FOURTH CANADIAN EDITION

PERSONAL FINANCE

JEFF MADURA • HARDEEP SINGH GILL

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BRIEF CONTENTS

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PART 5 RETIREMENT AND ESTATE PLANNING

PREFACE

When will you be able to buy a home? Can you afford a new car or a vacation? How can you pay off your credit card balance? What should you invest in?

The answers to these questions are tied directly to how you, as a **student,** manage your finances. Managing your finances wisely will bring a sense of security and freedom that you can enjoy for years to come. Very few courses you will take throughout your post-secondary career will have the potential to profoundly shape your future like a personal finance course. Taking this course is your first step on the path toward a stable financial future.

With *Personal Finance*, Fourth Canadian Edition, as your guide, you will master key concepts that will aid you in managing and increasing your personal wealth. The aim of this textbook is to equip you with knowledge and decision-making tools to help you make sound financial decisions.

New to the Fourth Canadian Edition

Revised Chapter Introduction Cases

Each chapter opens with a chapter introduction, with student-centric scenarios that include at least two discussion questions designed to introduce important concepts and themes covered in the chapter.

Free Apps for Personal Finance

Throughout each chapter, students are advised of a variety of useful applications that they can download to their smartphones, for free, that apply to many of the key concepts covered in the chapter.

Psychology of Personal Finance

Personal finance behaviour is influenced by psychology. For example, some spending decisions are made on impulse due to the desire for immediate satisfaction. A feature called Psychology of Personal Finance explains how financial planning decisions are affected by psychology. At the end of every chapter, there is also an accompanying section that tests students' understanding of how psychological forces influence personal finance decisions.

End-of-Chapter *Challenge Questions*

Multi-step financial planning problems called Challenge Questions require deeper analysis, inviting students to apply knowledge and demonstrate chapter material comprehension.

End-of-Chapter *Mini-Cases*

At the end of each chapter, new mini-cases provide students with an opportunity to synthesize and to apply a number of concepts from each chapter in a practical manner. There are one to two mini-cases per chapter.

More Visual Exhibits

More exhibits appear throughout the entire book to enhance concept retention and to provide a visual representation of facts and figures.

Improved *Ethical Dilemmas*

End-of-chapter ethical scenarios focus on topics of student interest to engage the reader. Designed to help students apply ethical principles to financial situations and problems, these real-life ethical situations are presented along with critical thinking questions.

Key Chapter Updates

Chapter 1: In addition to being SMART (specific, measurable, action-oriented, realistic, and time bound), goals must be prioritized. The idea of prioritizing your goals is introduced through a new mini case and the use of an online tool that helps students understand that goals need to be considered in terms of their priority relative to your personal situation.

Chapter 2: The discussion of the simple interest formula, $I = P \times r \times t$, has been expanded to include variations of this formula that allow students to solve for P, r, and t. In addition, a new learning outcome provides a brief discussion and example calculations for solving for the number of compounding periods (N) and the nominal annual interest rate (I/Y). At the end of the chapter, a revised and expanded list of financial planning problems provides students with an opportunity to use their financial calculator to solve for all time value of money variables.

Chapter 3: A summary of the budgeting steps covered in Learning Outcome 3, Creating a Budget, is provided at the end of the section. This summary will help reinforce the actions that are required in this critical component of personal financial planning.

Chapter 5: The topic of Interac e-transfers is introduced for the first time in this edition as a new banking service available to Canadians.

Chapter 6: A new table summarizing the advantages and disadvantages of using credit is introduced in this edition. The home equity loan has been reintroduced as the home equity line of credit, HELOC, in order to better reflect how these types of secured credit facilities are set up in Canada. The section on negotiating the price of a car has been expanded so as to provide further guidance to those students who are in the market for a car—now or in the future.

Chapter 7: The section on mortgage refinancing is now complemented by a new example calculation for a blend-and-extend mortgage refinancing.

Chapter 8: The concept of maintaining a minimum amount of coverage on a homeowner's insurance policy that provides replacement cost coverage is clarified with the use of a detailed example.

Chapter 11: The topic of electronic trading systems is expanded with a discussion of the bid price, ask price, and the bid–ask spread, including definitions and examples. Learning Outcome 4 has been better organized, updated, and renamed *How to Analyze Stocks*. Learning Outcome 5 on *Stock Valuation* has been updated to include a discussion on the two main methods to value a stock—the intrinsic valuation mode and the relative valuation model.

TRIED AND TRUE LEARNING TOOLS IN THE FOURTH CANADIAN EDITION

Learning Objectives

Corresponding to the main headings in each chapter, and indicated by marginal callouts throughout the chapter, the list of learning objectives guides students through the material.

Marginal Glossary

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

Explanation by Example

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

Myth or Fact

Throughout the text, "Myth or Fact" features highlight popular misconceptions about financial planning; providing students with an opportunity to reinforce key ideas from the chapter and/or to use their intuition to determine whether a statement is a myth or a fact.

Summary

In bullet form, the summaries correlate the key points from each chapter with the learning objectives provided at the beginning of the chapter.

Review Questions

The Review Questions test students' understanding by asking them to compare and contrast concepts, interpret financial quotations, and decide how financial data can be used to make personal finance decisions.

Financial Planning Problems

At the end of each chapter, Financial Planning Problems require students to demonstrate knowledge of mathematically based concepts to perform computations in order to make well-informed personal finance decisions.

End-of-Chapter Study Guide

Each chapter concludes with 10 multiple-choice and 10 true/false study questions for extra review.

AN INTERACTIVE APPROACH

Personal Finance's interactive approach incorporates online resources along with many examples, problems, and ongoing case studies, all of which focus on providing students with hands-on practice applying financial concepts.

MyLab Finance

This integrated online homework tool gives students the hands-on practice and tutorial assistance they need to learn skills efficiently. Ample opportunities for online practice and assessment in MyLab™ Finance are seamlessly integrated into the content of each chapter and organized by section within the chapter summaries. Select Financial Planning Problems and Bonus questions are available in the Study Plan, and select Review Questions, new Chapter Test questions, and new Financial Literacy Test questions are available for instructors to assign. MyLab Finance also includes helpful financial planning tools such as financial calculators and tutorials and glossary flashcards. Please visit MyLab Finance for more information and to register.

Build Your Own Financial Plan

Personal Finance's structure mirrors a comprehensive financial plan. In each chapter, students learn the skills they need to build their own financial plan. The Build Your Own Financial Plan exercises are an integrated series of problems and worksheets that present a portion of a financial plan based on the concepts presented in each chapter. The exercises and associated worksheets are available on MyLab Finance. At the end of the course, students will have completed a financial plan that they can continue to implement beyond the school term.

Financial Planning Weblinks

In every chapter, marginal weblinks highlight useful internet resources. You will find a website address and a description of what type of information the website provides.

Financial Planning Online Exercises

At the end of each chapter, Financial Planning Online Exercises show students how to obtain, critically evaluate, and use internet-based resources in making personal finance decisions.

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. They are eager to start saving toward a new car, their children's post-secondary education, and their retirement. Students apply chapter concepts to counsel the Sampsons. The Sampsons—A Continuing Case chapter-end cases and accompanying worksheets are provided on MyLab Finance.

Appendix A: Projects

Appendix A provides a number of projects for students to complete relating to specific aspects of personal finance. The list of projects includes:

- Assessing Your Credit
- Career Planning Project

- Leasing an Apartment
- Stock Market Project
- Comparison Shopping: Online versus Local Purchases
- Mortgage Case Project
- Mutual Fund Comparison Project

Appendix B: Your Career

Appendix B provides direction on determining and managing your career. Topics include:

- Determining Your Career Path
- Getting the Skills You Need
- Changing Your Career

Real-Life Scenarios

Students are prompted to **build a financial plan for Brad MacDonald** using the Brad MacDonald—A Continuing Case scenarios that are provided at the end of each part of the text. Brad has expensive tastes—as evidenced by his soaring credit card balance—and he needs assistance in gaining control over his finances. The accompanying worksheets for Brad MacDonald—A Continuing Case are available on MyLab Finance.

HALLMARKS OF *PERSONAL FINANCE*, FOURTH CANADIAN EDITION

We recognize that students who decide to take a course in personal finance have a variety of academic backgrounds, interests, and personal goals. For some, such a course might be a prerequisite to a future in finance or business. Others may decide to take the course because they want to learn more about how to create a budget or to plan for a large purchase such as a car on their current income. Our aim with this text is to provide students with all the tools they need to fully understand and plan their personal finances in a way that is useful, engaging, and rewarding.

Textbook Content and Organization

We have organized this text into a logical chapter order. The first chapter establishes the text's organization by introducing students to the key components of a financial plan. The text is then organized into six parts, beginning with Chapter 2, which are keyed to the components of a comprehensive financial plan.

Part 1: Tools for Financial Planning

Part 2: Managing Your Financial Resources

Part 3: Protecting Your Wealth

Part 4: Personal Investing

Part 5: Retirement and Estate Planning

Part 6: Synthesis of Financial Planning

Key Topics in the Fourth Canadian Edition of *Personal Finance*

We have included several important topics for Canadian students in this edition. You will find some examples of these key discussions in the following chapters:

Chapter 2: In Chapter 2, we discuss the importance of the time value of money (TVM) concept and provide a step-by-step introduction to the calculator steps, using the TI BA II Plus calculator, used to perform TVM calculations.

Chapter 4: In Chapter 4, we provide background on taxes and tax planning strategies, and then provide an appendix that guides students step by step through the process of completing a tax return.

Chapter 6: In Chapter 6, we discuss identity theft, different identity theft tactics, and ways to protect against this kind of theft.

Chapter 9: In Chapter 9, we discuss the various levels of health and life insurance coverage available to Canadians, including disability, critical illness, and long-term care.

Chapter 10: In Chapter 10, we examine different types of investments and the trade-offs that need to be considered when examining investment return and risk.

Chapter 11: In Chapter 11, we show students how to complete an analysis of a firm, an economic analysis of stocks, and an industry analysis of stocks in order to determine an investment strategy.

Chapter 14: In Chapter 14, we present a comprehensive review of public and private retirement options, including the process of converting retirement assets to income.

Decision-Making Emphasis

All of 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 provided on MyLab Finance. Key to understanding personal finance is knowing how to apply concepts to real-life planning scenarios. The many examples, financial planning problems, exercises, and cases place students in the role of the decision-maker and planner.

Focus on Opportunity Costs

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 numerous examples and exercises to illustrate and teach students about the interdependence of personal finance decisions.

The quantitative side of financial planning intimidates many students. *Personal Finance* simplifies the mathematics of personal finance by explaining its 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 keypad illustration. Students are referred to websites with online calculators whenever pertinent. The Financial Planning Problems and Financial Planning Online Exercises provide students with ample opportunity to practise 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.

For Instructors

- *Instructor's Resource and Solutions Manual*—This comprehensive manual pulls together a wide variety of teaching tools and resources. Each chapter contains a chapter overview, chapter objectives, teaching tips, and detailed answers and step-by-step solutions to the Chapter Overview Questions, Review Questions, Financial Planning Problems, Challenge Questions, Ethical Dilemma Questions, Mini-Case Questions, Sampson family case questions, and Myth or Fact Margin Questions. Each part concludes with solutions to the Brad MacDonald case questions.
- *Computerized Test Bank*—Pearson's computerized test banks allow instructors to filter and select questions to create quizzes, tests, or homework. Instructors can revise questions or add their own, and may be able to choose print or online options. These questions are also available in Microsoft Word format.
- *PowerPoint Slides*®—This useful tool provides PowerPoint slides illustrating key points from each chapter. Instructors can easily convert the slides to transparencies or view them electronically in the classroom during lectures.

Learning Solutions Managers

Learning Solutions Managers work with faculty and campus course designers to ensure that Pearson technology products, assessment tools, and online course materials are tailored to meet your specific needs. This highly qualified team is dedicated to helping schools take full advantage of a wide range of educational resources, by assisting in the integration of a variety of instructional materials and media formats. Your local Pearson Education sales representative can provide you with more details on this service program.

For Students

MyLab Finance

MyLab Finance provides students with personalized Study Plans and the opportunity for additional practice. MyLab Finance also includes the Pearson eText. The Pearson eText gives students access to their textbook anytime, anywhere. In addition to note taking, highlighting, and bookmarking, the Pearson eText offers interactive and sharing features. Instructors can share their comments or highlights, and students can add their own, creating a tight community of learners within the class.

Financial Planning Problems are available in the Study Plan, and the following resources are also available:

- Build Your Own Financial Plan exercises and worksheets
- Brad MacDonald—Continuing Case
- The Sampson Family—Continuing Case
- Financial calculators and calculator tutorials
- Interactive Glossary Flashcards for all of the key terms in the text

Read the Build Your Own Financial Plan exercises, then use the worksheets to generate a personal cash flow statement, create a personal balance sheet, and set personal financial goals. After reading the case study, use the Continuing Case worksheets to prepare cash flow statements and balance sheets for Brad MacDonald and for the Sampsons.

ACKNOWLEDGMENTS

I wish to acknowledge the help and support of the many people associated with Pearson Canada who made this textbook possible, including Keara Emmett, Acquisitions Editor; Patti Sayle, Developmental Editor; Sarah Gallagher, Project Manager; Revathi Viswanathan, Production Editor; Heather MacDougall, Copy Editor; Joel Gladstone, Proofreader; and Charmaine Felder, Technical Checker. I also wish to thank Cecile Wendlandt, who provided the initial spark that gave me the energy to work on this project.

—Hardeep Gill

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CHAPTER

1

Overview of a Financial Plan

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After a long semester that ended with their graduation from college, Mo (age 23) and Farah (age 23) could not help but feel an overwhelming sense of satisfaction as they enjoyed the sand and surf on their post-graduation beach vacation. Now that they were moving on with their respective careers, the soon-to-be-married couple faced a new set of financial challenges.

As they imagined their financial futures, the young couple had to think about a number of financial choices, some of which could only be accomplished at the expense of not reaching other goals immediately. Should they buy a new car now? If they did buy a new car, how would this decision impact their plans for their wedding and honeymoon? The couple also had to consider whether they should move out of their apartment and buy a house. How would home ownership impact their cash flow? Although it was a long way off, Mo and Farah were also wondering when they should start thinking about retirement. All of these decisions require detailed planning, but the idea of establishing personal and financial goals for their futures seemed like a difficult task. There was so much they wanted to do and they were not sure if they would ever have the financial resources to do it all.

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 them.

QUESTIONS:

1. What are some of the important financial decisions that Mo and Farah should consider at this stage of their lives?
2. What steps should Mo and Farah take in order to establish their goals?
3. If they wanted professional advice, how should they go about finding a financial adviser?

THE LEARNING OBJECTIVES OF THIS CHAPTER ARE TO:

1. Explain how you could benefit from personal financial planning
2. Identify the key components of a financial plan
3. Outline the steps involved in developing a financial plan

L.O.1

HOW YOU BENEFIT FROM AN UNDERSTANDING OF PERSONAL FINANCE

personal finance (personal financial planning)
The process of planning your spending, financing, and investing activities, while taking into account uncontrollable events, such as death or disability, in order to optimize your financial situation over time.

personal financial plan
A plan that specifies your financial goals and describes the spending, financing, and investing activities that are intended to achieve those goals and the risk management strategies that are required to protect against uncontrollable events, such as death or disability.

per capita debt
The amount of debt each individual in Canada would have if total debt (consumer debt plus mortgages) was spread equally across the population.

Personal finance, also referred to as **personal financial planning**, is the process of planning your spending, financing, and investing activities, while taking into account uncontrollable events such as death or disability, in order to optimize your financial situation over time. A **personal financial plan** specifies your financial goals and describes the spending, financing, and investing activities that are intended to achieve those goals and the risk management strategies that are required to protect against uncontrollable events such as death or disability. Although Canada is one of the world's wealthier countries, many Canadians do not manage their financial situations well. Consequently, they tend to rely too much on credit and have excessive debt. Excessive debt levels affect your ability to achieve important financial goals. Consider the following statistics:

- As of June 2015, total consumer bankruptcies increased by 4.2 percent over the previous year.
- The personal savings rate has been decreasing for the past 30 years and was estimated to be at 4.2 percent as of the third quarter of 2015.
- The delinquency rate on personal loans for youth aged 18 to 25 increased by 11.7 percent from 2015 to 2016.
- From 2000 to 2014, the level of household debt relative to income has increased from 110.1 percent to 166.1 percent, making Canadians the most indebted householders among G7 countries.
- As of May 2016, the per capita debt of Canadians has increased to $17 995. **Per capita debt** represents the amount of debt each individual in Canada would have if total debt (consumer debt plus mortgages) were spread equally across the population.

You have numerous options regarding the choice of bank deposits, credit cards, loans, insurance policies, investments, and retirement plans. All of these options involve decisions you will have to make for yourself. Relying on government benefits alone may not provide you with the financial future you imagine for yourself. 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 of various 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 really understand some basic personal finance concepts.

Do you consider yourself financially literate? Try the financial literacy/knowledge quiz of the Canadian Financial Capability Survey located on the Statistics Canada website at www.statcan.gc.ca/pub/11-008-x/2011001/article/11413-eng.htm#a11. Even if your knowledge of personal finance is limited, you can substantially increase your knowledge and improve your financial planning skills by reading this text. An understanding of personal finance is beneficial to you in many ways.

Make Your Own Financial Decisions

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 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 cellphone costs $100 per month, you have forgone the possibility of using that money to buy new clothes 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.

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

myth or **fact** Financial planners and advisers are registered with a provincial financial planning regulatory agency.

Opportunity cost will also affect your savings decisions. In Chapter 3, we will discuss how you can use budgeting tools to increase your savings. Savings can then be used toward short-, medium-, or long-term goals. Generally, the savings in an emergency fund—a short-term goal—will earn less interest than will your investments in a retirement plan—a long-term goal. Although an emergency fund is very important to your personal financial plan, saving too much for short-term needs does limit your opportunity for long-term growth. You should strive to balance your savings goals among short-, medium-, and long-term goals.

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 rather than 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 percent ($2000) this year, but he will charge you 4 percent of the investment ($400) for his advice. If you had a background in personal finance, you would know that no investment can be guaranteed to increase in value. 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 at no cost).

The **Financial Planning Standards Council (FPSC)** is a not-for-profit organization that was created to benefit the public through the development, enforcement, and promotion of the highest competency and ethical standards in financial planning. It provides a series of questions that you can ask a financial adviser, also known as a financial planner. The answers that you receive to these questions will help you evaluate whether or not you are comfortable with the perspective and business approach of a potential financial adviser. You can access these questions through the FPSC website at financialplanningforcanadians.ca/financial-planning/10-questions-to-ask-your-planner. Each question comes with some hints and tips so that you can get the most benefit from the responses you receive.

Financial Planning Standards Council (FPSC)
A not-for-profit organization that was created to benefit the public through the development, enforcement, and promotion of the highest competency and ethical standards in financial planning.

Become a Financial Adviser

Although a single course such as this is not sufficient to become a financial adviser, an interest in and aptitude for the number of products and ideas discussed in this text may lead you to consider a career in the financial services sector. Financial advisers are in demand because many people lack an understanding of personal finance, are not interested in making their own financial decisions, or simply do not have the time necessary to research and educate themselves on financial issues in order to make informed decisions. (It should be clearly stated, though, that most advisers cannot make decisions for their clients. An individual must give permission to the financial adviser before any action can be taken.)

The FPSC website provides a description of the six steps that must be completed in order to earn the Certified Financial Planner (CFP)® designation. Obtaining this credential is a significant step toward building a successful career as a financial adviser because it indicates that you have met the education, examination, experience, and ethical requirements set by the FPSC. Step 1 involves the successful completion of an approved core curriculum program. Step 2 involves successful completion of the FPSC Level 1® Examination in Financial Planning; upon completing this exam, a candidate moves to Step 3 and becomes an FPSC Level 1 certificant. Step 4 involves completing an FPSC-Approved Capstone Course. At Step 5, a candidate will complete their final exam on the path to CFP® certification. After completing this exam and obtaining three years of qualifying work experience in a financial planning–related position, the candidate is eligible to complete their final step by applying for CFP® certification. In order to maintain their certification, a CFP® professional must adhere to the FPSC Standards of Professional Responsibility, complete 25 hours of continuing education requirements, and renew their CFP® certification on an annual basis. Additional information describing the path to CFP® certification may be found at www.fpsc.ca/beaplanner/path-to-certification. The CFP® examinations cover fundamental financial planning practices, financial management, investment planning, insurance and risk management, tax planning, retirement planning, and estate planning and legal aspects. Obtaining and maintaining CFP® certification allows you to be identified by potential clients as a financial adviser who is dedicated to a high level of professionalism in providing financial planning advice.

L.O.2

COMPONENTS OF A FINANCIAL PLAN

A complete financial plan contains your personal finance decisions related to five key components:

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

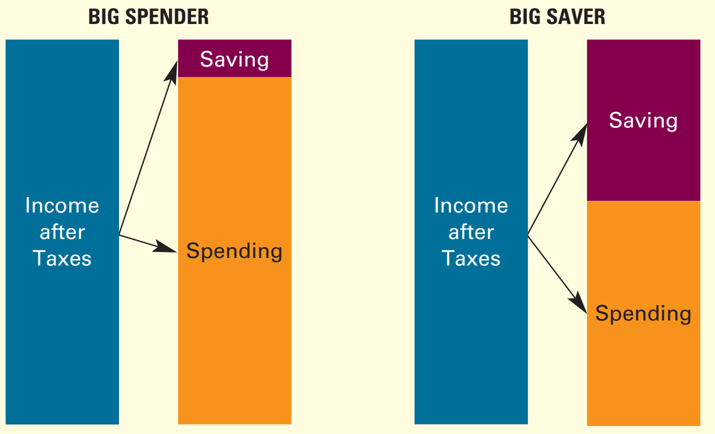
These five components are very different; decisions concerning each component are captured in separate plans that, taken together, form your overall financial plan. To begin your introduction to the financial planning process, let's briefly explore each component.

A Plan for Your Budgeting and Tax Planning

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

Budget planning (also referred to as **budgeting**) is the process of forecasting future income, expenses, and savings goals. That is, it requires you to decide whether to spend or save money. If you receive $750 in income during one month, the amount you save is the amount of money (say, $100) that you do not spend. The relationship between income after taxes, 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

EXHIBIT 1.1 How a Budget Plan Affects Savings



have little or no money left for saving. Others are "big savers": they set a savings goal and consider spending their income after taxes 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 reasonable and practical goal for saving each month.

A first step in budgeting should be 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** (or wealth) 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. Budgeting 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.

myth or **fact** Budgeting is more important for individuals who have trouble covering their monthly expenses.

Your budget is influenced by your income, which in turn is influenced by your life stage. Exhibit 1.2 provides an overview of the six major life stages and the key financial considerations you will make at each of those stages. Individuals who are pursuing post-secondary education during their education stage of life tend to have smaller incomes, usually from part-time jobs, and thus smaller budgets. At this stage, it is important to establish good saving and spending habits—consider saving money inside a TFSA—and begin establishing a credit rating. After completing their education, individuals advance to the early career stage of life and are able to obtain jobs that pay higher salaries, which result in larger budgets. Adopting the pay-yourself-first principle, managing your debt, buying furnishings for your own place or a car for your first job, and building your investment portfolio by starting with a mutual fund are important considerations for someone at this life stage.

FREE APPS for Personal Finance

Your Spending Decisions

Application:

Use iSpending by Hana Mobile LLC to keep track of your income and expenses. You can add transactions under different categories, such as income, food, and entertainment. Summaries for today/week/month/year are also available.

EXHIBIT 1.2 Typical Financial Planning Life Stages

	Life Stages					
	Education	**Early Career**	**Family and Mid-Career**	**Prime Earning**	**Early Retirement**	**Late Retirement**
Age Group	0–22	23–30	31–49	50–64	65–74	75+
Consider Your Current Financial Position	▪ Establish good saving and spending habits ▪ Consider saving money inside a TFSA ▪ Establish a credit rating	▪ Follow the pay-yourself-first principle ▪ Pay off student loans and other short-term debt ▪ Buy furnishings for a home ▪ Buy a car ▪ Consider a mutual fund, inside or outside an RRSP	▪ Buy a home and review insurance needs (health, life, disability, critical illness) ▪ Start a family ▪ Open an RESP account ▪ Continue with your RRSPs ▪ Reduce/minimize taxes ▪ Have a will and power of attorney ▪ Investigate employer-based savings options ▪ Start a business	▪ Are all debts paid? ▪ Have taxes been minimized? ▪ Adequate savings? ▪ Children's education fund? ▪ Weddings? ▪ Job security? ▪ Elder care?	▪ What can you expect from OAS/CPP programs? ▪ RRSP/LIRA/workplace pension maturity options? ▪ Account for all your assets ▪ Retirement income distribution patterns ▪ What happens if a spouse dies? ▪ Changes to your will and power of attorney	▪ RRSP/LIRA maturity options? ▪ Annuitize assets? ▪ Reverse mortgage? ▪ Wealth management: how, who, where? ▪ Estate planning
Milestones	▪ Graduation	▪ First job ▪ New job/Raise	▪ Marriage ▪ First house ▪ First baby ▪ Divorce	▪ Empty nest ▪ Parental care ▪ Close to retirement	▪ Retirement ▪ Empty nest ▪ Travel ▪ Parental care	

As you progress through the next three life stages, you may experience various milestones. Milestones, such as getting married, having children, or starting a new job, will often result in a need or desire to update your personal financial plan. However, waiting for milestones before creating a personal financial plan can be very dangerous because you may not have any time to prepare. For example, when you reach the milestone of marriage, you may find that the expense of planning a wedding requires you to change your spending habits. At that point, you will have to ask yourself how much you can afford to spend on a wedding. If you have not been planning ahead, you may have to scale back on your wedding plans. As a student, not planning ahead for a milestone would be the same as not studying for your final exam until the day before you are supposed to write it—not a good idea! Budget planning is the first step in building a successful plan so that you do not have to sacrifice what you really want when the time comes.

Although the majority of your personal financial plan will be in place by the time you reach the late retirement life stage, it is still important to be aware of any issues that are outstanding. In particular, you may need to review your wealth management options and your estate plan. Managing your money will become more difficult as you move through this life stage. Therefore, it is important to understand what wealth management options are available and to plan accordingly. In addition, your estate plan should be reviewed to ensure that it reflects your wishes at death. As you can see, personal finance is a subject that you will encounter throughout your life. Refer back to Exhibit 1.2 as you read this textbook. The alternatives you will consider at each life stage and/or milestone will be discussed at various points in the textbook.

Another key part of budgeting is estimating the typical expenses that you will incur each month. If you underestimate expenses, you will not achieve your savings goals. Achieving future wealth requires you to sacrifice by moderating your spending today.

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

A Plan to Manage Your Financial Resources

Short-term cash needs and unexpected expenses, such as emergencies, are a fact of life, and you must plan how you will cover them. Your ability to cover these expenses depends on your liquidity. **Liquidity** refers to your access to ready cash, including savings and credit, to cover short-term or unexpected expenses. The budget planning process described above will help you reach your savings goals. Your liquidity can be allocated to short-term needs, such as a cup of coffee or an unexpected car repair, or to long-term needs, such as retirement. You can enhance your liquidity through money management and credit management.

liquidity
Access to ready cash, including savings and credit, to cover short-term or unexpected expenses; also, the ease with which an investor can convert an investment into cash without a loss of capital.

Money management involves decisions regarding how much money to retain in liquid form and how to allocate the funds among short-term investment instruments. If you do not have access to money to cover short-term needs, you may have insufficient liquidity. As a result, it is important to set up an emergency fund to cover short-term needs. An **emergency fund** contains the portion of savings that you have allocated to short-term needs such as unexpected expenses in order to maintain adequate liquidity. 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. Money management is discussed in Chapter 5.

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

emergency fund
A portion of savings that you have allocated to short-term needs such as unexpected expenses in order to maintain adequate liquidity.

As an alternative to establishing an emergency fund by investing some of their savings for short-term needs, many individuals rely on credit to supplement their liquidity. As a result, credit and credit management are important aspects of liquidity. **Credit management** involves decisions regarding how much credit to obtain 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 since you must repay borrowed funds with interest (and the interest expenses may be very high). Unfortunately, the use of consumer credit has steadily increased since 1980. As of 2005, consumer credit represented 38 cents of each dollar of personal spending in Canada. Combined with the steady decline in the personal savings rate mentioned earlier in this chapter, it is clear that credit management has become a very important part of liquidity for many Canadians. Credit management is discussed in Chapter 6. The use of money management and credit management to manage your liquidity is illustrated in Exhibit 1.3.

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

Loans are typically needed to finance large expenditures, such as university or college tuition, 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 1.4. 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 an appropriate interest rate.

EXHIBIT 1.3 Managing Your Liquidity

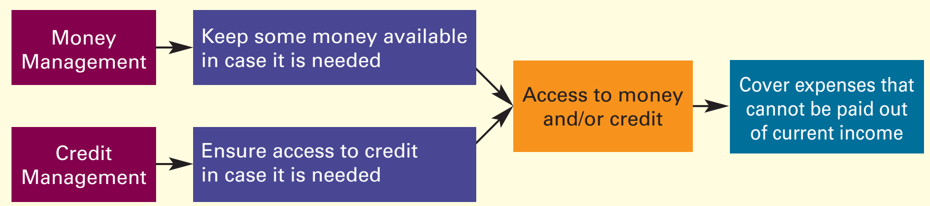
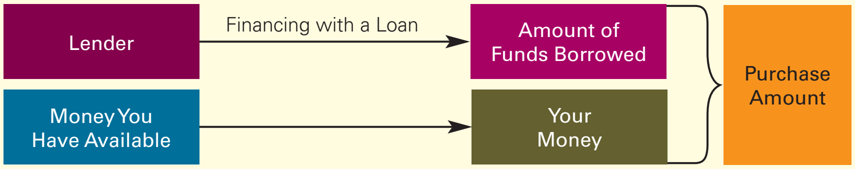


EXHIBIT 1.4 Financing Process



A Plan for Protecting Your Assets and Income

risk
Exposure to events (or perils) that can cause a financial loss.

risk management
Decisions about whether and how to protect against risk.

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

In the context of insurance, the term **risk** can be defined as exposure to events (or perils) that can cause a financial loss. **Risk management** represents decisions about whether and how to protect against risk. Individuals may avoid, reduce, accept, or share (insure) their exposure to risk. Insuring against risk involves insurance planning.

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 and life insurance protect your income. In general, it is important to insure risks that would result in either a significant loss of income for a long period of time or an unplanned use of your financial resources.

A Plan for Your Investing

investment risk
Uncertainty surrounding not only the potential return on an investment but also its future potential value.

risk tolerance
A person's ability to accept risk, usually defined as a potential loss of return and/or loss of capital.

Any savings 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 return. Potential investments include stocks, bonds, mutual funds, and real estate. You must determine how much you wish to allocate toward investments and what types of investments you wish to consider. Since investments are subject to **investment risk** (uncertainty surrounding their potential return and future potential value), you need to understand your personal tolerance to risk in order to manage it. There are many different kinds of risk; however, at this point in our discussion, risk can most easily be defined as a potential loss of return and/or loss of capital. Your ability to accept such potential losses is your **risk tolerance**.

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 and/or after 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, with the exception of tax-free savings accounts (TFSAs), is sheltered from taxes until it is withdrawn from the retirement account. Money contributed to a TFSA is not only tax sheltered, but also tax free when it is withdrawn.

Estate planning is the act of determining how your wealth will be distributed before and/or after your death. Effective estate planning protects your wealth against unnecessary taxes and ensures that your wealth is distributed in a timely and orderly manner.

The Components of a Financial Plan

The components of a financial plan are illustrated in Exhibit 1.5. Each part is shown as a step in the exhibit, with the lower step serving as a foundation for the higher steps. Budgeting focuses on how cash received (from income or other sources) is allocated to savings, spending, and taxes. Budget planning serves as the foundation of the financial plan, as it is your base for making personal financial decisions.

The next component is managing your financial resources because you must have adequate liquidity and a plan for financing your major purchases such as a new car or a home. Insurance is used to protect your wealth. Next, you can consider investment

EXHIBIT 1.5 Components of a Financial Plan

alternatives such as stocks, bonds, and mutual funds. Finally, planning for retirement and estate planning focuses on the wealth that you will accumulate by the time you retire.

An effective financial plan builds your wealth and therefore enhances your net worth. In this text you will have the opportunity to develop the components of your financial plan. By completing the Building Your Own Financial Plan exercises, you will build a personal financial plan by the end of the school term. Exhibit 1.6 lists examples of the decisions you will make in each component.

EXHIBIT 1.6 Example of Decision Made in Each Component of a Financial Plan

A Plan for:	**Types of Decisions**
1. Managing your income	What expenses should you anticipate?
	How much money should you attempt to save each month?
	How much money must you save each month toward a specific purchase?
	What debt payments must you make each month?
2. Managing your financial resources	How much money should you maintain in your bank account?
	Should you use credit cards as a means of borrowing money?
	How much money can you borrow to purchase a car?
	Should you borrow money to purchase a car or should you lease a car?
	How much money can you borrow to purchase a home?
	What type of mortgage loan should you obtain to finance the purchase of a house?
3. Protecting your assets and income	What type of insurance do you need?
	How much insurance do you need?
4. Investing	How much money should you allocate toward investments?
	What types of investments should you consider?
	How much risk can you tolerate when investing your money?
5. Planning your retirement and estate	How much money will you need for retirement?
	How much money must you save each year so that you can retire in a specific year?
	How will you allocate your estate among your heirs?