Personal Finance

Jeff Madura

Edition

5

PERSONAL FINANCE

The Pearson Series in Finance

Bekaert/Hodrick
International Financial Management

Berk/DeMarzo
*Corporate Finance**

Berk/DeMarzo
*Corporate Finance: The Core**

Berk/DeMarzo/Harford
*Fundamentals of Corporate Finance**

Brooks
*Financial Management: Core Concepts**

Copeland/Weston/Shastri
Financial Theory and Corporate Policy

Dorfman/Cather
Introduction to Risk Management and Insurance

Eiteman/Stonehill/Moffett
Multinational Business Finance

Fabozzi
Bond Markets: Analysis and Strategies

Fabozzi/Modigliani
Capital Markets: Institutions and Instruments

Fabozzi/Modigliani/Jones
Foundations of Financial Markets and Institutions

Finkler
Financial Management for Public, Health, and Not-for-Profit Organizations

Frasca
Personal Finance

Gitman/Zutter
*Principles of Managerial Finance**

Gitman/Zutter
*Principles of Managerial Finance—Brief Edition**

Haugen
The Inefficient Stock Market: What Pays Off and Why

Haugen
The New Finance: Overreaction, Complexity, and Uniqueness

Holden
Excel Modeling in Corporate Finance

Holden
Excel Modeling in Investments

Hughes/MacDonald
International Banking: Text and Cases

Hull
Fundamentals of Futures and Options Markets

Hull
Options, Futures, and Other Derivatives

Keown
*Personal Finance: Turning Money into Wealth**

Keown/Martin/Petty
*Foundations of Finance: The Logic and Practice of Financial Management**

Kim/Nofsinger
Corporate Governance

Madura
*Personal Finance**

Marthinsen
Risk Takers: Uses and Abuses of Financial Derivatives

McDonald
Derivatives Markets

McDonald
Fundamentals of Derivatives Markets

Mishkin/Eakins
Financial Markets and Institutions

Moffett/Stonehill/Eiteman
Fundamentals of Multinational Finance

Nofsinger
Psychology of Investing

Ormiston/Fraser
Understanding Financial Statements

Pennacchi
Theory of Asset Pricing

Rejda
Principles of Risk Management and Insurance

Seiler
Performing Financial Studies: A Methodological Cookbook

Smart/Gitman/Joehnk
*Fundamentals of Investing**

Solnik/McLeavey
Global Investments

Stretcher/Michael
Cases in Financial Management

Titman/Keown/Martin
*Financial Management: Principles and Applications**

Titman/Martin
Valuation: The Art and Science of Corporate Investment Decisions

Weston/Mitchel/Mulherin
Takeovers, Restructuring, and Corporate Governance

*denotes MyFinanceLab titles   Log onto **www.myfinancelab.com** to learn more

To Mary

PERSONAL FINANCE

Edition 5

JEFF MADURA

Florida Atlantic University

PEARSON

Boston Columbus Indianapolis New York San Francisco Upper Saddle River
Amsterdam Cape Town Dubai London Madrid Milan Munich Paris Montreal Toronto
Delhi Mexico City Sao Paulo Sydney Hong Kong Seoul Singapore Taipei Tokyo

Editor-in-Chief: Donna Battista
Acquisitions Editor: Katie Rowland
Editorial Project Managers: Jill Kolongowski and Emily Biberger
Editorial Assistant: Elissa Senra-Sargent
Senior Marketing Manager: Jami Minard
Managing Editor: Jeff Holcomb
Senior Production Project Manager: Meredith Gertz
Senior Manufacturing Buyer: Carol Melville
Design Manager: Jonathan Boylan
Cover Design: Creative Circle
Image Manager: Rachel Youdelman
Photo Research: Integra Software Services, Ltd.
Text Permissions Project Supervisor: Jill C. Dougan
Text Permissions Researcher: Tyler Thompson
Director of Media: Susan Schoenberg
Content Leads, MyFinanceLab: Melissa Honig and Miguel Leonarte
Project Management and Text Design: Gillian Hall, The Aardvark Group
Composition and Illustrations: Laserwords Maine
Copyeditor: Rebecca Greenberg
Proofreader: Holly McLean-Aldis
Indexer: John Lewis
Printer/Binder: Courier Kendallville
Cover Printer: Lehigh Phoenix
Text Font: Sabon

Credits and acknowledgments borrowed from other sources and reproduced, with permission, in this textbook appear on appropriate page within text (or on page 653).

As this book went to press, we verified that all the cited Web sites were active and valid. However, URLs are dynamic. Web sites to which we refer in the text sometimes change or are discontinued because companies change names, are bought or sold, merge, or fail. Sometimes Web sites are down for maintenance, repair, or redesign. Many organizations have dropped the initial "www" designation for their sites, but some still use it. If you have a problem connecting to a Web site that we mention, please be patient and simply run a Web search to try to identify the possible new site. Most times, you can quickly find the new site through one of the popular search engines. We apologize in advance for this inconvenience.

Many of the designations by manufacturers and sellers to distinguish their products are claimed as trademarks. Where those designations appear in this book, and the publisher was aware of a trademark claim, the designations have been printed in initial caps or all caps.

Library of Congress Cataloging-in-Publication Data
Madura, Jeff.
Personal finance / Jeff Madura.—5th ed.
p. cm.
ISBN-13: 978-0-13-299434-7
ISBN-10: 0-13-299434-8
1. Finance, Personal. I. Title.
HG179.M252 2014
332.024--dc22 2009048699

Copyright © 2014, 2011, 2008 Pearson Education, Inc. All rights reserved. Manufactured in the United States of America. This publication is protected by Copyright, and permission should be obtained from the publisher prior to any prohibited reproduction, storage in a retrieval system, or transmission in any form or by any means, electronic, mechanical, photocopying, recording, or likewise. To obtain permission(s) to use material from this work, please submit a written request to Pearson Education, Inc., Permissions Department, One Lake Street, Upper Saddle River, New Jersey 07458, or you may fax your request to 201-236-3290.

10 9 8 7 6 5 4 3 2 1

PEARSON

www.pearsonhighered.com

ISBN 13: 978-0-13-299434-7
ISBN 10: 0-13-299434-8

BRIEF CONTENTS

DETAILED CONTENTS

PART 1 TOOLS FOR FINANCIAL PLANNING

PART 4 PROTECTING YOUR WEALTH

PART 5 PERSONAL INVESTING

PART 6 RETIREMENT AND ESTATE PLANNING

The Most Interactive Book on the Market

The Fifth Edition of Personal Finance *integrates the Building Your Own Financial Plan and case study worksheets into each chapter, helping students to create their own personalized plan for financial success.*

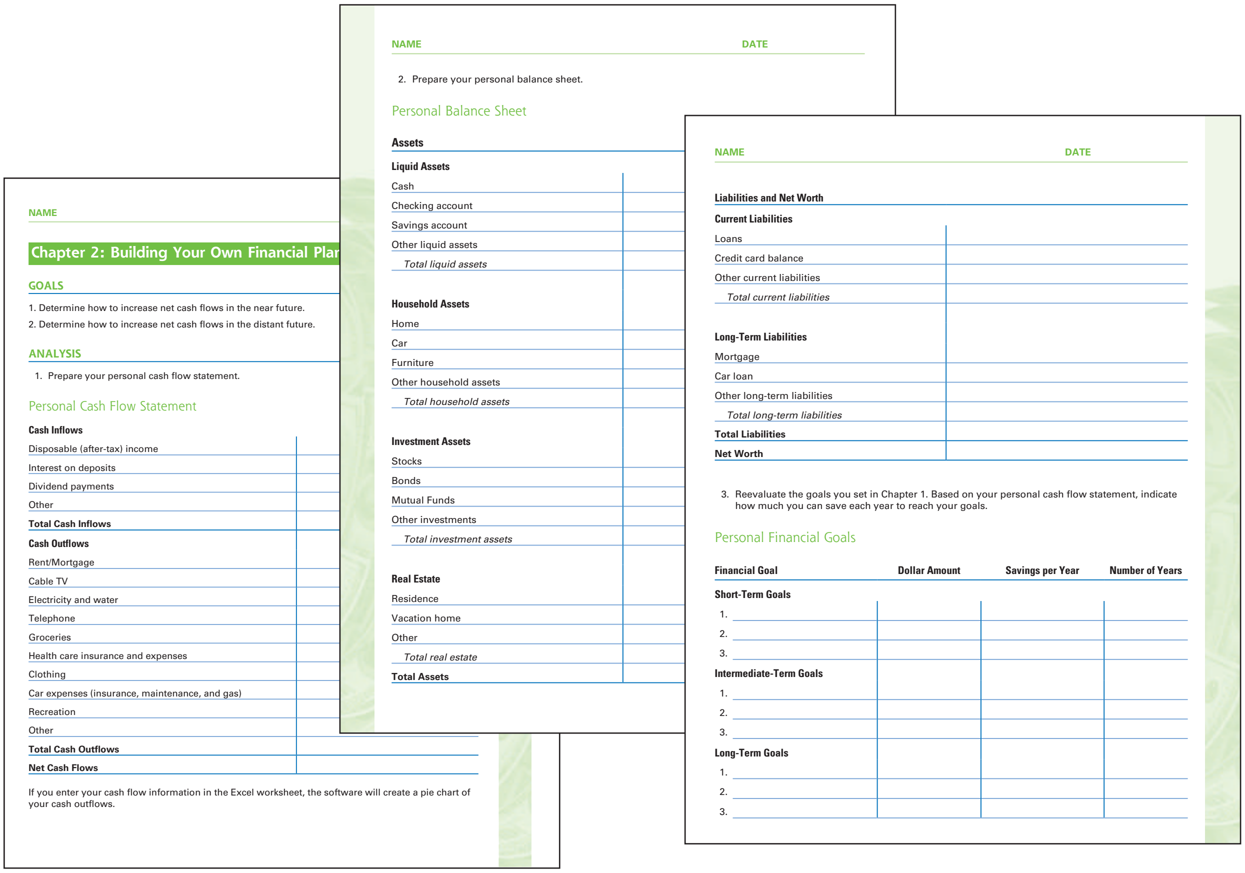
BUILDING YOUR OWN FINANCIAL PLAN

Personal Finance's structure mirrors a comprehensive financial plan, teaching students the skills they need to build their own financial plan. The Building Your Own Financial Plan chapter-ending case studies are presented as an integrated series of exercises and worksheets that represent a portion of a financial plan. At the end of the course, students will have completed a financial plan that they can continue implementing beyond the school term. All of the worksheets are also available on the Financial Planning CD-ROM, which is included in each new book.

BUILDING YOUR OWN FINANCIAL PLAN

Based on the goals that you established in Chapter 1 and the personal cash flow statement that you created in Chapter 2, you are now ready to begin determining how to go about achieving many of your goals. Most financial goals are achieved by some sort of savings/investment plan.

Go to the worksheets at the end of this chapter and to the CD-ROM accompanying this text, to continue building your financial plan.



An Interactive Approach

Personal Finance's *interactive approach 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.*

FREE APPS for Personal Finance

Finding an ATM Nearby

Application:

Use the ATM Hunter app to find a nearby ATM. You can use your current location when searching, or input an address or an airport.

More information at:

itunes.apple.com/us/app/atm-hunter/id309754128?mt=8

A new feature in the fifth edition, 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.frbsf.org/publications/consumer/creditrights.html

To get:
information about various laws that protect your rights when using credit.

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 require students to demonstrate knowledge of mathematically based concepts to perform computations in order to make well-informed personal finance decisions. All Financial Planning Problems are available in MyFinanceLab.

FINANCIAL PLANNING PROBLEMS

All Financial Planning Problems are available in MyFinanceLab *at www.myfinancelab.com.*

1. **Interest Earned.** Teresa has just opened a NOW account that pays 3.5% interest. If she maintains a minimum balance of $500 for the next 12 months, how much interest will she earn?
2. **Interest Earned.** Lisa is depositing $2,500 in a six-month CD that pays 4.25% interest. How much interest will she accrue if she holds the CD until maturity?
3. **Value of CD.** Travis has invested $3,000 in a three-month CD at 4%. How much will Travis have when the CD matures?

FINANCIAL PLANNING ONLINE EXERCISES

1. Go to www.bankrate.com/checking.aspx and answer the following questions:
   a. What bank in what city, nationally, will give you the highest rate on an MMA?
   b. What bank in what city, locally, will give you the highest rate on an MMA?
   c. Find what bank in what city, nationally, will pay you the highest rate on a one-year CD.
   d. Find what bank in what city, locally, will pay you the highest rate on a one-year CD.

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

Real-Life Scenarios

EXAMPLE

Stephanie Spratt wants to determine the amount of interest that she would earn over one year if she deposits $1,000 in a savings account that pays 4% interest.

Interest Earned = Deposit Amount × Interest Rate

= $1,000 × .04

= $40

Although the interest income is attractive, she cannot write checks on a savings account. As she expects to need the funds in her checking account to pay bills in the near future, she decides not to switch those funds to a savings account at this time.

A running example of Stephanie Spratt, 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

The Sampsons have been carrying a balance of about $2,000 on their credit card. They have been paying the minimum amount due and have been using any excess net cash flows to implement their new savings plan for a new car and their children's college education. To date, they have saved $2,000; they are currently earning 5% on the savings. Meanwhile, their credit card is charging them 18%. Dave and Sharon want to evaluate the return they are receiving from their savings versus the interest expenses they are accruing on their credit card.

Go to the worksheets at the end of this chapter, and to the CD-ROM accompanying this text, to continue this case.

Build a financial plan for the Sampson family! The parents of two children, Dave and Sharon Sampson have made few plans regarding their financial future and are 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 worksheets.

PART 6: BRAD BROOKS—A Continuing Case

Brad tells you that he has revised his retirement plans. He would like to retire in 20 years instead of the original 30. His goal is to save $500,000 by that time. He is not taking advantage of his employer's retirement match; his employer will match retirement plan contributions up to $300 per month. Factoring in the employer match, Brad could have a possible total annual retirement contribution of $7,200.

Brad also unveils his plans to provide for his two nephews' college in the event of his death. He does not have a will and wonders if one is necessary.

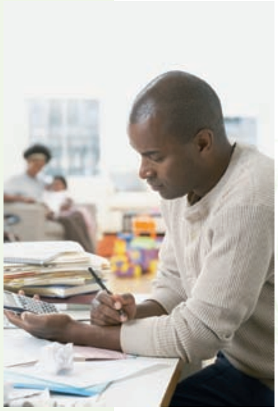
Go to the worksheets at the end of this chapter, and to the CD-ROM accompanying this text, to complete this case.

At the end of each part, students are prompted to build a financial plan for Brad Brooks using the accompanying worksheets. Brad has expensive tastes—as evidenced by his soaring credit card balance—and he needs assistance in gaining control over his finances.

Learning Tools

chapter
2

Planning with Personal Financial Statements



Where does it all go? It seems like the last paycheck is gone before the next one comes in. Money seems to burn a hole in your pocket, yet you don't believe that you are living extravagantly. Last month you made a pledge to yourself to spend less than the month before. Somehow, though, you are in the same position as you were last month. Your money is gone. Is there any way to plug the hole in your pocket?

What are your expenses? For many people, the first obstacle is to correctly assess their true expenses. Each expense may seem harmless and worthwhile, but combined they can be like a pack of piranhas that quickly gobble up your modest income. What can you do to gain control of your personal finances?

Just read on in this chapter and you will see how to take control of your finances. However, your task is not easy because it takes self-discipline and there may be no immediate reward. The result is often like a diet: easy to get started, but hard to carry through.

Your tools are the personal balance statement, the personal cash flow statement, and a budget. These three personal financial statements show you where you are, predict where you will be after three months or a year, and help you control expenses. The potential benefits a ments, and peace of mind from kn

MyFinanceLab helps you ma efficiently. Visit www.myfina

34

The objectives of this chapter are to:

- Explain how to create your personal cash flow statement
- Identify the factors that affect your cash flows
- Show how to create a budget based on your forecasted cash flows
- Describe how to create your personal balance sheet
- Explain how your net cash flows are related to your personal balance sheet (and therefore affect your wealth)

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.

EXAMPLE

You wish to buy a used car for $2,000 from Rod Simpkins, who is concerned that you may not have sufficient funds in your account. So you go to Lakeside Bank, where you have your checking account. You obtain a cashier's check from Lakeside Bank made out to Rod Simpkins. After verifying your account balance, the bank complies with your request and reduces your checking account balance by $2,000. It will likely charge you a small fee such as $10 or $15 for this service. Rod accepts the cashier's check from you because he knows that this check is backed by Lakeside Bank and will not bounce.

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

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.

PSYCHOLOGY of Personal Finance

Twisted Perception of the Risk Premium. When the economy weakens and the risk premium rises (for the reasons explained above), some investors are attracted to investments, but for the wrong reasons. They may decide to pursue investments with higher risk premiums in a weak economy to make up for limited income. However, their logic is irrational. The higher risk premium on investments during a weak economy is offered

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

Impact of the Economy on the Risk Premium. As economic conditions change, the risk premium on various types of investments changes. When economic conditions weaken, firms that issue various types of debt securities must pay a higher risk premium in order to sell their securities. Investors become more concerned that these types of firms might go bankrupt and not repay their debt. Thus, you and other individuals would

Economic Impact

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

SUMMARY

Common Types of Investments. Common types of investments include money market securities, stocks, bonds, mutual funds, and real estate. Each type of investment is unique in how it provides a return to its investors.

Measuring Return on Investment. The return on an investment is determined by the income that the investment generates and the capital gain of the investment over the investment horizon. Some stocks offer periodic income in the form of dividends, while bonds offer periodic income in the form of coupon payments.

Summary

In paragraph form, the chapter summary presents the key points of the chapter to aid in student study.

REVIEW QUESTIONS

All Review Questions are available in MyFinanceLab at www.myfinancelab.com.

1. **Investing Priorities.** What should your first priority of investing be? What is the disadvantage of investments that satisfy that priority?
2. **Stocks.** What are stocks? How are stocks beneficial to corporations? Why do investors invest in stocks?
3. **Secondary Markets.** Distinguish between the primary and secondary stock markets. Why does the price of a stock change each day in the secondary market?

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 MyFinanceLab.

13. **Ethical Dilemma.** Carlo and Rita's daughter just celebrated her 16th birthday and Carlo and Rita realize they have accumulated only half the money they will need for their daughter's college education. With college just two years away, they are concerned about how they will save the remaining amount in such a short time.

Ethical Dilemmas

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

VIDEO EXERCISE: Selecting Health Insurance

Go to one of the Web sites that contain video clips (such as www.youtube.com) and view some video clips about selecting health insurance. You can use search phrases such as "selecting health insurance." 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 process of selecting health insurance as a result of watching this video clip?

Video Exercise

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, there 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: Your Investments

1. Some investors get a bigger thrill from gambling with money than paying off a loan. Thus, they invest in stocks hoping to make a larger return than whatever interest rate they are paying on their loan. Describe your behavior of investing. Do you use money to invest that could have been used to pay off a credit card loan? If so, why? Do you think there is any risk associated with such a strategy?
2. Read one practical article about how psychology affects decisions when investing in stocks. You can easily retrieve possible articles by doing an online search using the terms "psychology" and "investing in stocks." 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 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 even if the taxpayer does not itemize.
   a. Exemptions
   b. Tax credits
   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)

Appendix B PROJECTS

The following pages include projects for you to complete relating to specific aspects of personal finance. They are also available on this book's companion Web site www.pearsonhighered.com/madura.

Assessing Your Credit
Career Planning Project
Leasing an Apartment
Stock Market Project
Comparison Shopping: Online Versus Local Purchases

Assessing Your Credit

If you do not own a credit card, answer the following questions based on 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 the Federal Trade Commission Web site www.ftc.gov/bcp/edu/pubs/consumer/credit/cre34.shtm 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 in order 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 of 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.
- *Comparison Shopping: Online Versus Local Purchases* allows students to compare the prices of products in stores versus online and to assess the pros and cons of purchasing products online.

Preface

Ask yourself these financial questions:

- Should you buy a new car or pay off your credit card balance first?
- How much can you borrow?
- Which bank offers the best services to satisfy your needs?
- How can you obtain easy access to funds in an emergency situation?
- Do you have enough insurance?
- Will you be able to retire at an early age?

This textbook allows you to address these and other related financial dilemmas. It equips you with the knowledge and tools to help you make sound decisions. 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.

New to the Fifth Edition

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

- Attention is given to the financial crisis and economic recession where appropriate.
- A new feature called Psychology of Personal Finance explains how financial planning decisions are affected by psychology. There is also an exercise at the end of each chapter that asks students to evaluate if their personal finance decisions regarding a specific behavior discussed in the chapter is influenced by psychology.
- A new feature called Free Apps for Personal Finance identifies free apps that students can use to help make informed personal finance decisions.
- Chapter 1 has been substantially revised to thoroughly explain how the various financial planning components introduced there are integrated. Thus, students quickly see how they begin with budgeting as the foundation (in Chapter 2) and then additional components are covered in each chapter to develop a complete financial plan.
- Chapter 6, Managing Your Money, has been revised to reinforce the need to be conservative when investing money that will be needed to pay bills in the near future.
- Chapter 7, Assessing and Securing Your Credit, now gives more attention to how credit is commonly misused and can lead to credit problems.
- Chapter 8, Managing Your Credit, has been revised to ensure a clear flow of concepts, and emphasis is now given to The Credit Card Accountability, Responsibility, and Disclosure Act (also called the Credit CARD Act) of 2009. This act was passed in an effort to ensure that consumers who pursued credit card services are treated fairly and have access to complete information about the fees and other provisions of the credit agreement. Chapter 8 describes many provisions of the act that can provide students with more protection.
- Chapter 9, Personal Loans, devotes more attention to how excessive borrowing to buy an expensive car can complicate all other personal finance decisions.
- Chapter 10, Purchasing and Financing a Home, devotes more attention to how excessive borrowing to buy an expensive home can complicate all other personal finance decisions. In addition, more emphasis is given to determining how much one can afford when buying a home, the impact of economic conditions on home values, and how the financial crisis affected home values.

- Chapter 14, Investing Fundamentals, devotes more attention to how some types of investments that could generate high returns are also subject to much risk (potential for large losses).
- Chapter 15, Investing in Stocks, now more thoroughly explains why stock prices change, and also explains the impact of the international environment on stock prices. It also elaborates on the limitations when analyzing stocks, as even the most thorough stock analysis can lead to investment decisions that result in major losses.
- Chapter 18, Asset Allocation, now places more emphasis on the need to properly assess risk when investing among various types of assets.
- Chapter 19, Retirement Planning, now gives more attention to the importance of planning for retirement at a young age, and illustrates how individuals who save for retirement at an early age can possibly retire much earlier or will have much more to spend during their retirement years.
- Career Planning (in Appendix A) has been expanded substantially to explain how to select a college, how to select a major, and whether to pursue graduate school.

Hallmarks of Personal Finance

The first chapter establishes the text's organization by introducing the key components of a financial plan. 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 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.

Decision Making

All the information presented in this book is geared toward equipping students with the expertise they need to make informed financial decisions. Each chapter establishes a foundation for the decisions that form the basis of a financial plan. When students complete each chapter, they are therefore prepared to complete the related financial plan subsection. The key to understanding personal finance is applying concepts to real-life planning scenarios.

Personal Finance calls attention to the trade-offs involved in financial decisions. The decision to buy a new car affects the amount of funds available for recreation, rent, insurance, and investments. The text uses ongoing scenarios woven throughout all the chapters to illustrate the interdependence of personal finance decisions, including the following:

- *Examples* feature Stephanie Spratt, a recent college graduate and new entrant into the workforce.
- *Building Your Own Financial Plan* exercises prompt students to revise their goals, personal cash flow statement, and personal balance sheet to reflect their shifting priorities.

- *The Sampsons* case at the end of each chapter highlights a family with two young children struggling to organize their finances.
- The part-ending *Brad Brooks* cases illustrate the adverse effects of poor decision-making.
- The capstone 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.

Math-Friendly Presentation

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.

Instructor and Student Support Package

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

MyFinanceLab

This fully integrated online homework tool gives students the hands-on practice and tutorial assistance they need to learn finance skills efficiently. Ample opportunities for online practice and assessment in MyFinanceLab are seamlessly integrated into the content of each chapter and organized by section within the chapter summaries. All end-of-chapter Review Questions and Financial Planning Problems are available in MyFinanceLab. Please visit www.myfinancelab.com for more information and to register.

Instructor's Resource Center

This password-protected site, accessible at www.pearsonhighered.com/irc, hosts all of the instructor resources that follow. Instructors should click on the "IRC Help Center" link for easy-to-follow instructions on getting access or may contact their sales representative for further information.

Instructor's Manual

Prepared by Dianne R. Morrison, University of Wisconsin, La Crosse, this comprehensive online manual pulls together a wide variety of teaching tools. Each chapter contains an overview of key topics, teaching tips, and detailed answers and step-by-step solutions to the Review Questions, Financial Planning Problems, and Sampson family case questions. Each part concludes with answers to the Brad Brooks case questions.

Test Bank

Prepared by Angela M. Seidel, Cambria-Rowe Business College, the online Test Bank contains over two thousand questions in true-false, multiple-choice, and short-essay format that can be used for quick test preparation.

PowerPoint Lecture Presentation

Authored by Barbara Rice, Gateway Community and Technical College, this useful tool provides slides illustrating key points and exhibits as well as Web site information from the text in lecture note format.

TestGen

The easy-to-use testing software (TestGen-EQ with QuizMaster-EQ for Windows and Macintosh) is a valuable test preparation tool that allows instructors to view, edit, and add Test Bank questions.

Financial Planning Workbook and CD-ROM

The workbook has been fully integrated into the text for the Fifth Edition. 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 can easily rip out the perforated worksheets to build their financial plan. Each new copy of the text is also packaged with a Financial Planning CD-ROM, which is designed to run on Microsoft® Office 2003, 2007, and 2010.

The software templates prompt students through the key steps in the financial decision-making process as they complete the Building Your Own Financial Plan exercises. The software's true power lies in the linking of all the worksheets; students are prompted to revise their goals, cash flow statement, and personal balance sheet to demonstrate their understanding of the interrelationships among their financial decisions. Creating a complete and integrated plan has never been this easy!

Additional software features include the following:

- New calculation-based templates on topics such as determining one's federal income tax liability, reconciling a checking account, estimating the time it will take to pay off credit card debt, and determining disability insurance needs.
- For decisions that require time value of money analysis, the software directs students for input and then performs the calculations.
- 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.

Companion Website

Available at www.pearsonhighered.com/madura, the Web site provides online access to innovative teaching and learning tools, including:

- Financial Planning Software Spreadsheets
- Financial Calculator Guide
- Up-to-date links to the Financial Planning Online features and Financial Planning Online Exercises.

CourseSmart for Instructors

CourseSmart goes beyond traditional teaching resources to provide instant, online access to the textbooks and course materials you need at a lower cost to students. And while students save money, you can save time and hassle with a digital textbook that allows you to search the most relevant content at the very moment you need it. Whether it's for evaluating textbooks or creating lecture notes to help students with difficult concepts, CourseSmart can make life a little easier. See how by visiting the CourseSmart Web site at www.coursesmart.com/instructors.

CourseSmart for Students

CourseSmart goes beyond traditional expectations by providing instant, online access to the textbooks and course materials students need at lower cost. Students can also search, highlight, and take notes anywhere at any time. See all the benefits to students at www.coursesmart.com/students.

List of Reviewers

Pearson sought the advice of many excellent reviewers, all of whom strongly influenced the organization, substance, and approach of this book. The following individuals provided extremely useful evaluations:

Shannon Donovan,
Bridgewater State University

Michael S. Gutter,
University of Florida

David Marlett,
Appalachian State University

Thomas Matula,
Great Basin College

Jake Posey,
Florida State College at Jacksonville, Nassau Campus

Greg M. Richey,
California State University, San Bernardino

Tom Severance,
Mira Costa College

Pearson would also like to thank the following individuals who provided feedback in previous editions:

Tim Alzheimer,
Montana State University, Bozeman

Pat Andrus,
University of Louisiana, Lafayette

Eddie Ary,
Ouachita Baptist University

Albert L. Auxier,
University of Tennessee, Knoxville

H. David Barr,
Blinn College

Omar Benkato,
Ball State University

Charles Blaylock,
Lamar University

John Blaylock,
Northeast Community College

Lyle Bowlin,
University of Northern Iowa

Kathleen Bromley,
Monroe Community College

Ted Caldwell,
California State University, Fullerton

Margaret A. Camp,
University of Nebraska, Kearney

Joyce Cantrell,
Kansas State University

Steven L. Christian,
Jackson Community College

Conrad Ciccotello,
Georgia State University

Bruce A. Costa,
University of Montana

Richard L. Craig,
Western State College

John Cross,
California State University, Fullerton

Charles E. Downing,
Massasoit Community College

Dorsey Dyer,
Davidson County Community College

Sidney W. Eckert,
Appalachian State University

Brenda Eichelberger,
Portland State University

Sharon Farley,
Saddleback Community College

James Farris,
Golden West College

Michael Fenick,
Broward College

Cheryl J. Fetterman,
Cape Fear Community College

Michael Finke,
University of Missouri

Thomas M. Finnicum,
Oklahoma State University, Oklahoma City

Joseph F. Fowler,
Florida Community College

Glenn Gelderloos,
Grand Rapids Community College

Garry Grau,
Northeast State Technical Community College

Joseph D. Greene,
Augusta State University

Joyce Griffin,
Kansas City Kansas Community College

Ramon Griffin,
Metropolitan Community College, Denver

Reynolds Griffith,
Stephen F. Austin State University

Clark Grinde,
Iowa State University

Michael Gutter,
University of Wisconsin, Madison

Donald G. Hardwick,
Lexington Community College

Eric Hayden,
University of Massachusetts, Boston

Celia Ray Hayhoe,
University of Kentucky

Richard Healy,
Canyon College

Ruth Henderson,
Union County College

Jeanne Hilton,
University of Nevada, Reno

David R. Hoffman,
Arizona State University

M. Janice Hogan,
University of Minnesota

Marilynn E. Hood,
Texas A&M University

Samira Hussein,
Johnson County Community College

Roger Ignatius,
Husson College

Jan R. Jasper,
Prairie View A&M University

Debora C. Johnson,
Southeastern Louisiana University

Ronald R. Jordan,
New Mexico State University

Raymond Kerlagon,
Webster University

Judith Mae King,
Western Carolina University

Lee Kitchen,
Tallahassee Community College

Daniel Klein,
Bowling Green State University

Kenneth Knauf,
University of Wisconsin, Green Bay

Tina Knickerbocker,
Sam Houston State University

Dave Kraemer,
Maysville Community College

Edward Krohn,
Miami-Dade Community College, Kendall Campus

Andrew H. Lawrence,
Delgado Community College

Lauren Leach,
Northwest Missouri State University

John R. Ledgerwood,
Bethune-Cookman College

Catherine H. LoCascio,
Niagara County Community College

Robert A. Lupton,
Central Washington University

Robert A. Lutz,
University of Utah

Willard Machen,
Amarillo College

Kjartan T. Magnusson,
Salt Lake City Community College

James Mallett,
Stetson University

Ken Mark,
Kansas City Kansas Community College

Maggie L. McDermott,
Winona State University

Cindy Miglietti,
Bowling Green State University

Geofrey Mills,
University of Northern Iowa

Diann Moorman,
University of Georgia

Dianne R. Morrison,
University of Wisconsin, La Crosse

David W. Murphy,
Madisonville Community College

John V. O'Connor,
California State University, Fullerton

David Oliver,
Edison Community College

Susan L. Pallas,
Southeast Community College

Armand Picou,
University of Central Arkansas

Aimee D. Prawitz,
Northern Illinois University

Barbara Rice,
Florida College

Julia Sampson,
Malone College

Nick Sarantakes,
Austin Community College

Larry Schrenk,
American University

Elizabeth Scull,
University of South Carolina

A. S. Sethi,
University of Montana, Western

Gerald Silver,
Purdue University

Marilynn K. Skinner,
Central Georgia Technical College

Carolyn Strauch,
Crowder College

Timothy Strudell,
University of Texas at San Antonio

Melinda Taintor,
City University

Nancy Titus-Piersma,
Oklahoma State University

Robert S. Walsh,
SUNY Oswego

Marsha Weber,
Minnesota State University, Moorhead

Sally Wells,
Columbia College

Wayne Williams,
University of North Florida

Tony Wingler,
University of North Carolina at Greensboro

Michael J. Woodworth,
Purdue University

Myrna Wulfson,
SUNY Rockland Community College

Carol Wysocki,
Columbia Basin College

Robert S. Young,
Salt Lake Community College

Austin Zekeri,
Lane College

Acknowledgments

I benefited from the insight of John Bernardin, Dave Brooks, Ed Everhart, Marianne Hudson, and Victor Kalafa regarding various personal finance issues. I also benefited from many individuals whom I surveyed to identify the personal finance concepts that were most important to them, and to determine how I could most effectively communicate common personal finance dilemmas and solutions.

Special acknowledgment is due to several individuals whose contributions to this Fifth Edition and expertise are great assets: to Dianne R. Morrison for authoring the Instructor's Manual; to Angela M. Seidel for revising the Test Bank; and to Barbara Rice for preparing the PowerPoint Lecture Note Presentation. I am especially indebted to Michael J. Woodworth for his contributions to the tax chapter in the Fifth Edition. I am also grateful to Mike Casey for his work accuracy checking the end-of-chapter content.

I wish to acknowledge the help and support of many people associated with Pearson who made this textbook possible. First and foremost, I wish to thank Katie Rowland, my editor, for her continual support. The efforts of Jill Kolongowski, project manager, and Emily Biberger, who managed the supplements, are also noteworthy.

I greatly appreciated the copy editing by Rebecca Greenberg. Other contributors in the production process whose commitment to quality benefited the project are Meredith Gertz, senior production project manager; Jonathan Boylan, cover designer; and Gillian Hall, project manager at The Aardvark Group.

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 even if the taxpayer does not itemize.
   a. Exemptions
   b. Tax credits
   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)

Copyright © Pearson Education, Inc. All rights reserved.

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. realtor'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. If a stock market is _______, this implies that stock prices fully reflect information that is available to investors.
    a. highly leveraged
    b. systematic
    c. efficient
    d. perfect
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 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

Copyright © Pearson Education, Inc. All rights reserved.

chapter 1

Overview of a Financial Plan

Imagine that you are taking a vacation next year. You have many financial choices to make. How big is your vacation budget and how do you want to allocate it? The more money that you save now, the more you will have to spend on your vacation.

Now, imagine that you are planning your financial future. You have many choices to make. How much of your budget should be allocated to food and utilities? How much can you afford to spend on clothes? Should you spend all of your money as you earn it, or should you use some money for investment opportunities? Should you buy a new car? Should you buy a house? If so, what type of house should you buy? When do you want to retire? Do you want to leave an estate for your heirs? All of these decisions require detailed planning.

In a world where there are few guarantees, thorough financial planning, prudent financial management, and careful spending can help you achieve your financial goals.

The personal financial planning process enables you to understand a financial plan and to develop a personal financial plan. The simple objective of financial planning is to make the best use of your resources to achieve your financial goals. The sooner you develop your goals and a financial plan to achieve those goals, the easier it will be to achieve your objectives.

MyFinanceLab helps you master the topics in this chapter and study more efficiently. Visit www.myfinancelab.com for more details.

Copyright © Pearson Education, Inc. All rights reserved.

The objectives of this chapter are to:

- Explain how you benefit from personal finance
- Identify the key components of a financial plan
- Outline the steps involved in developing your financial plan

How You Benefit from Personal Finance

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, many Americans do not manage their financial situations well. Consequently, they tend to rely too much on credit and have excessive debt. Consider these statistics:

- More than 1 million people filed for personal bankruptcy in 2011.
- The level of savings in the United States is less than 3% of income earned. (Some investments, including retirement accounts, are not included as savings.)
- About half of all surveyed people in the United States who are working full time state that they live from one paycheck to the next, without a plan for saving money.
- About 40% of people who work full time do not save for retirement. Those who do typically save a relatively small amount of money.

ECONOMIC IMPACT

Personal finance has become even more critical since the 2008–2009 financial crisis, as this caused the wealth of many people to be reduced substantially. The values of many homes were cut in half or more and still have not fully recovered. The values of many types of investments were cut in half or more, and they too still have not fully recovered. Economic conditions are still not as strong as in the period before the crisis, which have limited the available jobs. Overall, people have less wealth and fewer opportunities to earn income. Thus, they need an effective financial plan to achieve their financial goals.

You will have numerous options regarding the choice of bank deposits, credit cards, loans, insurance policies, investments, and retirement plans. With an understanding of personal finance, you will be able to make decisions that can enhance your financial situation.

How much do you know about personal finance? Various government agencies in different countries have attempted to assess financial literacy in recent years. Surveys have documented that people tend to have very limited personal finance skills. In addition, surveys have found that many people who believe they have strong personal finance skills do not understand some basic personal finance concepts. If you haven't already taken the Financial Literacy Pre-Test that precedes this chapter, be sure to take it. You can substantially increase your understanding and improve your financial planning skills by reading this text. An understanding of personal finance is beneficial to you in many ways, including the following.

Make Your Own Financial Decisions

opportunity cost
What you give up as a result of a decision.

An understanding of personal finance enables you to make informed decisions about your financial situation. Each of your spending decisions has an **opportunity cost**, which represents what you give up as a result of that decision. By spending money for a specific

Copyright © Pearson Education, Inc. All rights reserved.

purpose, you forgo alternative ways that you could have spent the money and also forgo saving the money for a future purpose. For example, if your decision to use your cell phone costs $100 per month, you have forgone the possibility of using that money to buy concert tickets or to save for a new car. Informed financial decisions increase the amount of money that you accumulate over time and give you more flexibility to purchase the products and services you want in the future.

Judge the Advice of Financial Advisers

The personal financial planning process will enable you to make informed decisions about your spending, saving, financing, and investing. Nevertheless, you may prefer to rely on advice from various types of financial advisers. An understanding of personal finance allows you to judge the guidance of financial advisers and to determine whether their advice is in your best interest (or in their best interest).

EXAMPLE

You want to invest $10,000 of your savings. A financial adviser guarantees that your investment will increase in value by 20% (or by $2,000) this year, but he will charge you 4% of the investment ($400) for his advice. If you have a background in personal finance, you would know that no investment can be guaranteed to increase in value by 20% in one year. Therefore, you would realize that you should not trust this financial adviser. You could either hire a more reputable financial adviser or review investment recommendations made by financial advisers on the Internet (often for free).

Become a Financial Adviser

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.

Components of a Financial Plan

A complete financial plan contains your personal finance decisions related to six key 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.

Copyright © Pearson Education, Inc. All rights reserved.

FREE APPS for Personal Finance

Your Spending Decisions

Application:

The Adaptu Wallet app allows you to review your present financial situation before you decide to make a purchase. It shows your present cash flows and your debt, so that you can determine whether you can afford the purchase that you are considering.

More information at:

itunes.apple.com/us/app/adaptu-wallet-personal-finance/id478912145?mt=8

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.

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.

assets
What you own.

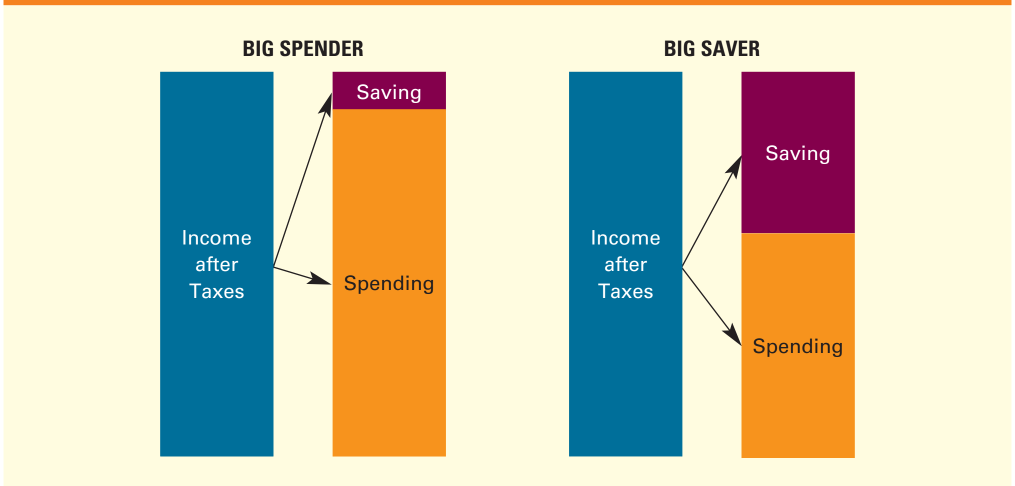
liabilities
What you owe; your debt.

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

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.

EXHIBIT 1.1 How a Budget Plan Affects Savings



Copyright © Pearson Education, Inc. All rights reserved.

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.

A Plan to Manage Your Liquidity

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

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 Your Financing

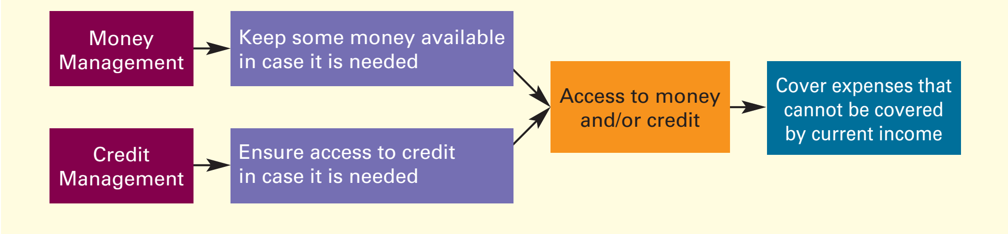
Loans are typically needed to finance large expenditures, such as the payment of college tuition or the purchase of a car or a home. The amount of financing needed is the difference between the amount of the purchase and the amount of money you have available, as illustrated in Exhibit 1.3. Managing 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.

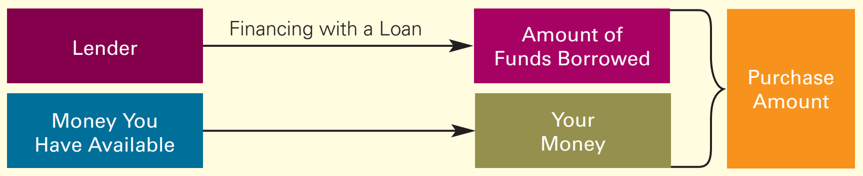
To protect your assets, you can conduct **insurance planning**, which determines the types and amount of insurance that you need. In particular, automobile insurance and homeowner's insurance protect your assets, while health insurance limits your potential medical expenses. Disability insurance and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

EXHIBIT 1.2 Managing Your Liquidity



Copyright © Pearson Education, Inc. All rights reserved.

EXHIBIT 1.3 Financing Process



A Plan for Your Investing

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
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.

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.

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 on the CD-ROM 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.

How Financial Plan Decisions Affect Your Cash Flows

All components of your financial plan affect your cash inflows and cash outflows, and therefore affect the amount of cash you have available. This section explains how each component of your financial plan affects your cash flows.

Copyright © Pearson Education, Inc. All rights reserved.

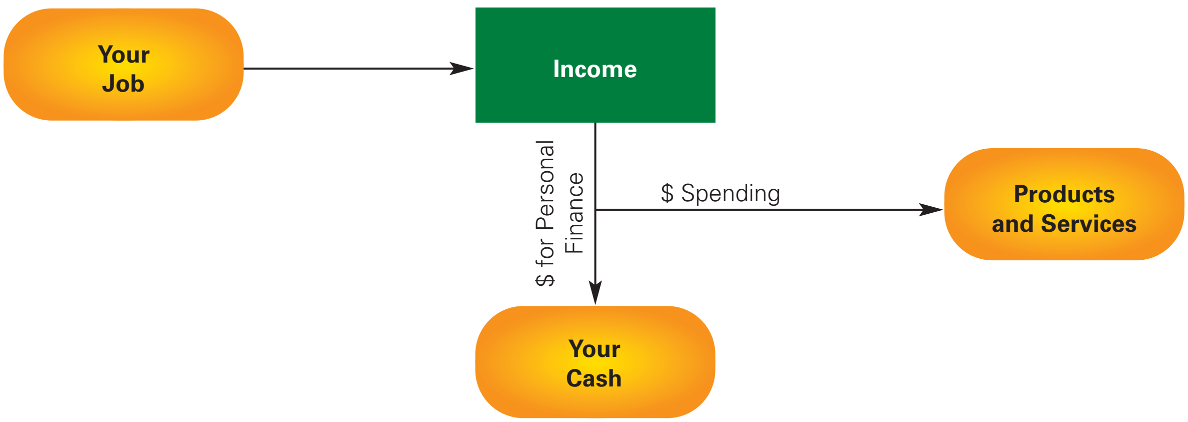
Part 1: Tools for Financial Planning

Part 1 of this text focuses on the tools required for budgeting, which is the first component of your financial plan. Budgeting allows you to plan how you will use the cash you receive in a given period (such as a month). Your salary is probably your most important source of cash inflows each month, and it might be your only source of income. You may rely on cash inflows from your income so that you can purchase products or services each month. Your budget decisions determine how much you spend and the amount of your cash outflows each month. If your spending exceeds your income, your cash inflows cannot cover your cash outflows in a particular month, and therefore you will not have any cash to allocate for savings.

Your budget decisions include:

- How much should you work this month (if your employer allows flexibility)? This decision determines your cash inflows for the month.
- What products or services should you purchase this month? This decision determines your cash outflows for the month.

CASH FLOWS DUE TO YOUR BUDGETING DECISIONS



Part 2: Managing Your Liquidity

Part 2 of this text focuses on liquidity management, which is the second component of your financial plan. When your cash inflows exceed your cash outflows (covered in Part 1) in a particular month, you use liquidity management to decide how much of this cash should be allocated to savings at your financial institution. Conversely, if your cash inflows are less than your cash outflows, you use liquidity management to withdraw savings or obtain funds from another source in order to cover your spending for the month. Your liquidity management decisions include:

- If you have excess cash this month, how much cash should you add to your checking or savings account?
- If you have a cash deficiency this month, how much cash should you withdraw from your checking or savings account?
- If you have a cash deficiency this month, how much credit should you use from credit cards or other sources?

Copyright © Pearson Education, Inc. All rights reserved.