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CHAPTER 1

Developing a Financial Plan

Jim Meredith and Robert Arffa

Why Do You Need a Financial Plan?

Most of us make our way day by day. Our society has conditioned us to think and react with a short-term perspective. Occasionally we can become overwhelmed when we think about future commitments like paying for the kids' education or our retirement. However, it is the rare person who determines exactly what it is going to take to reach his or her goals, and follow through the necessary steps. But planning makes it much more likely that you will be able to accomplish your goals.

A major part of this process is determining your own set of values and goals. You and your spouse or companion must reach a consensus. There is little that is more important than for a couple to sit down and talk about their respective life goals. Most goals and life events involve finances. Marriage, change in job, relocation, starting your own business, number of children, caring for aged parents, age of retirement—these are a few examples of life decisions that affect your finances. Reaching a consensus with your spouse on your goals, their relative priorities, and the use of your financial resources to reach them is essential for your relationship as well as your financial security.

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Financial planning helps you both to balance the constant trade-off between spending on what you want today and saving for what you want in the future.

Making a financial plan is not a one-time or static decision. It is as dynamic as life itself. Your financial situation changes over time, and so may your goals. Often life will throw you curves, and a good plan will prepare you and protect you as much as possible from what life may bring. Developing an emergency fund can help you cope with unexpected expenses or financial setbacks. You can estimate the size of such a reserve, and where those funds should be placed. You can also determine what types and amounts of insurance you need to protect your family from catastrophic financial losses.

The Planning Process

The first step in developing a financial plan is to *make a commitment to the process*. It takes time, and often difficult or uncomfortable decisions must be made. You have to think about and discuss with your spouse your financial situation, goals, and priorities. You must review your spending, savings, investments, and insurance. You may have to work out compromises with your spouse on some important issues. However, in the long run the time spent will be profitable.

There is no way to come to conclusions quickly. Designing a long-term plan follows the same path as building a home. Plan the size, shape, number of rooms, cost, and so on before breaking ground. Many of us rush to pick out wallpaper before we've determined the size and shape of the room and locations of doors and windows. Instead of following a plan, many people patch together a poorly designed house, frequently changing directions in the middle of the project.

The next step is to *set your goals*. You begin with a simple list of your needs and dreams, and through the planning process (Figure 1.1.) they are prioritized, revised, and refined. The most common goals are buying a (first/larger/nicer/more expensive) home, children's education, and retirement. Many other goals are listed in Table 1.1. Generally goals fall into two categories: accumulation goals and income replacement goals. With an accumulation goal you are aiming to have a certain amount of money by a given date. College funding is one example. An income replacement goal is a need to generate a stream of cash flow starting at some point and continuing into the future, such as for retirement. Retirement funding is often the most challenging goal, because retirement can be so far in the future, and it involves such a large amount of savings.

Once you have a tentative list of goals, you and your spouse should *priori-*

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The Planning Process

1. Commit to the process.
2. Develop a list of goals.
3. Prioritize your goals.
4. Assess your current financial status:
   Current resources/balance sheet.
   Cash flow analysis.
5. Make projections for each goal.
6. Revise/refine your goals.
7. Devise a strategy to achieve all goals:
   Spending/savings plan.
   Investment plan.
8. Review risk management.

FIGURE 1.1 The Planning Process

tize them. For example: Is it more important to retire at a younger age or move into a larger home? Should you purchase a larger home or a vacation home? Should you leave more investments in your names for retirement, or gift them to the children?

The next step is to *assess your current financial status*. Create a portrait of your family's finances from a business perspective. Three different types of assessments must be performed: a balance statement, a cash flow statement, and future projections. A balance statement is a summary of (1) your assets,

TABLE 1.1 Planning Goals

An emergency fund	An expensive car
Starting a business	Jewelry
Relocating	Charitable gifts
Changing occupations	Family gifts
Obtaining further education	Providing for aged parents
Repaying education loans	Disabled child needs
Repaying a mortgage	Closely held business planning
A second home	Divorce-remarriage issues

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such as investments, pension plans, your home, and other possessions; and (2) your debts or liabilities, such as mortgage, education loans, and car loans. Your net worth is the difference between your assets and your liabilities (Table 1.2). The cash flow statement is an itemized list of annual income, expenditures, and savings (Table 1.3).

If your net worth is negative, it means that either you are early in your earnings phase or your household is operating like the federal government—borrowing money to make ends meet. The cash flow statement will tell you which of these applies. Are you saving money, repaying loans, and accumulating investments, or is your debt growing?

Together these two statements will give you a good idea of how you have used your resources. Even if you are making progress, most likely you are saving and accumulating less wealth than you might have expected.

Information from these two statements is then used to *make projections*, and determine whether you are likely to meet your goals, given your present course. A financial planner (person or software) can calculate the funds required for each of your goals, and whether you can expect to accumulate those funds, based on your current assets and savings rate.

Making these projections entails assumptions about several important variables:

- Your future income, spending, and savings rate
- Rates of inflation (for consumer products in general, for real estate, for college expenses, etc.)
- Rate of return on your investments
- Your life span(s)
- Tax rates

Which numbers you choose for each of these have a significant effect on the results of the projections. Here's one example: Your child will enter college in 15 years, and current total annual private college expenses are $30,000. If you predict the rate of inflation of college expenses will be 6%, you will need $314,500. But if you predict that expenses will rise at only 4% per year, you need to save only $230,000. Let's say that you have $25,000 saved now. If you invest this amount, what will it be worth in 15 years? If you assume a return of 11%, it should amount to $119,500 when your child enters college. If you assume a return of 8% you would expect to have $79,000.

Therefore, even if you hire someone to do this analysis for you, it is important to review the assumptions to make sure that they are realistic. Some rea-

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TABLE 1.2 Family Balance Statement

Date: / /

Assets		
Cash and Bank Accounts	Balance	
________________	__________	
________________	__________	
________________	__________	
________________	__________	
Total Cash and Bank Accounts		__________
Investments		
Tax-Deferred Accounts	Balance	
Pension Plan/401(k) 1	__________	
Pension Plan/401(k) 2	__________	
IRA/Keogh 1	__________	
IRA/Keogh 2	__________	
Annuity	__________	
Other	__________	
Taxable Accounts		
__________	__________	
__________	__________	
__________	__________	
__________	__________	
__________	__________	
__________	__________	
Total Investments		__________
Other Assets	Value	
House 1	__________	
House 2	__________	
Car 1	__________	
Car 2	__________	
Jewelry	__________	
Home furnishings	__________	
Computer/Audio Equipment	__________	
Other	__________	
Total Other Assets	__________	
Total Assets		__________

(Continued)

TABLE 1.2 Continued

Liabilities		
Credit card balances	________	
Mortgage 1	________	
Mortgage 2	________	
Home equity loan	________	
Education loans	________	
Automobile loan/lease	________	
Other debts	________	
Total Liabilities		________
Net Worth (Total Assets Less Total Liabilities)		________

sonable assumptions will be discussed in later chapters. Generally it is better to be a little conservative on your assumptions, to make it more likely that you will achieve your goals. We recommend using a general inflation rate of 4%, a life expectancy of 95 years, and current tax rates. Investment returns depend on your asset mix, which, in turn, will vary with the time span and your risk tolerance. Try to err a little on the conservative side in estimating your future income as well.

Using these assumptions, you then determine how much cash you would need to save each year to meet each of your goals. From this, you add up the total savings required each year, and determine whether you can achieve it. Are you currently saving enough, or can you increase income or cut back spending enough to accumulate the savings? If not, you must revise one or more goals.

Once you have decided on a set of goals that you think you can achieve, you must *devise a strategy*. How much money will you put away each month? Into what accounts and investments will those funds go? What is the asset allocation (mix of investment assets) for each goal?

Tracking Your Finances

Owners of businesses, whether large or small, must regularly close their account books to review their progress and tally their assets. Building a positive net worth requires the same discipline. Sitting down once every one or two years and trying to analyze your finances is next to impossible without thor-

TABLE 1.3 Family Cash Flow Statement

Period: One year beginning / /		
Inflows		
Salary 1	______	
Salary 2	______	
Other income source 1	______	
Other income source 2	______	
Investment income		
Interest	______	
Dividends	______	
Capital gains	______	
Pension plans	______	
Total Inflows		______
Outflows		
Accounting	______	
Alimony/child support	______	
Automobile/transportation		
Fuel	______	
Repairs/maintenance	______	
Lease/loan payments	______	
Charity	______	
Children		
Child care	______	
School	______	
Other classes	______	
Clothing	______	
Dining out	______	
Education	______	
Entertainment	______	
Gifts	______	
Groceries	______	
Home repair	______	
Household furnishings	______	
Miscellaneous household expenses	______	
Insurance	______	
Loan payments	______	
Medical expenses	______	

(Continued)

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TABLE 1.3 Continued

Mortgage/Rent	____________	
Recreation	____________	
Taxes		
Federal income	____________	
Medicare	____________	
FICA	____________	
State income	____________	
City income	____________	
Property	____________	
Travel	____________	
Utilities	____________	
Wines and spirits	____________	
Other	____________	
Total Outflows		____________
Overall Total (Inflows Less Outflows)		____________

Note: Bold print indicates relatively fixed expense.

ough records. We strongly encourage use of a home computer with personal financial software. There are several excellent personal finance programs, such as Quicken (Intuit) and Money (Microsoft). Also, many web sites offer simpler versions. Any of these will help you track income and spending, monitor the performance of your investments, and keep track of tax-related information. However, in our experience they work only if you enter all your data regularly, at least monthly. Currently it is possible for the programs to download personal bank, credit card, and investment account information via telephone or the Internet. Use of these programs is of great assistance in creating and monitoring your financial plan. They also facilitate setting up a monthly or annual budget and tracking your adherence to it.

The best way to figure out how you can save more is to track your spending carefully, and find the fat. Table 1.3 suggests how to categorize your spending. This makes it easier to see where your money is going and to identify categories of discretional spending that can be trimmed. Chapter 2 contains statistics about the spending of typical American families for comparison.

Table 1.4 lists recommendations for which types of records to retain, where to keep them, and how long you should keep them.

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Table 1.4 Records You Should Retain

Type	Where	For How Long
Household bills paid	File by year	Three years
Checks/account statements	File by year	Seven years
Credit card statements	File by year	Seven years
Investment account statements	File by account	Seven years after account closed
Major equipment receipts/ manuals	File	Until disposed of
Home records (purchase, repair, improvements)	File	Until after house sold
Tax returns and related documents	File by year	Seven years
Insurance policies and statements (life, health, disability, auto, homeowner)	File by policy	Three years after expired
Inheritance documents	Safe-deposit box	Indefinitely
Gift tax returns	File	Indefinitely
Copies of your will, living will, durable power of attorney, and inventory or important papers and documents	Safe-deposit box	Indefinitely
Stock certificates	Safe-deposit box	Indefinitely
Deeds, mortgages, and other real estate title documents	Safe-deposit box	Indefinitely
Inventory, receipts, and photos or video of valuable possessions	Safe-deposit box	Indefinitely, regularly update
Automobile titles	Safe-deposit box	Indefinitely

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Risk Management

Risk management is protecting yourself and your family from large, unexpected financial events. Yes, insurance is boring or depressing, but it is essential to have adequate coverage. Many of us realize this, but partly because we dislike it so much, we don't take the care to make sure that we are properly insured. The National Insurance Consumer Organization reports that more than 9 of 10 Americans carry the wrong types and amounts of insurance coverage (according to Eric Tyson, *Personal Finance for Dummies*, Chicago: IDG Books, 1995, p. 333).

Giving sound insurance advice does not necessarily mean selling another insurance policy. Insurance is nothing more than transferring a risk for a price. Avoid in-house or captive agents. With only one tool available such as a hammer, every need starts to look like a nail. Good insurance is not and will never be a good investment. Remember that you are paying someone to assume your risk. If the insurers do not make a profit from your business, they may not stay in business long enough to be there when you need them.

What Do You Need?

The simple answer is to buy coverage for all possible financial catastrophes. Don't consider how remote the possibility of the disaster. If the risk is very low, the insurance will not be expensive. Insurance companies are very accurate at calculating risks, and almost the entire insurance premium goes toward that risk. (Most of the money they make is from investing the funds while they have them.)

Everyone must have health insurance. If you have any dependents (spouse/children/aged parents) you probably need life insurance to support them when you cannot. The only circumstances in which life insurance is not necessary are (1) if either spouse can earn enough to provide for your dependents, or (2) if you have accumulated sufficient wealth to provide for them.

If you own a home, you need homeowners insurance. If you live in an area where flooding is possible, separate flood insurance must be purchased. Anyone who earns money used for living expenses should have disability insurance. Anyone who drives a car is required by law to have automobile insurance.

Chapter 25 goes into more detail about purchasing life and disability insurance, determining your needs, and how to obtain coverage. Health insurance is a complicated subject and is currently in a state of evolution, so it will not be covered in this book. We would just like to make some general insurance recommendations here.

Insure Only Against Catastrophic Expenses

Don't purchase insurance that reimburses you for expenses you could easily pay yourself. Whenever possible, be your own insurer. Don't purchase small insurance policies, such as extended warranties or other product insurance, dental insurance, or rental car insurance. Take the highest deductible you can on your automobile, homeowners, and medical insurances. In the long run, you'll save more than you spend.

Shop Around, and Buy Direct

There are significant pricing differences among insurance policies, and price is poorly correlated with the quality of the company and the policy. It is possible to find lower-cost, high-quality policies by shopping around. The most likely source of these policies is directly from the company itself. By eliminating the insurance agent, you are less likely to have a more expensive policy or more coverage than you need. However, coverage issues can be more complex than you realize, so thorough research or professional advice can be valuable.

Also, take advantage of group membership. Group policies (other than life insurance) tend to be lower in price than policies you can buy on your own. Make sure that you check out the insurance company before purchasing a policy. Obtain its financial rating from several rating agencies, and find out what other policy owners' experiences have been in dealing with the company.

Generally Avoid Add-on Riders

Companies and agents push add-on riders because they have high profit margins. They are usually not worth purchasing. Riders are additions to the standard policy that provide further benefits or special features. The most common riders are waiver of premium in the event of the policyholder's disability, options to purchase additional insurance in the future without a new health examination, and additional benefits in the event of accidental death.

Emergency Fund

An important part of risk management is to have a fund of cash or other liquid assets to fall back on in case of emergency. Most financial advisers recommend cash or cash-equivalent investment equal to three to six months of earned income. However, this depends on your situation. If your employee benefits include disability insurance that begins at 90 days, and you are certain that if you were laid off you could start another job within three months, you may need a reserve of only two to three months' expenses.

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In actuality, your money earns less if you keep funds in cash rather than higher-returning investments like stocks. For example, if your current annual earned income is $100,000, keeping $50,000 in a money-market account for 20 years will yield $132,000 (at 5%, before taxes) versus $336,000 in the stock market (assuming 10% return, before taxes). Therefore, if it is unlikely that you will need the funds, a more profitable liquid investment such as a mutual fund can be used.

Planning for Other Needs

Anyone with assets or dependents needs a *will*. If you do not have a will, the state will appoint someone to determine what happens to your assets and dependents. It will take the state a long time to decide, and the state and federal governments probably will keep a large portion of your assets in the process. A will names a guardian to oversee the interests of minor children, and an executor to administer your estate. Your property is transferred more rapidly and smoothly, and to whom you intend.

A *living will* declares your wishes regarding medical measures that could be taken in the event of grave illness or injury. If you are incapacitated and unable to make decisions or communicate your wishes, your family and doctors can use this document to guide their decisions regarding treatment.

You should designate someone to make decisions for you in the event that you become incapacitated or mentally incompetent. Such *durable power of attorney* is usually given to your spouse or an adult child. You can indicate which decisions this person has the authority to make, such as writing checks, paying bills, selling your property, or designating gifts to your loved ones. (A word of caution: Avoid contingent or springing powers events, or medical conditions that are not clearly defined.)

A *health care proxy* designates an attorney-in-fact to make health-care decisions for you if you are incapacitated. This document may contain a living will, but the powers can be broader.

You should also make an inventory of important information and documents for your survivors. This contains detailed information about your personal property, financial assets, and advisers who may assist in settling your estate. It should list all bank and investment accounts, pension and employee benefit plans, mortgages, and other loans. Information about insurance policies, stock certificates, certificates of deposit, buy-sell agreements, tax records and returns, real estate deeds, and legal documents such as birth and marriage certificates and wills should be recorded.

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Conclusion

This chapter outlines the value of making a personal financial plan and the most crucial issues. Most of the important topics—investment vehicles, asset allocation, expected returns on investments, insurance, retirement planning, estate planning—are covered in later chapters.

Don't forget that it is your plan. You are the final arbiter of all decisions.