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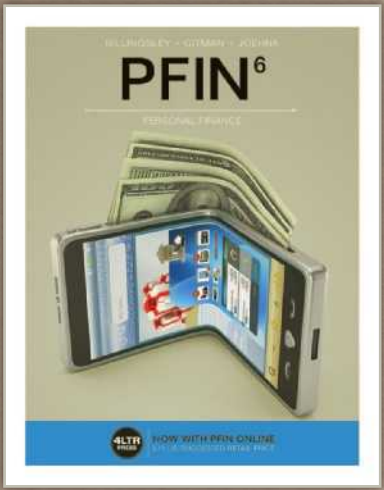
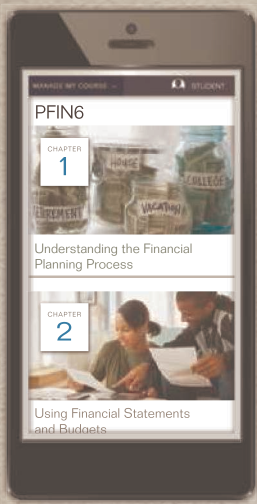
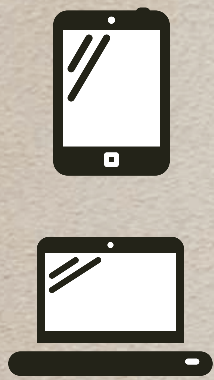


Print + Online





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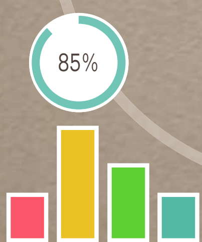

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RANDALL S. BILLINGSLEY is a finance professor at Virginia Tech. He received his bachelor's degree in economics from Texas Tech University and received both an M.S. in economics and a Ph.D. in finance from Texas A&M University. Professor Billingsley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

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

LAWRENCE J. GITMAN is an emeritus professor of finance at San Diego State University. He received his bachelor's degree from Purdue University, his M.B.A. from the University of Dayton, and his Ph.D. from the University of Cincinnati. Professor Gitman is a prolific textbook author and has more than 50 articles appearing in *Financial Management, The Financial Review,* the *Journal of Financial Planning,* the *Journal of Risk and Insurance,* the *Financial Services Review,* the *Journal of Financial Research, Financial Practice and Education,* the *Journal of Financial Education,* and other scholarly publications.

His major textbooks include *The Future of Business,* Sixth Edition, and *The Future of Business: The Essentials,* Fourth Edition, both of which are co-authored with Carl McDaniel; and *Fundamentals of Investing,* Twelfth Edition, which is co-authored with Michael D. Joehnk and Scott B. Smart. Gitman and Joehnk also wrote *Investment Fundamentals: A Guide to Becoming a Knowledgeable Investor,* which was selected as one of 1988's 10 best personal finance books by *Money* magazine; *Principles of Managerial Finance,* Sixth Brief Edition, and *Principles of Managerial Finance,* Thirteenth Edition, both co-authored with Chad J. Zutter; *Foundations of Managerial Finance,* Fourth Edition; and *Introduction to Finance,* co-authored with Jeff Madura.

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

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

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

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Finally, our wives – Bonnie, Robin, and Charlene – have provided needed support during the writing of this book. We are forever grateful to them.

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1 Understanding the Financial Planning Process

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LEARNING OBJECTIVES

After studying this chapter, you will be able to…

- **LO1** Identify the benefits of using personal financial planning techniques to manage your finances.
- **LO2** Describe the personal financial planning process and define your goals.
- **LO3** Explain the life cycle of financial plans, their role in achieving your financial goals, how to deal with special planning concerns, and the use of professional financial planners.
- **LO4** Examine the economic environment's influence on personal financial planning.
- **LO5** Evaluate the impact of age, education, and geographic location on personal income.
- **LO6** Understand the importance of career choices and their relationship to personal financial planning.

After finishing this chapter go to **PAGE 26** for **STUDY TOOLS**

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

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

1-1 THE REWARDS OF SOUND FINANCIAL PLANNING

LO1 What does living "the good life" mean to you? Does it mean having the flexibility to pursue your dreams and goals in life? Is it owning a home in a certain part of town, starting a company, being debt free, driving a particular type of car, taking luxury vacations, or having a large investment portfolio? Today's complex, fast-paced world offers a bewildering array of choices. Rapidly changing economic, political, technological, and social environments make it increasingly difficult to develop solid financial strategies that will improve your lifestyle consistently. Moreover, the financial crisis of 2008–2009 dramatizes the need to plan for financial contingencies. No matter how you define it, the good life requires sound planning to turn financial goals into reality.

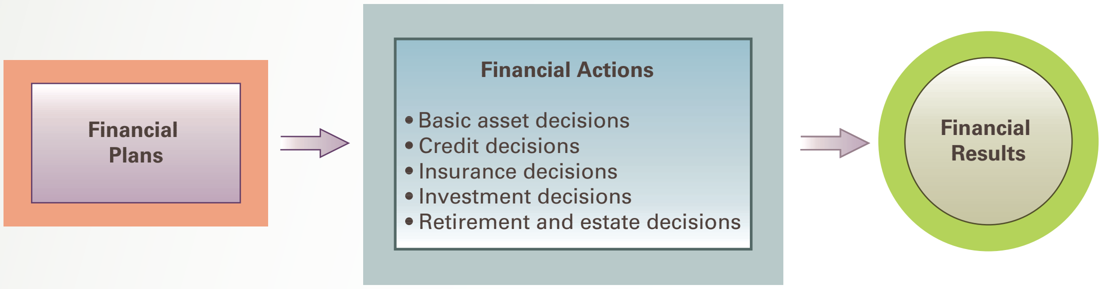
The best way to achieve financial objectives is through *personal financial planning,* which helps define your financial goals and develop appropriate strategies to reach them. And being financially self-aware provides more insight into the range of available financial choices and their trade-offs. Your comfortable retirement should not depend solely on employee or government benefits—such as steady salary increases or adequate funding from employer-paid pensions or Social Security. Creating flexible plans and regularly revising them is the key to building a sound financial future.

Successful financial planning also brings rewards that include greater flexibility, an improved standard of living, wiser spending habits, and increased wealth. Of course, planning alone does not guarantee success; but having an effective, consistent plan can help you use your resources wisely. Careful financial planning

Exhibit 1.1

Organizational Planning Model

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



increases the chance that your financial goals will be achieved and that you will have sufficient flexibility to handle such contingencies as illness, job loss, and even financial crises.

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

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

Each part explains a different aspect of personal financial planning, as shown in Exhibit 1.1. This organizational scheme revolves around financial decision making that's firmly based on an operational set of financial plans. We believe that sound financial planning enables individuals to make decisions that will yield their desired results.

1-1a Improving Your Standard of Living

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

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

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

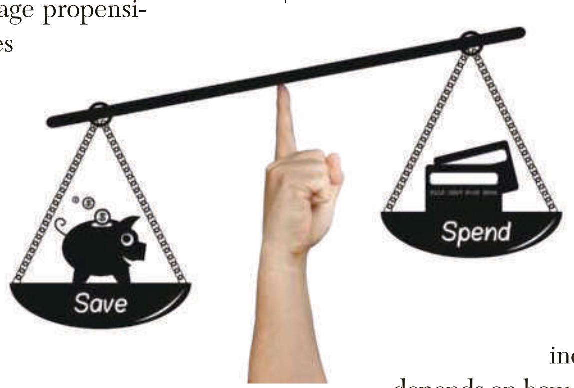
One trend profoundly affecting our standard of living is the *two-income family*. What was relatively rare in the early 1970s has become commonplace today, and the incomes of millions of families have risen sharply as a result. About 75 percent of married adults say that they and their mate share all their money. Two incomes not only buy more, but they also require greater responsibility to manage the money wisely.

1-1b Spending Money Wisely

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

Current Needs Your current spending level is based on the necessities of life and your **average propensity to consume**, which is the percentage of each dollar of income, on average, that is spent for current needs rather than savings. A minimum level of spending would allow you to obtain only the necessities of life: food, clothing, and shelter. Although the quantity and type of food, clothing, and shelter purchased may differ among individuals depending on their wealth, we all need these items to survive.

Some people with high average propensities to consume earn low incomes and spend a large portion of it on basic necessities. On the other hand, individuals earning large amounts quite often have low average propensities to consume, in part because the cost of necessities represents only a small portion of their income.



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

Future Needs A carefully developed financial plan should set aside a portion of current income for future spending. Placing these funds in various savings and investment vehicles allows you to earn a return on your funds until you need them. For example, you may want to build up a retirement fund to maintain a desirable standard of living in your later years. Instead of spending the money now, you defer actual spending until the future when you retire. Nearly 35 percent of Americans say retirement planning is their most pressing financial concern. Other examples of deferred spending include saving for a child's education, a primary residence or vacation home, a major acquisition (such as a car or home entertainment center), or even a vacation.

The portion of current income we commit to future needs depends on how much we earn and also on our average propensity to consume. Many affluent Americans say they need at least $5 million to feel rich. And more generally, most people say that it would take about twice their current net worth to feel wealthy. The more we earn and the less we devote to current spending, the more we can commit to meeting future needs. Regardless of income or wealth, some portion of current income should be set aside regularly for future use. Doing so creates good saving habits and provides for your future needs.

Financial Planning Tips

BE SMART IN PLANNING YOUR FINANCIAL GOALS

Success is most likely if your goals are:

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

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

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

Realistic: Am I willing and able to do this?

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

Inspired by Paul J. Meyers, *Attitude Is Everything*, The Meyer Resource Group, 2003.

1-1c Accumulating Wealth

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

One's **wealth** is the net total value of all the items that the individual owns. Wealth consists of financial and tangible assets. **Financial assets** are intangible, paper assets such as savings accounts and securities (stocks, bonds, mutual funds, and so forth). They are *earning assets* that are

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

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

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

Exhibit 1.2

The Average American, Financially Speaking

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

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

Source: Adapted from Jesse Bricker, Lisa J. Dettling, Alice Henriques, Joanne W. Hsu, Kevin B. Moore, John Sabelhaus, Jeffrey Thompson, and Richard A.Windle, "Changes in U.S. Family Finances from 2010 to 2013: Evidence from the Survey of Consumer Finances," Board of Governors of the Federal Reserve System, Washington, D.C., October 24, 2014. Data is for 2013. http://www.federalreserve.gov/pubs/bulletin/2014/pdf/scf14.pdf, Tables 1–4, accessed September 2016.

held for their expected future returns. **Tangible assets**, in contrast, are physical assets such as real estate and automobiles. These assets can be held for either consumption (e.g., your home, car, artwork, or jewelry) or investment purposes (e.g., a duplex purchased for rental income). The goal of most people is to accumulate as much wealth as possible while maintaining current consumption at a level that provides the desired standard of living. To see how you compare with the typical American in financial terms, check out the statistics in Exhibit 1.2.

1-2 THE PERSONAL FINANCIAL PLANNING PROCESS

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

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

LO2 Many people mistakenly assume that personal financial planning is only for the wealthy. However, nothing could be further from the truth. Whether you have a lot of money or not enough, you need personal financial planning. If you have enough money, planning can help you spend and invest it wisely. If your income seems inadequate, taking steps to plan your financial activities will lead to an improved lifestyle. **Personal financial planning** is a systematic process that considers the important elements of an individual's financial affairs and is aimed at fulfilling his or her financial goals.

Everyone—including recent college graduates, young married couples, and others—needs to develop a personal financial plan.

Everyone—including recent college graduates, young married couples, and others—needs to develop a personal financial plan. Knowing what you need to accomplish financially, and how you intend to do it, gives you an edge over someone who merely reacts to financial events as they unfold. Just think of the example provided by the financial crisis of 2008–2009. Do you think that a financial plan would have helped in weathering the financial storm?

1-2a Steps in the Financial Planning Process

The financial planning process translates personal financial goals into specific financial plans, which then

Exhibit 1.3

The Six-Step Financial Planning Process

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

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

help you implement those goals through financial strategies. The financial planning process involves the six steps shown in Exhibit 1.3.

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

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


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1-2b Defining Your Financial Goals

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

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

BEHAVIOR MATTERS

Practicing Financial Self-Awareness

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

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

Then ask yourself two critically important questions:

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

Source: Adapted from Carl Richards, "Practicing Radical Self-Awareness," Behaviorgap.com, http://us2.campaign-archive1.com/?u=23ce2ac179e81 58f7583c4e3f&id=86f42577bc&e=b50e826a9e, accessed September 2016.

The Role of Money About 75 percent of Americans believe that money is freedom. **Money** is the medium of exchange used to measure value in financial transactions. It would be difficult to set specific personal financial goals and to measure progress toward achieving them without the standard unit of exchange provided by the dollar. Money, as we know it today, is the key consideration in establishing financial goals. Yet it's not money, as such, that most people want. Rather, we want the **utility**, which is the amount of satisfaction received from buying quantities of goods and services of a given quality, that money makes possible.

People may choose one item over another because of a special feature that provides additional utility. For example, some people will pay more for a car with satellite radio than one with only an audio player. The added utility may result from the actual usefulness of the special feature, from the "status" it's expected to provide, or from both. Regardless, people receive varying levels of satisfaction from similar items, and their satisfaction isn't necessarily directly related to the cost of the items. We, therefore, need to consider utility along with cost when evaluating alternative qualities of life, spending patterns, and forms of wealth accumulation.

money the medium of exchange used as a measure of value in financial transactions

utility the amount of satisfaction received from purchasing certain types or quantities of goods and services

Go to Smart Sites

Is getting the lowest price important to you? Where can you search for the best prices? A highlight box in each chapter of PFIN Online includes "Smart Sites," a list of resources and sites that offer additional information on topics in the PFIN text. Log in at www.cengagebrain.com.

The Psychology of Money Money and its utility are not only economic concepts; they're also closely linked to the psychological concepts of values, emotion, and personality. Your personal value system—the important ideals and beliefs that guide your life—will also shape your attitude toward money and wealth accumulation. If you place a high value on family life, you may choose a career that offers regular hours and less stress or choose an employer who offers flex-time rather than a higher-paying position that requires travel and lots of overtime.

You may have plenty of money but choose to live frugally and do things yourself rather than hire someone to do them for you. Or you may spend a high proportion of your current income on acquiring luxuries. Financial goals and decisions should be consistent with your personal values. You can formulate financial plans that provide the greatest personal satisfaction and quality of life by identifying your values.

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Money is an important motivator of personal behavior because it has a strong effect on self-image. Each person's unique personality and emotional makeup determine the importance and role of money in his or her life. You should become aware of your own attitudes toward money because they are the basis of your "money personality" and money management style.

Some questions to ask yourself include: How important is money to me? Why? What types of spending give me satisfaction? Am I a risk taker? Do I need large financial reserves to feel secure? Knowing the answers to these questions is a prerequisite for developing realistic and effective financial goals and plans. Trade-offs between current and future benefits are strongly affected by values, emotions, and personality. Effective financial plans are both economically and psychologically sound. They must not only consider your wants, needs, and financial resources but must also realistically reflect your personality and emotional reactions to money.

1-2c Money and Relationships

The average couple spends between 250 and 700 hours planning their wedding. While most couples spend less than $10,000 on the big day, the average cost has risen to more than $32,000, depending on where they live. But with all the hoopla surrounding the wedding day, many couples overlook one of the most important aspects of marriage: financial compatibility. Money can be one of the most emotional issues in any relationship, including that with a partner, parents, or children. Most people are uncomfortable talking about money matters and avoid such discussions, even with their partners. However, differing opinions on how to spend money may threaten the stability of a marriage or cause arguments between parents and children. Learning to communicate with your partner about money is a critical step in developing effective financial plans.

The best way to resolve money disputes is to be aware of your partner's financial style, consistently communicate openly, and be willing to compromise. It's highly unlikely that you can change your partner's style, but you can work out your differences. Financial planning is an especially important part of the conflict resolution process. You need to work together to develop your financial goals.

1-2d Types of Financial Goals

Financial goals cover a wide range of financial aspirations: controlling living expenses, meeting retirement needs, setting up a savings and investment program, and minimizing your taxes. Other important financial goals include having enough money to live as well as possible, being financially independent, sending children to college, and providing for retirement.

Financial goals should be defined as specifically as possible. Saying that you want to save money next year is not a specific goal. How much do you want to save, and for what purpose? A goal such as "save