   a. personal balance sheet
   b. assets
   c. personal cash flow statement
   d. Borrowers probably need to provide information regarding all of the above.
10. The ______ the cost of a home, the ______ the insurance.
   a. higher; higher
   b. higher; lower
   c. lower; higher
   d. none of the above

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Appendix B PROJECTS

The following pages include projects for you to complete relating to specific aspects of personal finance.

- Assessing Your Credit
- Career Planning Project
- Leasing an Apartment
- Stock Market Project

Assessing Your Credit

Answer the following questions based on how you use your credit card, or how you think you would use a credit card:

1. **Credit Spending.** How much do you spend per month on your credit card?
2. **Number of Credit Cards.** Do you have many credit cards? Are all of them necessary? Do you spend more money than you would normally as a result of having extra credit cards?
3. **Credit versus Cash.** Would you make the most of your purchases if you used cash instead of a credit card? Do you feel like purchases have no cost when you use a credit card instead of cash?
4. **Pay Off Part or All of Balance.** What is your normal strategy when you receive a credit card bill? Do you only pay the minimum amount required? Do you typically pay off your entire balance on a monthly basis? If you do not pay off the entire balance, is it because you cannot afford to pay it off, or because you would prefer to have extra cash on hand? If you have a positive balance, how do you plan to pay off that balance? Pay all of it off next month? Or pay only the minimum amount required next month?
5. **Credit Limit.** Consider the limit on the amount you can spend using your credit cards. Does the limit restrict your spending? Would you benefit if the limit were increased? Or reduced?
6. **Obtaining Your Credit Report.** Go to www.annualcreditreport.com to obtain your free credit report. If you recently obtained your report, just review that report rather than obtaining a new one. Notice the types of companies that requested information on your credit. Is your credit report accurate? If not, you can write to the credit bureau to have the wrong information corrected, as explained in the text.
7. **Assessing Your Credit Report.** Are you satisfied with your existing credit rating? If not, what steps do you plan to take to improve your credit rating? For example, could you reduce some debt in the future? See Chapter 7 for more ideas on improving your credit rating.

Career Planning Project

Personal financial planning involves how you budget your money, manage your liquidity, finance purchases, protect your assets, invest your money, and plan your retirement and estate. All these activities are focused on your money. A related task is career planning, which determines the amount of money that you can earn over time. Furthermore, your career determines your quality of life. Most people think about their ideal career (such as rock star, professional athlete, movie star), but do not spend enough time planning a realistic career. This project allows you learn about possible career opportunities in which you might have an interest. Your instructor may offer you additional details regarding the deadline date and length of the project.

Projects

Several projects are available in Appendix B.

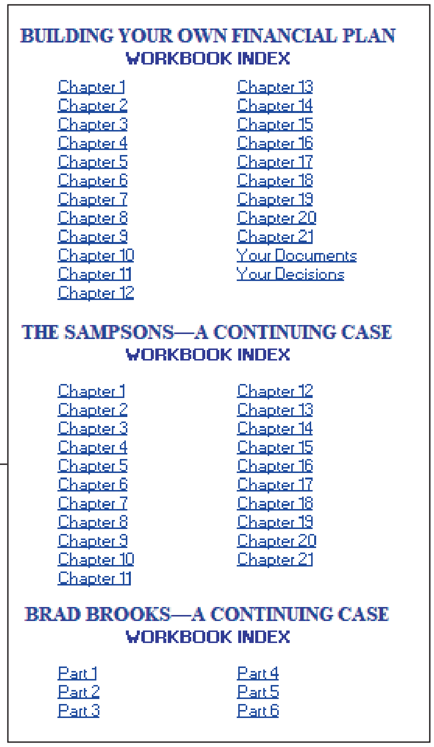
- *Assessing Your Credit* prompts students to evaluate their credit card balance and credit limit. It also guides students to obtain their credit score and to consider whether they should implement a strategy to pay down their existing credit balance.
- *Career Planning Project* allows students to research a particular career that they plan to pursue and report on their research.
- *Leasing an Apartment* allows students to assess the cost and potential benefits of leasing a particular apartment that they have identified.
- *Stock Market Project* allows students to simulate the investing process, monitor a particular stock, and analyze how stock values respond to economic conditions.

Financial Planning Workbook

The financial planning workbook, which requires students to take decisions based on their learning, is fully integrated into the text. At the end of each chapter, the student is prompted to complete the Building Your Own Financial Plan exercises and the Sampson family continuing case. At the end of each part, the student is prompted to complete the Brad Brooks continuing case. Students should use the worksheets in MyLab Finance where Excel software can be applied to facilitate the process.

Additional software features include the following:

- Calculation-based templates allow students to easily forecast their future salary, forecast their future savings, determine their income tax liability, and estimate their monthly payments on a mortgage.
- Enhanced graphics, such as pie charts and bar graphs that are generated based on user input, aid students in visualizing their cash outflows and asset allocation.


BUILDING YOUR OWN FINANCIAL PLAN
WORKBOOK INDEX

Chapter 1, Chapter 2, Chapter 3, Chapter 4, Chapter 5, Chapter 6, Chapter 7, Chapter 8, Chapter 9, Chapter 10, Chapter 11, Chapter 12, Chapter 13, Chapter 14, Chapter 15, Chapter 16, Chapter 17, Chapter 18, Chapter 19, Chapter 20, Chapter 21, Your Documents, Your Decisions

THE SAMPSONS—A CONTINUING CASE
WORKBOOK INDEX

Chapter 1, Chapter 2, Chapter 3, Chapter 4, Chapter 5, Chapter 6, Chapter 7, Chapter 8, Chapter 9, Chapter 10, Chapter 11, Chapter 12, Chapter 13, Chapter 14, Chapter 15, Chapter 16, Chapter 17, Chapter 18, Chapter 19, Chapter 20, Chapter 21

BRAD BROOKS—A CONTINUING CASE
WORKBOOK INDEX

Part 1, Part 2, Part 3, Part 4, Part 5, Part 6

Developing Employability Skills

This textbook enhances the employability skills of students in the following ways:

- It provides a background on all the major personal finance functions, which is essential for employment in financial services fields such as banking or insurance, where personal customer service is crucial.
- It enables students to develop their own personal financial plan, which is a necessary skill in order to pursue employment as a financial advisor.
- The financial planning exercises and cases give students experience in critical thinking, and solving dilemmas, which is necessary for many occupations.
- The personal budgeting and financial planning skills that students attain can be applied to many occupations in the business world, because businesses must manage liquidity and financing in order to accommodate their spending plans.

This table identifies which features and end-of-chapter materials will help students to develop their employability skills:

	Communication	Critical Thinking	Collaboration	Knowledge Application and Analysis	Business Ethics and Social Responsibility	Information Technology and Computing Skills	Data Literacy
Building Your Own Financial Plan	✓	✓		✓		✓	✓
Financial Planning Problems	✓	✓		✓		✓	✓
Financial Planning Online Exercises		✓		✓		✓	✓
Example: Stephanie Spratt		✓		✓			✓

	Communication	Critical Thinking	Collaboration	Knowledge Application and Analysis	Business Ethics and Social Responsibility	Information Technology and Computing Skills	Data Literacy
Case: The Sampsons	✓	✓	✓	✓	✓	✓	✓
Case: Brad Brooks	✓	✓	✓	✓	✓	✓	✓
Ethical Dilemmas		✓		✓	✓		✓
Web Search Exercise		✓		✓		✓	✓
Video Exercise		✓		✓		✓	✓
Projects (Appendix B)	✓	✓	✓	✓			✓

Instructor Teaching Resources

The following array of supplementary materials is available to help busy instructors teach more effectively and to allow busy students to learn more efficiently.

Supplements available to instructors at *www.pearsonhighered.com/madura*	**Features of the Supplement**
Instructor's Manual authored by Mike Casey	• Chapter-by-chapter summaries • Examples and activities not in the main book • Teaching tips • Solutions to all questions and problems in the book
Test Bank authored by Alan Wolk	Over 2,000 multiple-choice, true/false, and short-answer questions with these annotations: • Difficulty level (1 for straight recall, 2 for some analysis, 3 for complex analysis) • Topic (the term or concept the question supports) • AACSB learning standard (Written and Oral Communication; Ethical Understanding and Reasoning; Analytical Thinking; Information Technology; Interpersonal Relations and Teamwork; Diverse and Multicultural Work; Reflective Thinking; Application of Knowledge)
Computerized TestGen	TestGen allows instructors to: • Customize, save, and generate classroom tests • Edit, add, or delete questions from the Test Item Files • Analyze test results • Organize a database of tests and student results
PowerPoints authored by Mike Casey	Slides includes graphs, tables, and equations in the textbook. PowerPoints meet accessibility standards for students with disabilities. Features include, but not limited to: • Keyboard and Screen Reader access • Alternative text for images • High color contrast between background and foreground colors

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Financial Literacy PRE-TEST

The following test will help you determine how much you already know about personal finance. It contains basic questions that can determine your ability to make proper financial planning decisions. This text explains the concepts identified in the test that are essential to make financial planning decisions. It also covers more analytical concepts that can allow you to develop an effective financial plan.

After taking the test, grade your performance based on the answers provided at the end of the test.

1. If you give something up as a result of making a decision, you are incurring a(n) ________.
   a. liquidity problem
   b. net cost
   c. opportunity cost
   d. none of the above
2. ________ sell shares to individuals and invest the proceeds in investment instruments such as bonds or stocks.
   a. Financial plans
   b. Budget plans
   c. Mutual funds
   d. none of the above
3. When finding the present value of a future value or the present value of an annuity, the ________ the interest rate, the ________ the present value.
   a. higher; higher
   b. lower; lower
   c. higher; lower
   d. none of the above
4. ________ reduce taxable income if the taxpayer does not itemize.
   a. The standard deduction
   b. Dividends
   c. Capital gains
   d. none of the above
5. When the Federal Reserve wishes to ________ interest rates, it ________ the amount of funds at commercial banks.
   a. reduce; reduces
   b. increase; increases
   c. reduce; increases
   d. Answers (a) and (b) are correct.
6. A ________ offered by a depository institution specifies a minimum amount that must be invested, a maturity date on which the deposit matures, and an annualized interest rate.
   a. NOW account
   b. money market deposit account
   c. certificate of deposit
   d. savings account
7. In all cases of identity theft, you should notify the ________.
   a. FTC
   b. U.S. Postal Service
   c. FBI
   d. Secret Service
8. The ________ quoted on credit represents the simple interest rate charged after including any fees imposed by the creditor.
   a. annual percentage rate (APR)
   b. money market rate (MMR)
   c. effective annual rate (EAR)
   d. debit card rate (DCR)

9. Which of the following is not a disadvantage of leasing?
   a. You may have to purchase more car insurance than you already have.
   b. You must worry about finding a buyer for the car at the end of the lease period.
   c. You have no equity investment in the car.
   d. You may be charged if you drive more than a maximum number of miles specified in the original lease agreement.
10. When purchasing a home, which of the following costs will you not incur?
   a. Closing costs
   b. Loan application fee
   c. Real estate broker's commission
   d. Down payment
11. A deductible of $500 requires ________.
   a. you to pay the first $500 in damages
   b. the party at fault to pay the first $500 in damages
   c. the insurance company to pay the first $500 in damages
   d. none of the above
12. ________ is not a source of disability income insurance.
   a. Insurance from Social Security
   b. Employer disability insurance
   c. Insurance from worker's compensation
   d. All of the above are sources of disability income insurance.
13. For a given life insurance policy with specific benefits, the insurance premium is ________ related to one's age.
   a. rarely
   b. never
   c. positively
   d. inversely
14. ________ is not a common investment mistake made by individuals.
   a. Making decisions based on unrealistic goals
   b. Borrowing to invest
   c. Taking risks to recover losses from previous investments
   d. All of the above are common investment mistakes made by individuals.
15. When investors purchase stock on margin, they
   a. are buying stock in the over-the-counter market.
   b. are using a buy-stop order.
   c. are borrowing money from the brokerage firm to fund part of the purchase.
   d. are lending money to the brokerage firm.
16. The ________ a bond provides credit.
   a. shareholder of
   b. investor in
   c. issuer of
   d. none of the above
17. Which of the following is not a motive for investing in mutual funds?
   a. The expertise of the portfolio managers who decide how to invest the money you provide
   b. Mutual funds are designed to meet specific investment goals
   c. Investing in a broadly diversified portfolio with a small initial investment
   d. All of the above are motives for investing in mutual funds.
18. The price at which an option can be exercised is the ________.
   a. premium
   b. put add-on
   c. call price
   d. exercise price
19. Individuals subject to a ________ income tax rate enjoy the greatest tax benefits as a result of using a retirement plan.
   a. middle
   b. high
   c. zero
   d. low
20. The executor of a will is also referred to as the ________.
   a. grantor
   b. guardian
   c. personal representative
   d. trustee

Answers

1. C	11. A
2. C	12. D
3. C	13. C
4. A	14. D
5. C	15. C
6. C	16. B
7. A	17. D
8. A	18. D
9. B	19. B
10. C	20. C

chapter 1

Overview of a Financial Plan

How is it that Jill Warden could afford to purchase a nice condominium this year, while many of her friends who have similar income levels are barely able to pay their rent? Jill has made many personal finance decisions over time that have favorably affected her financial situation. She went to a well-respected but public university where the annual tuition was relatively low. She drives a car that is not flashy but is functional and economical. She uses much of her free time to exercise or watch movies on television, rather than spending money at restaurants or clubs. She buys nice clothes, but only when they are on sale and are not designer brands. These personal finance decisions saved her money, which allowed her to afford a nice condominium. Furthermore, she rents out a room in her condominium, which makes it easy for her to cover her monthly mortgage payment.

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You have many personal finance decisions to make. Your choice of your major in college has a major impact on your job satisfaction and your future income. Your decision on your car purchase has a major impact on your budget. Your decision to live at home or get an apartment has a major impact on your budget. Personal finance decisions that require some sacrifice enable you to make other personal finance decisions that are rewarding.

A first step in achieving your financial success is to establish a financial plan, whereby you assess your existing financial position and consider how you may be able to improve it, so that you can use your money in the manner that you desire. This textbook introduces the key components of the financial plan and enables you to establish your own financial plan. The sooner you develop your goals and a financial plan to achieve those goals, the easier it will be to achieve your objectives.

MyLab Finance helps you master the topics in this chapter and study more efficiently. Visit www.pearson.com/mylab/finance for more details.

The objectives of this chapter are to:

- Explain how personal finance enhances your wealth
- Explain how personal finance enhances your job marketability
- Identify the key components of a financial plan
- Explain how financial planning affects your cash flows
- Outline the steps involved in developing your financial plan

How Personal Finance Can Enhance Your Wealth

personal finance (personal financial planning)
The process of planning your spending, financing, and investing to optimize your financial situation.

personal financial plan
A plan that specifies your financial goals and describes the spending, financing, and investing plans that are intended to achieve those goals.

Personal finance (also referred to as **personal financial planning**) is the process of planning your spending, financing, and investing to optimize your financial situation. A **personal financial plan** specifies your financial goals and describes the spending, financing, and investing plans that are intended to achieve those goals. Although the United States is one of the wealthiest countries in the world, many Americans do not manage their financial situations well. Consequently, they tend to rely too much on credit and have excessive debt.

Historically, most educational systems have not given much attention to personal finance. Consequently, many people have limited personal finance skills, or had to teach themselves in response to financial dilemmas that they experienced. To assess your own understanding, take the Financial Literacy Pre-Test that precedes this chapter. Even if you presently have limited personal finance skills, you have taken the first step to improve those skills by reading this textbook.

Personal finance does not require a genius mind, but does require the use of common sense and discipline. If you make proper personal finance decisions, you will spend your money more carefully, which can reduce the amount of funds you need to borrow, or can increase your savings. Either result increases your wealth, and allows you to more easily afford purchases of products or services in the future. Conversely, poor personal finance decisions can cause you to borrow excessively, to the point at which you might not be capable of repaying your debt. About 790,000 people in the United States filed for personal bankruptcy in 2016. You might think that personal bankruptcy only occurs when an individual pursues a very risky strategy, such as borrowing excessively and losing all the money from gambling or from investing in a very risky stock. However, many bankruptcies are the result of some simple personal finance decisions that lack common sense.

EXAMPLE

Brittney and Laura are twin sisters who performed equally well in high school. Their parents could not afford to pay their college tuition. The main personal finance decisions Brittney and Laura made in the last five years are summarized below:

Type of Personal Finance Decision	Brittney's Decision	Laura's Decision
Selection of University	Attended the local state university ($8,000 per year tuition) located in the city where she lives.	Attended the local private university which has an academic reputation similar to the local state university, but charges $30,000 per year tuition, and is located in the city where she lives.

Type of Personal Finance Decision	Brittney's Decision	Laura's Decision
Selection of Major	Decided to major in nursing because she would enjoy a job in healthcare, and because many sources suggested that there were many nursing jobs available at high salaries.	Selected a specific major that is known to require very little studying, and most students selecting this major get very high grades without much effort.
Use of Credit Card	Used to cover entertainment expenses; she pays off the balance each month.	Used to cover entertainment expenses; she only paid the interest expense per month during her college years.
Housing During College	Lived at home with her parents and commuted to her university.	Lived on campus at the private university.
Housing After Graduating College	Lived at home with parents for one year after college to avoid the expense of paying rent.	Moved into a nice apartment.
Work During College	Worked part-time during her college years in order to cover her entertainment expenses.	Did not work during her college years.
Car Purchase After Graduating College	Decided to just retain her 5-year-old car instead of buying a new car, because it still runs well.	Traded in her 5-year-old car so that she could buy a new one; she needed to borrow $20,000 after considering the trade-in to purchase the car.

When comparing Brittney and Laura's personal finance decisions, it is obvious that Laura had a lot more fun than Brittney over the last five years. Brittney spent her time pursuing a rigorous nursing degree while working part-time and living at home. Laura spent her time enjoying life without a job and without having to study, while living comfortably away from home.

However, consider how their very different personal finance decisions affected their debt level. Brittney has $30,000 in student loans that she needs to repay in the future. She has no credit card loan balance because she used the income from her part-time job to cover credit card payments. Conversely, Laura owes $160,000 on her loans and credit cards, because of her spending decisions.

Now consider how their very different personal finance decisions regarding their majors affected their occupation, their income level, and therefore their ability to repay their debt. Brittney used her nursing degree to obtain a job as a nurse, earning an annual salary of $60,000 plus major health care and retirement benefits. By living at home (and avoiding rent payments) for one year after graduation, Brittney was able to save enough money from her high-paying job to repay her $30,000 student loans. As of one year after graduation, she has no debt. Meanwhile, Laura struggled to find a rewarding job after graduating with a degree that has little job marketability. She took a temporary job that does not even require a college degree, which is paying her $2,000 per month. She is unable to pay off any of her student loans and credit card balance with this level of income. She is very frustrated, and feels she is the victim of horrible luck, while her twin sister was unusually lucky. It will be very difficult for Laura to overcome her debt problem, and she will likely file for personal bankruptcy in the future.

Based on their personal finance decisions, Brittney and Laura made their own luck. There was no logical reason for Laura to believe that her selection of her private university and her major were going to lead to an occupation with very high pay. Laura might have been better off working in some type of job over the past four years instead of going to college. Alternatively, she probably could have quickly found a permanent full-time job with better pay and with benefits if she had been willing to pursue college majors that enhance job marketability. It would have taken Laura no more than an hour to learn enough about job marketability associated with many different majors. Even if Laura was unwilling to consider other majors, she could have at least reduced her tuition (and therefore her debt) by $88,000 by going to the local state university instead of the private university. She could have reduced her debt even further by living at home during college or by avoiding the purchase of a new car.

In general, Brittney's personal finance decisions were based on satisfying her long-term goals, such as being able to afford a nice home (even though she sacrificed over the short-term). One year out of college, Brittney has put herself in a position in which she can reward herself, either by moving into a nice apartment, buying a new car, or building her savings so that she can purchase a home in the near future. Conversely, Laura's personal finance decisions were based on what would satisfy her the most over the short-term, even though she will be adversely affected in the long-term. Laura's personal finance decisions placed her in a hopeless position in which she has limited job marketability that prevents her from reducing her excessive debt.

Take a moment and assess your own personal finance situation, as related to the example above. Are you more like Brittney or Laura? Even if you think it would be difficult to make personal finance decisions like Brittney did, it is useful to consider the tradeoffs for any particular decision. Put yourself in Brittney's position so that you can weigh the tradeoffs from your own perspective. If you decided to pursue the private university while leaving all of Brittney's other decisions the same, your tuition payments (and therefore debt) would have been $88,000 higher. If you pursued a less marketable major than nursing while leaving all of Brittney's other decisions the same, your debt level upon graduation would not have changed, but it would likely take you longer to repay your student loans (because your income would be lower). If you decided to live on campus at the state university instead of living at home, your room and board might have been about $10,000 per year, which would add an extra $40,000 to your debt over the college years. If you decided to get an apartment immediately after graduation while leaving all of Brittney's other decisions the same, you would have needed a longer period (perhaps an extra six months) to pay off your student loans. Overall, each personal finance decision that you make will typically have an impact on either your future income or your debt in a manner that can be measured. Therefore, you can measure the potential benefits (such as how your income might increase) versus the potential cost (how your debt might increase) due to a personal finance decision.

Some media sources have mentioned situations like that of Laura in the previous example, making a point about the outrageous expense of a college education. While students might not have much control over the tuition charged by each university, they do have some control in their selection of a university. Students who want to pursue a college education and have limited funds are not forced to go to a private university.

They can consider state-supported universities, which commonly charge a substantially lower tuition. In addition, students are allowed to choose their own major. Nothing is forcing them to select the easiest possible major, for which there might be limited job marketability. Just because an educational institution is willing to help students obtain very large student loans, no one is forcing the student to borrow all the money that is available. Some students with limited funds accept the student loans without really assessing how difficult it will be to repay the loans in the future. Consequently, they might not always select the university that is the best value for them (that charges relatively low tuition while offering a quality education). Students who have an understanding of personal finance should be able to make college decisions and other financial decisions that allow them to accumulate wealth over time.

Reliance on Personal Finance Advice An understanding of personal finance would not make you an expert on every personal finance decision, but may at least help you determine whether to trust any specific advice offered to you.

EXAMPLE

Reconsider the previous example, in which Laura decided to pursue the private university instead of a state university of similar academic quality. This decision was partially due to advice she received from high school friends who went to that private university. However, one friend is on a scholarship, and her tuition is free. A second friend's parents are paying for her tuition and room and board, so she will have no debt upon graduation. A third friend is on a partial scholarship and majored in mechanical engineering, for which the private university has a great reputation. Thus, this friend's education will allow her to pursue jobs with very high salaries. Laura's three friends have very logical personal finance reasons for pursuing their education at that private university. Yet, they are not in the same position as Laura, and they did not consider Laura's position when they convinced Laura to attend the private university. Laura should have recognized that her friends are in different situations than her, but she simply reasoned that she would have a lot of fun being on the same campus as her four friends over a four-year period.

Each of Laura's friends told Laura to "chase your dreams." Everyone can interpret that advice in a different way, but when Laura was 18 years old and about to enter college, she had no long-term goals. She was living for the moment. Her dreams were completely focused on going away to college (a four-year vacation), without any consideration of a major that could lead to a rewarding career. So she listened to all the advice that would allow for the most satisfying outcome in the short run, with no consideration of the long-term consequences.

The only advice that Laura ignored was from her twin sister Brittney, who warned her about the potential long-term financial implications of pursuing an education where tuition payments were high and about choosing a major for which there were very few jobs. Brittney's advice was very valid, because Brittney was putting herself in Laura's position when offering this advice. In fact, Brittney used this same logic to make her own decisions to pursue a college education at a state university and to pursue a marketable major. Laura felt that Brittney was too serious about life, and even tried to convince Brittney to enroll at the private university and room together on campus so that they could have fun together over their college years. Had Brittney listened to Laura's advice, she would likely have been overloaded with debt just like Laura by the time of her graduation. If Laura had followed the basic principles of personal finance, she would not have made decisions that caused her to accumulate $160,000 in debt.

How Personal Finance Can Enhance Your Job Marketability

An understanding of personal finance may interest you in pursuing a career as a financial adviser. Financial advisers are in demand, because many people lack an understanding of personal finance or are not interested in making their own financial decisions. A single course in personal finance is insufficient to start a career as a financial adviser, but it may interest you in taking additional courses to obtain the necessary qualifications.

However, even if you decide to work for a company in a different capacity than as a financial adviser personal finance decisions are very similar to decisions that employees make within a company. You attempt to earn income so that you have money to spend or save. A company earns income so that it has money to spend or save. You spend money to buy products. A company spends money to buy products (or supplies). If you spend more money than the amount you have in savings, you need to finance your purchases by borrowing. When a company spends more money than it has saved, it has to finance its purchases. Your spending decisions affect your savings and your financing decisions. The more you spend, the less you save, or the more financing you need. Just as you need to develop a financial plan to guide your financial decisions, a company needs to develop a plan (called a business plan) to guide its business decisions. Once you fully understand the tradeoffs involved in the personal financial planning process, you can apply the same concepts when establishing a business plan for your own business or for a company where you are employed.

Furthermore, as you build your financial plan throughout this textbook, you are developing skills that enhance your employability. When you make personal finance decisions, you are managing yourself. Self-management is a very important trait in the workplace, because it means that you can take the initiative to make decisions. In addition, personal finance decisions require weighing tradeoffs of alternative options and problem solving (qualitative and quantitative). The process used in making personal finance decisions can be applied to make other business decisions.

Your decision regarding any single component of a financial plan affects all other components. Consequently, you must use your organizational skills to understand how your decisions about any single component of your financial plan can affect your decisions about other components of your financial plan (as illustrated later in this chapter). You will likely need to apply those organizational skills in the workplace whenever making any decision about one department that can influence other departments.

Finally, consider that a major function involved in completing your financial plan is to identify possible ways to achieve your financial goals (as explained later in this chapter). Specifically, this involves identifying the possible degrees you might need to pursue your desired occupation and to realize your financial goals. This planning task directly influences your employability, because your decision about pursuing a specific degree will likely have a major impact on your ultimate occupation and your employability.

Components of a Financial Plan

You can benefit from building your own financial plan, which consists of the following personal finance components:

1. Budgeting and tax planning
2. Managing your liquidity
3. Financing your large purchases
4. Protecting your assets and income (insurance)
5. Investing your money
6. Planning your retirement and estate

Each of the first six parts of this text is devoted to one component of the financial plan, and the seventh part synthesizes these components. To begin your introduction to the financial planning process, let's briefly explore each component.

A Plan for Your Budgeting and Tax Planning

budget planning (budgeting)
The process of forecasting future expenses and savings.

Budget planning (also referred to as **budgeting**) is the process of forecasting future expenses and savings. That is, it requires you to determine how you spend money, the amount of money to spend, and how much to save. Your spending decisions are critical, because they determine how much of your income can be used for other purposes.

FREE APPS for Personal Finance

Your Spending Decisions

Application:

The Spending Tracker app (by MH Riley Ltd) allows you to easily monitor how you spend your money.

To Find It:

Search for the "Spending Tracker" app on your mobile device.

If you receive $750 in income during one month, your amount saved is the amount of money (say, $100) that you do not spend. The relationship between income received, spending, and saving is illustrated in Exhibit 1.1. Some individuals are "big spenders": They focus their budget decisions on how to spend most or all of their income, and therefore have little or no money left for saving. Others are "big savers": They set a savings goal and consider spending their income received only after allocating a portion of it toward saving. Budgeting can help you estimate how much of your income will be required to cover monthly expenses so that you can set a goal for saving each month.

assets
What you own.

liabilities
What you owe; your debt.

net worth
The value of what you own minus the value of what you owe.

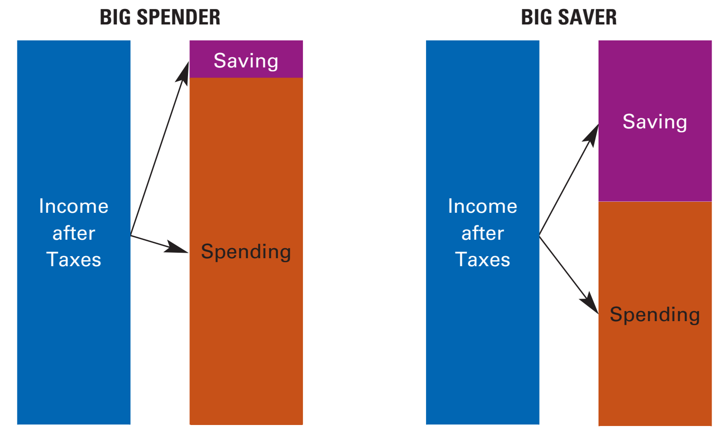
The first step in budget planning is to evaluate your current financial position by assessing your income, your expenses, your **assets** (what you own), and your **liabilities** (debt, or what you owe). Your **net worth** is the value of what you own minus the value of what you owe. You can measure your wealth by your net worth. As you save money, you increase your assets and therefore increase your net worth. Budget planning enables you to build your net worth by setting aside part of your income to either invest in additional assets or reduce your liabilities.

Your budget is influenced by your income, which in turn is influenced by your education and career decisions. Individuals who pursue higher levels of education tend to have smaller budgets during their education years. After obtaining their degrees, however, they typically are able to obtain jobs that pay higher salaries, and therefore have larger budgets.

A key part of budgeting is estimating the typical expenses that you will incur each month. If you underestimate expenses, you will need more cash inflows (money that you receive) than you expected to cover your cash outflows (money that you spend). Achieving a higher level of future wealth requires you to maintain your spending at a lower level today.

Many financial decisions are affected by tax laws, as some forms of income are taxed at a higher rate than others. By understanding how your alternative financial choices would be affected by taxes, you can make financial decisions that have the most favorable effect on your cash flows. Budgeting and tax planning are discussed in Part 1 because they are the basis for decisions about all other parts of your financial plan.

EXHIBIT 1.1 How a Budget Plan Affects Savings



A Plan to Manage Your Liquidity

liquidity
Access to funds to cover any short-term cash needs.

money management
Decisions regarding how much money to retain in a liquid form and how to allocate the funds among short-term investment instruments.

credit management
Decisions regarding how much credit to obtain to support your spending and which sources of credit to use.

You should have a plan for how you will cover your daily purchases. Your expenses can range from your morning cup of coffee to major car repairs. You need to have **liquidity**, or access to funds to cover any short-term cash needs. You can enhance your liquidity by utilizing money management and credit management.

Money management involves decisions regarding how much money to retain in a liquid form and how to allocate the funds among short-term investments. If you do not have access to money to cover your cash needs, you may have insufficient liquidity. That is, you have the assets to cover your expenses, but the money is not easily accessible. Finding an effective liquidity level involves deciding how to invest your money so that you can earn a return, but also have easy access to cash if needed. At times, you may be unable to avoid cash shortages because of unanticipated expenses.

Credit management involves decisions about how much credit you need to support your spending and which sources of credit to use. Credit is commonly used to cover both large and small expenses when you are short on cash, so it enhances your liquidity. Credit should be used only when necessary, however, as you will need to pay back borrowed funds with interest (and the interest expenses may be very high). The use of money management and credit management to manage your liquidity is illustrated in Exhibit 1.2.

A Plan for Financing Your Large Purchases

Loans are typically needed to finance large expenditures, such as the payment of college tuition or the purchase of a car or a home. The amount of financing needed is the difference between the amount of the purchase and the amount of money you have available, as illustrated in Exhibit 1.3. Managing loans includes determining how much you can afford to borrow, deciding on the maturity (length of time) of the loan, and selecting a loan that charges a competitive interest rate.

A Plan for Protecting Your Assets and Income

insurance planning
Determining the types and amount of insurance needed to protect your assets.

To protect your assets, you can conduct **insurance planning**, which determines the types and amount of insurance that you need. In particular, automobile insurance and homeowner's insurance protect your assets, and health insurance limits your potential medical expenses. Disability insurance and life insurance protect your income.

EXHIBIT 1.2 Managing Your Liquidity

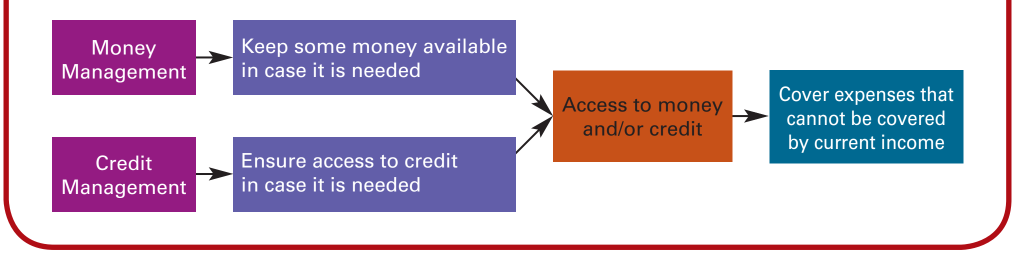
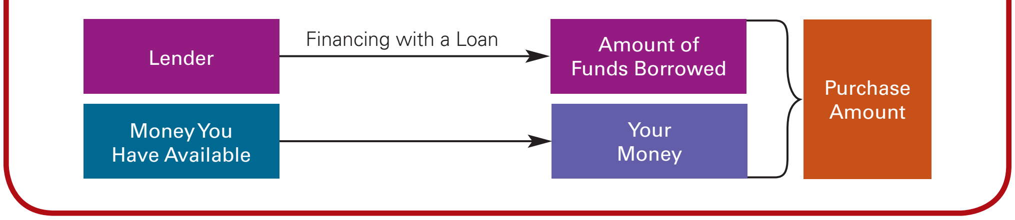


EXHIBIT 1.3 Financing Process



A Plan for Investing Your Money

Any funds that you have beyond what you need to maintain liquidity should be invested. Because these funds normally are not used to satisfy your liquidity needs, they can be invested with the primary objective of earning a high return. Potential investments include stocks, bonds, mutual funds, and real estate. You must determine how much of your funds you wish to allocate toward investments and what types of investments you wish to consider. Most investments are subject to **risk** (uncertainty surrounding their potential return), however, so you need to manage them so that your risk is limited to a tolerable level.

risk
Uncertainty surrounding the potential return on an investment.

A Plan for Your Retirement and Estate

Retirement planning involves determining how much money you should set aside each year for retirement and how you should invest those funds. Retirement planning must begin well before you retire, so that you can accumulate sufficient money to invest and support yourself after you retire. Money contributed to various kinds of retirement plans is protected from taxes until it is withdrawn from the retirement account.

Estate planning is the act of planning how your wealth will be distributed before or upon your death. Effective estate planning protects your wealth against unnecessary taxes and ensures that your wealth is distributed in the manner that you desire.

retirement planning
Determining how much money you should set aside each year for retirement and how you should invest those funds.

estate planning
Determining how your wealth will be distributed before or upon your death.

Building Your Own Financial Plan

An effective financial plan enhances your net worth, and therefore builds your wealth. In each part of this text, you will have the opportunity to develop a component of your financial plan. At the end of each chapter, the Building Your Own Financial Plan exercise offers you guidance on the key decisions that you can make after reading that chapter. Evaluate your options, and make decisions using the Excel-based software available with your text. By completing the Building Your Own Financial Plan exercises, you will build a financial plan for yourself by the end of the school term.