PERSONAL FINANCE

Third Canadian Edition

JEFF MADURA HARDEEP SINGH GILL

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Third Canadian Edition

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To Mary

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BRIEF CONTENTS

CONTENTS

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?

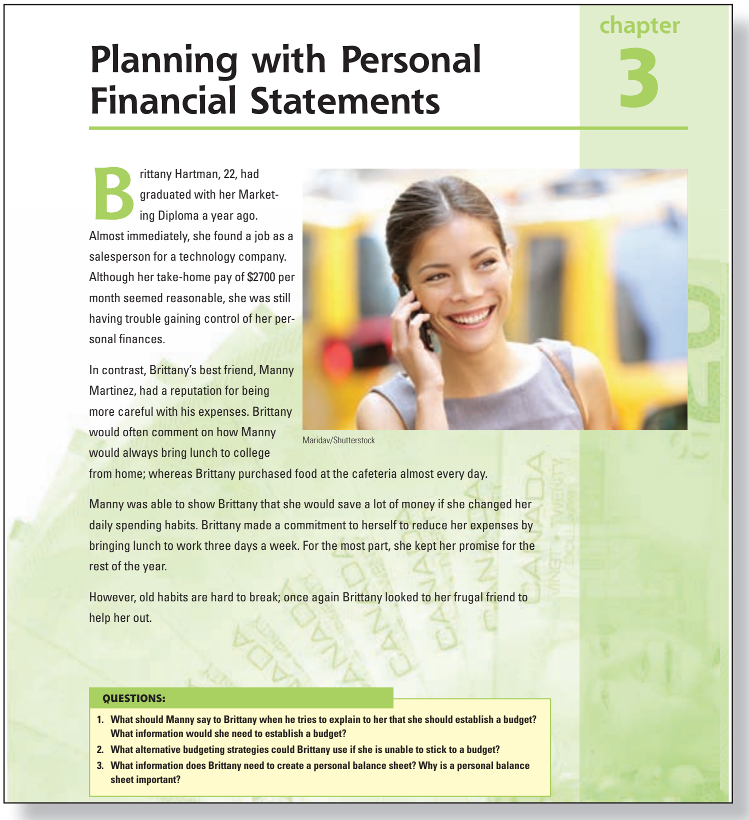
The answers to these questions are tied directly to how you, as a **student,** manage your finances. Managing your finances wisely will bring a sense of security and freedom that you can enjoy for years to come. Very few courses you will take throughout your post-secondary career will have the potential 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*, Third 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 Third Canadian Edition

Revised Chapter Introduction Cases:

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


chapter 3

Planning with Personal Financial Statements

Brittany Hartman, 22, had graduated with her Marketing Diploma a year ago. Almost immediately, she found a job as a salesperson for a technology company. Although her take-home pay of $2700 per month seemed reasonable, she was still having trouble gaining control of her personal finances.

In contrast, Brittany's best friend, Manny Martinez, had a reputation for being more careful with his expenses. Brittany would often comment on how Manny would always bring lunch to college from home; whereas Brittany purchased food at the cafeteria almost every day.

Manny was able to show Brittany that she would save a lot of money if she changed her daily spending habits. Brittany made a commitment to herself to reduce her expenses by bringing lunch to work three days a week. For the most part, she kept her promise for the rest of the year.

However, old habits are hard to break; once again Brittany looked to her frugal friend to help her out.

Maridav/Shutterstock

QUESTIONS:

1. What should Manny say to Brittany when he tries to explain to her that she should establish a budget? What information would she need to establish a budget?
2. What alternative budgeting strategies could Brittany use if she is unable to stick to a budget?
3. What information does Brittany need to create a personal balance sheet? Why is a personal balance sheet important?

New *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.

FREE APPS for Personal Finance

Goal Planning

Application:

Use goalGetter — Financial goal planner by Advisor Software, Inc. to determine how much you need to save to reach your goals. Use this app to enter your current savings, select goals and their value. goalGetter will let you know how much additional monthly savings are needed.

PSYCHOLOGY OF PERSONAL FINANCE: Your Taxes

1. This chapter explains how a portion of your income is withheld throughout the year by your employer, as required by the CRA. You may have some flexibility on how much income can be withheld. A psychological advantage of this so-called "withholding tax" is that the funds are pulled from your income before you receive your paycheque. It is as if that portion of your income was never yours anyway. It may be more painful to receive all the income and then have to pay a portion of the income in taxes later. If you have a choice, would you prefer to have a higher or lower amount of income withheld? Explain your opinion.
2. Read one practical article of how psychology affects behaviour when paying taxes. You can easily retrieve possible articles by doing an online search using the terms "psychology" and "paying taxes". Summarize the main points of the article.

New *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 new 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.

New 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.

CHALLENGE QUESTIONS

1. Calculate the NAVPS for a mutual fund with the following values:

Market value of securities in the portfolio	$1.2 billion
Liabilities of the fund	$37 million
Shares outstanding	60 million

2. At the beginning of last year, Thomas purchased 200 shares of the Web.com fund at a NAVPS of $26 and automatically reinvested all distributions. Because of reinvesting, Thomas ended the year with 265 shares of the fund with a NAVPS $32.20. What was his total percentage return for the year on this investment?

New 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 1 to 2 new mini-cases per chapter.

MINI-CASE: **SMART GOAL PLANNING**

Brittany Hartman, 22, graduated with her Marketing diploma a year ago. Almost immediately, she found a job as a salesperson for a technology company. After bonuses, she was making about $3500 per month.

Although Brittany was able to get by, she never really considered the impact of her daily spending habits on her cash flow. Now, she had some financial goals and she needs help. Whenever she can, Brittany uses her credit card to make purchases. Although the balance on her credit card is a little high (the balance is $8000 and climbing); Brittany has little trouble making the minimum monthly payment of $250. Brittany would like to see the credit card balance go down. Eventually, she would like to pay it off completely. Brittany's other goal is to save $4000 a year so that she can retire 35 years from now. She indicates that she would like to start saving in five years. She feels that delaying the start of her retirement will not have a big impact on the final amount of retirement savings she will accumulate.

Do Brittany's goals meet the SMART goal criteria? If not, which aspects of SMART goal planning is she missing with respect to her goal of paying off her credit card? How about with respect to her retirement goal? What advice do you have for Brittany that would help her make her goals SMART?

More visual exhibits:

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

EXHIBIT 13.5 An Example of Mutual Fund Price Quotations

Blazer Funds	NAVPS ($)	Net Change ($)	YTD Annual Return	3-Year Return
Growth Fund	32.23	+0.15	8.26%	22.51%
Equity Income Fund	45.10	+0.22	9.78%	26.34%

ETHICAL DILEMMA

To obtain more business, mutual fund companies have made it easier for investors to switch between mutual funds within the same family. For example, if you buy the XYZ Equity Growth Fund, you are able to switch to the XYZ Equity Value Fund at no charge. This feature is particularly beneficial for investors who purchase funds that have a back-end load, since these funds normally charge a fee if you redeem the investment within a certain period of time. In many cases, the same fund may be redeemed as a no-load fund or as a back-end load fund. Investment advisers normally earn more commission for selling a back-end load fund. However, the regular annual service fee on a no-load fund is higher than it is on a back-end load fund. As a result of the free switching rule, some advisers have recommended a back-end load fund and then transferred a portion of the investment during the following year into an identical fund that has a no-load fee structure. By doing this, the adviser is able to maximize his or her commission at the beginning of the trade and during the period that the investor owns the investment.

a. Discuss the ethics of this practice.

b. As a consequence of this practice, what is the impact on the MER over the long term? Discuss fully.

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 Chapter 1, there is a greater emphasis on the notion of SMART goal planning. That is, a goal should be specific, measurable, action-oriented, realistic, and time bound. Throughout Chapter 1 and the remainder of the text, examples are provided to demonstrate for students how SMART goals provide a simple way to organize your goals at various life stages and offer clarity as to what you need to do in order to enact your goals.

Chapters 6 and 7: Chapters 6 and 7 were combined in this edition. In addition to a new streamlined presentation of the topic of credit, students are introduced to the concepts of credit score, credit cards, personal loans, and identity theft as interrelated topics. Presenting these topics together reinforces the fact that they influence each other.

Chapter 11: The topic of investment risk is enhanced with a discussion of the difference between systematic and unsystematic risk. In addition, students are introduced to beta as a measure of investment risk.

Chapter 14: Content and examples have been updated to reflect new rules concerning the amount of benefit a pensioner may receive from the Old Age Security program and the Canada Pension Plan.

TRIED AND TRUE LEARNING TOOLS IN THE THIRD 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.

THE 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 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 will affect your ability to achieve important financial goals. Consider the following statistics:

Marginal Glossary

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

mortgage companies Non-depository institutions that specialize in providing mortgage loans to individuals.

Mortgage Companies. **Mortgage companies** specialize in providing mortgage loans to individuals. These companies are able to offer their clients competitive mortgage rates from a number of different financial institutions. This type of non-depository institution acts as a financial intermediary between depository institutions and the consumer. Referring to Exhibit 5.2, RBC offers these services through its RBC Royal Bank business segment.

investment dealers Non-depository institutions that facilitate the purchase or sale of various investments by firms or individuals by providing investment banking and brokerage services.

Go to: www.canpayday.ca/payday-loan-calculator.aspx

This website provides a calculator that allows you to determine the interest cost of a payday loan.

Investment Dealers. **Investment dealers** facilitate the purchase or sale of various investments, such as stocks or bonds, by firms or individuals by providing investment banking and brokerage services. Investment banking services include assisting corporations and governments in obtaining financing for many activities, such as building projects and expansion plans. This financing advice helps both corporations and governments to price their securities for sale and assists them in finding investors such as individuals, mutual funds, and other organizations willing to invest in their securities. Investment banking services also include advising and evaluating businesses with regard to mergers, acquisitions, and other similar corporate activities.

In addition to offering investment banking services, investment dealers provide brokerage services, which facilitate the trading of existing securities. That is, the firms execute trades in securities for their customers. One customer may want to sell a specific stock while another may want to buy that stock. Brokerage firms create a market for stocks and bonds by matching willing buyers and sellers. In the case of RBC, these services are offered through its RBC Capital Markets business segment.

insurance companies Non-depository institutions that sell insurance to protect individuals or firms from risks that can incur financial loss.

Insurance Companies. **Insurance companies** sell insurance to protect individuals or firms from risks that can result in financial loss. Specifically, life and health insurance companies provide insurance in the event of a person's death, disability, or critical illness. Property and casualty companies provide insurance against damage to property, including automobiles and homes. Insurance serves a crucial function for individuals because it protects them (or their beneficiaries) from a significant loss of income and/or savings that may occur as a result of injury, illness, or death. Chapters 8 and 9 discuss insurance options in detail. Exhibit 5.2 shows that RBC offers these services through its RBC Insurance business segment.

Explanation by Example

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

EXAMPLE Sarah Scott's expenses total $1930 per month. She would like to maintain an emergency fund equal to three months' expenses, and calculates that she needs $5790 ($1930 × 3) in the fund. Her disposable income is normally about $2260 per month, leaving her with $330 in net cash flows each month, or $3960 per year. To build up her emergency fund as quickly as possible, Sarah will deposit the entire $330 per month of excess cash into an emergency fund until she reaches her cash value objective. Based on her aggressive savings target, Sarah should be able to reach her goal within 18 months, assuming that she does not need to access the emergency fund during the period she is building it up.

myth or **fact**

I don't make enough money to save.

Myth or Fact

Throughout the text, "Myth or Fact" margin 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.

SUMMARY

L.O.1 Provide a background on money management

When applying money management techniques, you should invest any positive net cash flows in an account that is designed to hold short-term or liquid assets, such as a chequing account or a savings account. Liquidity is necessary because there will be periods when your income is not adequate to cover your expenses. A line of credit and/or a credit card are possible sources of short-term financing when short-term investments are insufficient.

L.O.2 Compare the types of financial institutions

Depository institutions (chartered banks, trust and loan companies, and credit unions/*caisses populaires*) accept deposits and provide loans. Financial conglomerates offer a wide variety of these services so that individuals can obtain all of their financial services from a single firm. Non-depository institutions include finance and lease companies (which provide financing and leasing options for assets, such as a car), mortgage companies (which provide mortgage brokerage services), investment dealers (which provide brokerage and other services), insurance companies (which provide insurance), mutual fund companies (which offer mutual funds), payday loan companies (which provide short-term loans), cheque cashing outlets (which cash cheques for a fee), and pawnshops (which provide small secured loans).

L.O.3 Describe the banking services offered by financial institutions

A depository institution may offer a wide variety of savings alternatives, including chequing services, debit cards, overdraft protection, a stop payment service, online banking, credit card financing, safety deposit boxes, automated banking machines (ABMs), certified cheques, money orders and drafts, and traveller's cheques.

L.O.4 Explain how to select a financial institution

Your choice of financial institution should be based on convenience, deposit rates, deposit insurance, and fees. You should be able to deposit and withdraw funds easily. Deposit rates vary for different types of savings alternatives at different financial institutions. The fees charged by financial institutions vary from one to the next.

L.O.5 Describe the savings alternatives offered by financial institutions

Popular short-term investments considered for money management include savings deposits, term deposits, GICs, Canada Savings Bonds, and money market funds. Savings deposits offer the most liquidity, while GICs and money market funds offer the highest return. In order to avoid tax on growth, a tax-free savings account can be used to hold many types of short-term investments.

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.

REVIEW QUESTIONS

1. Define money management. How does it differ from long-term investment or long-term borrowing decisions?
2. What is liquidity? How is your personal cash flow statement used to help manage your liquidity? Why is liquidity necessary?
3. Name some ways in which an individual might handle a cash flow deficiency. Which would be preferable? Why?
4. What types of investments are appropriate as short-term investment alternatives?
5. Describe and compare the three types of depository institutions.
6. What is a financial conglomerate? List some services that financial conglomerates provide. Give some examples of financial conglomerates.
7. List and describe the eight types of non-depository financial institutions.
8. List and describe some of the banking services offered by financial institutions.
9. Why do individuals use chequing accounts? What is the disadvantage of having funds in a chequing account? What is the difference between a debit card and a credit card?
10. Explain overdraft protection. Are all bank fee structures the same?
11. Name some special services that banks provide. How might you make use of them?
12. Steve just received his first paycheque and wants to open a chequing account. There are five banks in his hometown. What factors should Steve consider when choosing a bank?

FINANCIAL PLANNING PROBLEMS

MyFinanceLab All Financial Planning Problems can be found in MyFinanceLab.

Refer to the chart on the next page when answering Problems 1 through 4.

1. Stuart wants to open a chequing account with a $100 deposit. Stuart believes he will write 15 cheques per month and use other banks' ABMs eight times a month. He will not be able to maintain a minimum balance. Which bank should Stuart choose?
2. Julie wants to open a bank account with $75. Julie estimates that she will write 20 cheques per month and use her ABM card only at the home bank. She will maintain a $200 balance. Which bank should Julie choose?
3. Veronica plans to open a chequing account with her $1200 tax refund. She believes she can maintain a $500 minimum balance. Also, she estimates that she will write 10 cheques per month and will use other banks' ABMs as much as 15 times per month. Which bank should Veronica choose?

except for the two mailed yesterday have cleared. Based on his balance, Paul writes a cheque for a new stereo for $241. He has no intention of making a deposit in the near future. What are the consequences of his actions?

6. Mary's previous bank statement showed an ending balance of $168.51. This month, she deposited $600 in her account and withdrew a total of $239. Furthermore, she wrote a total of five cheques, two of which have cleared. These two cheques total $143. The three outstanding cheques total $106.09. Mary pays no fees at her bank. What is the balance shown this month on Mary's bank statement? What is the adjusted bank balance?
7. Nancy is depositing $2500 in a six-month GIC that pays 4.25 percent interest, compounded annually. How much interest will she accrue if she holds the

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.

Study Guide

Circle the correct answer and then check the answers in the back of the book to chart your progress.

Multiple Choice

1. Which of the following statements regarding liquidity is incorrect?
   a. Liquidity is necessary because there will be periods when your income is not adequate to cover your expenses.
   b. Alternative sources of liquidity include access to a credit card, a line of credit, or an emergency fund.
   c. Maintaining adequate liquidity is important for situations where your income exceeds your expenses.
   d. A useful rule of thumb is that you should have between three and six months' worth of expenses in an emergency fund.
2. Which of the following is a type of non-depository institution?
   a. Chartered banks
   b. Trust companies
   c. Credit unions
   d. Finance companies
3. The main types of non-depository institutions that serve individuals include finance and lease companies, pawnshops, investment dealers, and ______.
   a. Financial advisers
   b. Insurance companies
   c. Schedule III banks
   d. *Caisses populaires*
4. All of the following are advantages of online banking, except
   a. Provides real-time reporting of account information
   b. Allows you to transfer funds among accounts
   c. Allows you to close chequing, savings, or other accounts
   d. Allows you to pay bills electronically
5. The primary advantage of calling an automated phone service or logging on to your financial institution's website in order to check your account balance is
   a. You do not have to talk to someone

The cost of this service may include all of the following, except
   a. A high interest rate charged on the overdraft balance
   b. A limit to the number of banking services you can have with one financial institution
   c. A one-time fee every time you need to use the protection
   d. A monthly fee to your account simply for having the protection available

7. Rank the following ABM machines in order of cost to you, from least expensive to most expensive. ABM1 belongs to the bank with which you have a chequing account. ABM2 is owned privately. ABM3 is owned by a financial institution with which you do not have an account.
   a. ABM1, ABM2, ABM3
   b. ABM2, ABM1, ABM3
   c. ABM3, ABM2, ABM1
   d. ABM1, ABM3, ABM2
8. Which of the following banking products can be cashed immediately upon receipt?
   a. Certified cheque
   b. Traveller's cheque
   c. Draft
   d. All of the above
9. When are Canada Savings Bonds available for purchase?
   a. From early January to April 1 each year
   b. Throughout the entire year
   c. From early October to April 1 each year
   d. From early January to June 30 each year
10. Donald is considering how he should allocate the money he has in his emergency fund. He expects that interest rates will decrease sharply in the next six months. As a result, he is considering investing in a two-year GIC. He feels that when his investment matures, interest rates will have increased

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.

MyFinanceLab

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 MyFinanceLab are seamlessly integrated into the content of each chapter and organized by section within the chapter summaries. Nearly all Financial Planning Problems are available in MyFinanceLab, and select Review Questions are also available for instructors to assign. MyFinanceLab also includes helpful financial planning tools such as financial calculators and tutorials, finance news feeds, and glossary flashcards. Please visit MyFinanceLab for more information and to register.

MyFinanceLab Visit MyFinanceLab for additional study and practice tools. Financial Planning Problems are available in the Study Plan. Create your own study plan, generate personal cash flow statements and balance sheets, and set personal financial goals.

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 MyFinanceLab. At the end of the course, students will have completed a financial plan that they can continue to implement beyond the school term.

Go to
www.themoneybelt.ca/thecity-lazone/eng/mod2/mod2-2-eng.aspx

This website provides
a Lifestyle Reality Check to help you see if you can afford the choices you want to make.

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.

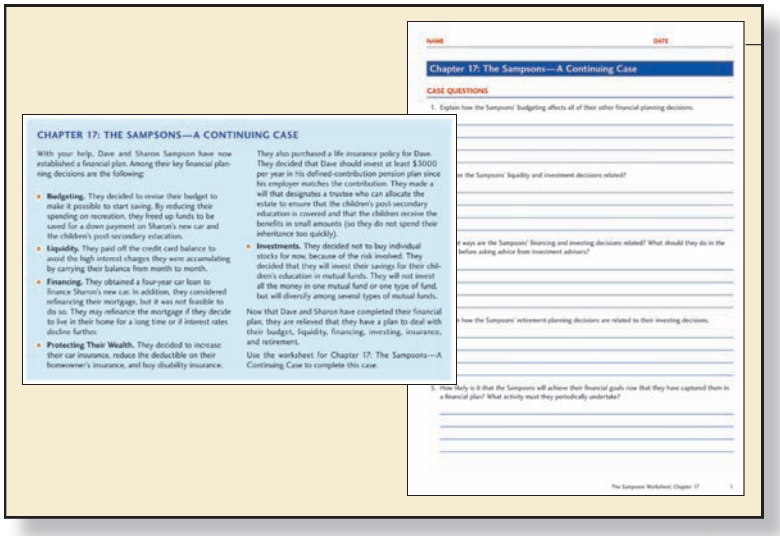
FINANCIAL PLANNING PROBLEMS

MyFinanceLab All Financial Planning Problems can be found in MyFinanceLab.

1. Pete's group insurance policy specifies that he pays 30 percent of expenses associated with orthodontic treatment for his children. If Pete incurs expenses of $5000, how much would he owe?
2. Christine's monthly expenses typically amount to $1800. About $50 of these expenses are work-related. Christine's employer provides disability insurance coverage of $500 per month. How much individual disability insurance should Christine purchase?

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 MyFinanceLab.



NAME DATE

Chapter 17: The Sampsons—A Continuing Case

CASE QUESTIONS

1. Explain how the Sampsons' budgeting affects all of their other financial planning decisions.

CHAPTER 17: THE SAMPSONS—A CONTINUING CASE

With your help, Dave and Sharon Sampson have now established a financial plan. Among their key financial planning decisions are the following:

- **Budgeting.** They decided to revise their budget to make it possible to start saving. By reducing their spending on recreation, they freed up funds to be saved for a down payment on Sharon's new car and the children's post-secondary education.
- **Liquidity.** They paid off the credit card balance to avoid the high interest charges they were accumulating by carrying their balance from month to month.
- **Financing.** They obtained a four-year car loan to finance Sharon's new car. In addition, they considered refinancing their mortgage, but it was not feasible to do so. They may refinance the mortgage if they decide to live in their home for a long time or if interest rates decline further.
- **Protecting Their Wealth.** They decided to increase their car insurance, reduce the deductible on their homeowner's insurance, and buy disability insurance. They also purchased a life insurance policy for Dave. They decided that Dave should invest at least $3000 per year in his defined-contribution pension plan since his employer matches the contribution. They made a will that designates a trustee who can allocate the estate to ensure that the children's post-secondary education is covered and that the children receive the benefits in small amounts (so they do not spend their inheritance too quickly).
- **Investments.** They decided not to buy individual stocks for now because of the risk involved. They decided that they will invest their savings for their children's education in mutual funds. They will not invest all the money in one mutual fund or one type of fund, but will diversify among several types of mutual funds.

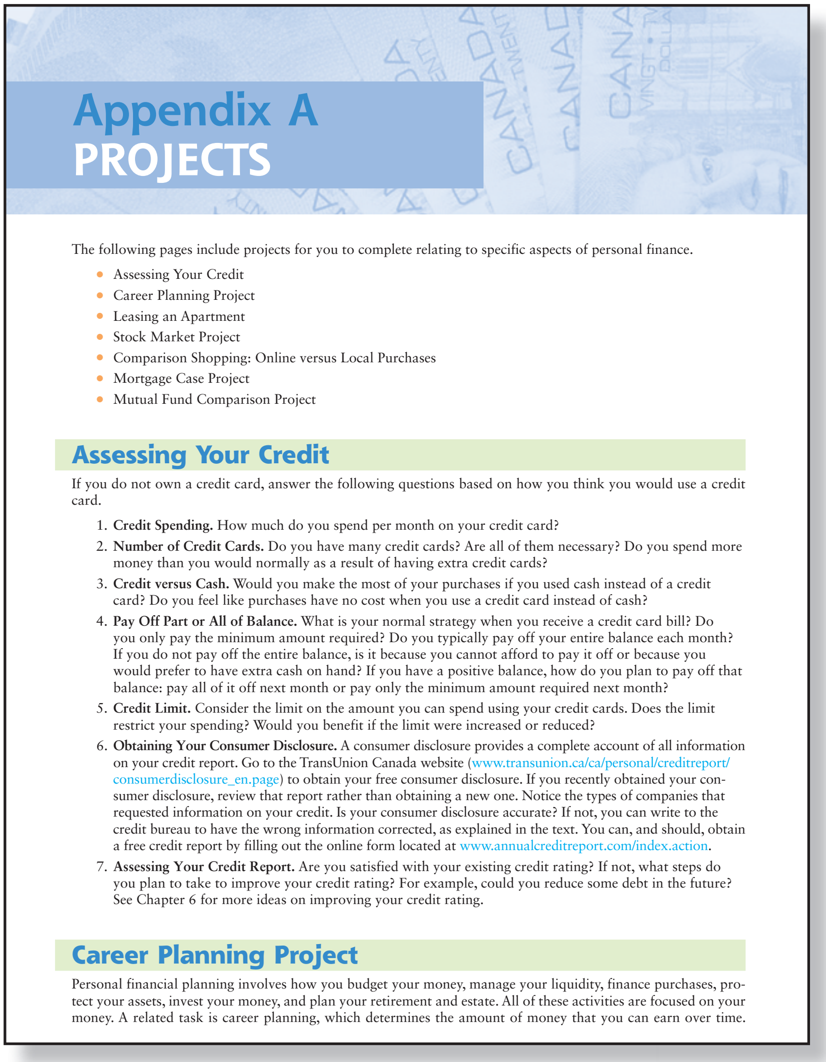
Now that Dave and Sharon have completed their financial plan, they are relieved that they have a plan to deal with their budget, liquidity, financing, investing, insurance, and retirement.

Use the worksheet for Chapter 17: The Sampsons—A Continuing Case to complete this case.

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 A
PROJECTS

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

- Assessing Your Credit
- Career Planning Project
- Leasing an Apartment
- Stock Market Project
- Comparison Shopping: Online versus Local Purchases
- Mortgage Case Project
- Mutual Fund Comparison Project

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 each month? 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 Consumer Disclosure.** A consumer disclosure provides a complete account of all information on your credit report. Go to the TransUnion Canada website (www.transunion.ca/ca/personal/creditreport/consumerdisclosure_en.page) to obtain your free consumer disclosure. If you recently obtained your consumer disclosure, review that report rather than obtaining a new one. Notice the types of companies that requested information on your credit. Is your consumer disclosure accurate? If not, you can write to the credit bureau to have the wrong information corrected, as explained in the text. You can, and should, obtain a free credit report by filling out the online form located at www.annualcreditreport.com/index.action.
7. **Assessing Your Credit Report.** Are you satisfied with your existing credit rating? If not, what steps do you plan to take to improve your credit rating? For example, could you reduce some debt in the future? See Chapter 6 for more ideas on improving your credit rating.

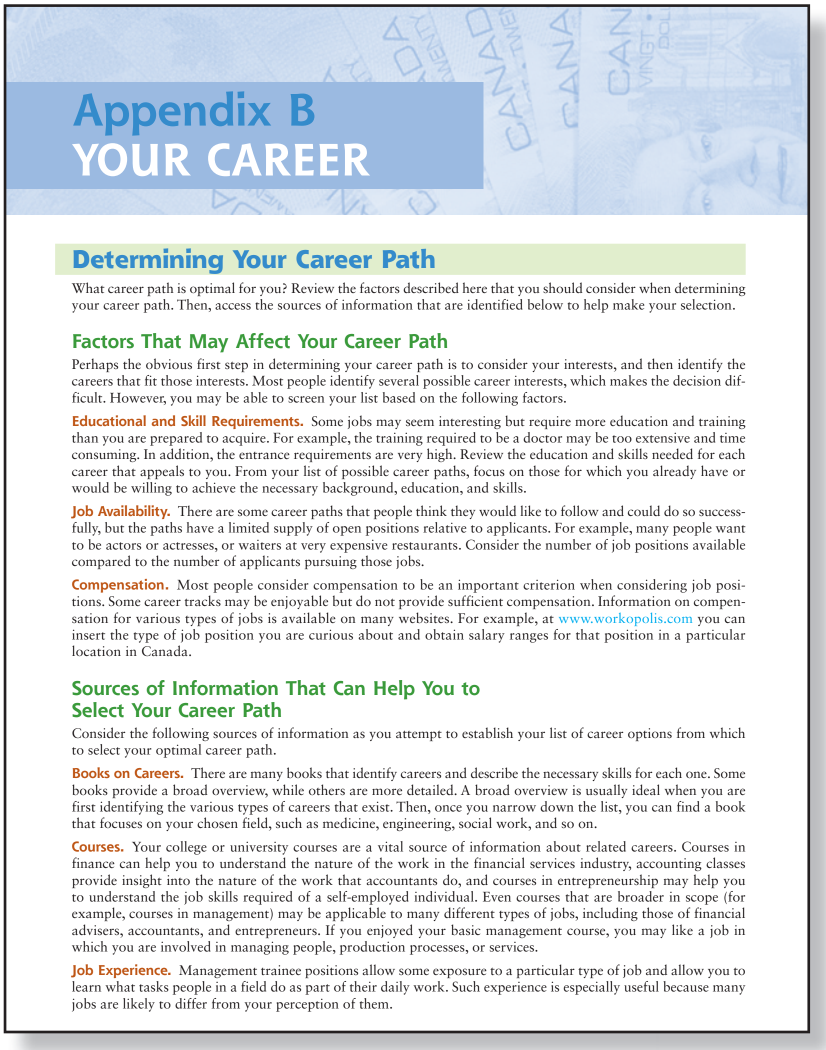
Career Planning Project

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.

Appendix B provides direction on determining and managing your career.

Topics include:

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



Appendix B
YOUR CAREER

Determining Your Career Path

What career path is optimal for you? Review the factors described here that you should consider when determining your career path. Then, access the sources of information that are identified below to help make your selection.

Factors That May Affect Your Career Path

Perhaps the obvious first step in determining your career path is to consider your interests, and then identify the careers that fit those interests. Most people identify several possible career interests, which makes the decision difficult. However, you may be able to screen your list based on the following factors.

Educational and Skill Requirements. Some jobs may seem interesting but require more education and training than you are prepared to acquire. For example, the training required to be a doctor may be too extensive and time consuming. In addition, the entrance requirements are very high. Review the education and skills needed for each career that appeals to you. From your list of possible career paths, focus on those for which you already have or would be willing to achieve the necessary background, education, and skills.

Job Availability. There are some career paths that people think they would like to follow and could do so successfully, but the paths have a limited supply of open positions relative to applicants. For example, many people want to be actors or actresses, or waiters at very expensive restaurants. Consider the number of job positions available compared to the number of applicants pursuing those jobs.

Compensation. Most people consider compensation to be an important criterion when considering job positions. Some career tracks may be enjoyable but do not provide sufficient compensation. Information on compensation for various types of jobs is available on many websites. For example, at www.workopolis.com you can insert the type of job position you are curious about and obtain salary ranges for that position in a particular location in Canada.

Sources of Information That Can Help You to Select Your Career Path

Consider the following sources of information as you attempt to establish your list of career options from which to select your optimal career path.

Books on Careers. There are many books that identify careers and describe the necessary skills for each one. Some books provide a broad overview, while others are more detailed. A broad overview is usually ideal when you are first identifying the various types of careers that exist. Then, once you narrow down the list, you can find a book that focuses on your chosen field, such as medicine, engineering, social work, and so on.

Courses. Your college or university courses are a vital source of information about related careers. Courses in finance can help you to understand the nature of the work in the financial services industry, accounting classes provide insight into the nature of the work that accountants do, and courses in entrepreneurship may help you to understand the job skills required of a self-employed individual. Even courses that are broader in scope (for example, courses in management) may be applicable to many different types of jobs, including those of financial advisers, accountants, and entrepreneurs. If you enjoyed your basic management course, you may like a job in which you are involved in managing people, production processes, or services.

Job Experience. Management trainee positions allow some exposure to a particular type of job and allow you to learn what tasks people in a field do as part of their daily work. Such experience is especially useful because many jobs are likely to differ from your perception of them.

Real-Life Scenarios

At the end of each part, 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.

HALLMARKS OF *PERSONAL FINANCE*, THIRD 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 Third 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 MyFinanceLab. 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 an overview of key topics, teaching tips, and detailed answers and step-by-step solutions to the Review Questions, Financial Planning Problems, Challenge Questions, and Sampson family case 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.

Pearson Custom Library

For enrolments of at least 25 students, you can create your own textbook by choosing the chapters that best suit your own course needs. To begin building your custom text, visit www.pearsoncustomlibrary.com. You may also work with your local Pearson Canada sales representative to create your ideal text —publishing your own original content or mixing and matching Pearson content.

For Students

MyFinanceLab—MyFinanceLab provides students with personalized Study Plans and the opportunity for additional practice. MyFinanceLab also includes the Pearson eText, a robust electronic version of the textbook that enables students and instructors to highlight sections, add notes, share notes, and magnify images and pages.

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
- Finance News Feeds
- 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.

CourseSmart eTextbook

CourseSmart goes beyond traditional expectations by providing instant, online access to textbooks at any time. CourseSmart provides instructors and students with the ability to search texts and find the content they need quickly, no matter where they are. With thousands of titles across hundreds of courses, CourseSmart helps instructors choose the best textbook for their class and give their students a new option for buying assigned textbooks at lower prices. See all the benefits at http://www.coursesmart.com.

LIST OF REVIEWERS

We 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 during the development of the Third Canadian Edition:

Robert Foster
Fanshawe College

Morna Fraser
Douglas College

James D Hebert
Red Deer College

Mary Iannazzo
Mohawk College

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Conestoga College

Jury Kopach
York University

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—Hardeep Gill

chapter

1

Overview of a Financial Plan

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.

Warren Goldswain/Shutterstock

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 future 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 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 will affect your ability to achieve important financial goals. Consider the following statistics:

- From 1990 to 2011, consumer bankruptcies increased 122 percent.
- For each dollar of personal income received in 1982, Canadians saved 17 cents. The personal savings rate in 2012 had decreased to 3.3 cents per dollar of personal income received.
- According to a 2011 study, 51 percent of youth, defined as those between 17 to 20 years of age, carry debt. In addition, 25 percent of these youth have an outstanding credit card balance.
- The per capita debt of Canadians has multiplied 3.9 times over a 30-year period, from $4336 in 1981–1982 to $16 883 in 2011–2012. **Per capita debt** represents the amount of debt each individual in Canada would have if total debt (consumer debt plus mortgages) was 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

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 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.

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 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). Choosing a financial adviser is no different than hiring other professionals such as doctors, mechanics, or plumbers. It is important to ask for references, conduct an interview, and use common sense when choosing an adviser.

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.

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 www.fpsc.ca/10-questions-ask-your-planner. Each question comes with some hints and tips so that you can get the most benefit from the responses you receive.

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 myriad 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 steps needed to earn the Certified Financial Planner (CFP) designation at www.fpsc.ca/beaplanner. 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. Education involves the successful completion of an approved educational program and fulfillment of annual continuing education requirements to keep abreast of planning strategies and financial trends. As well, a minimum of three years' work experience in a financial planning-related position is required to earn the designation. The CFP examination covers fundamental financial planning practices, tax planning, financial management, risk management, asset management, retirement planning, and estate planning. Finally, you must adhere to a professional Code of Ethics that requires you to act in an ethically and professionally responsible manner in all services and activities. Meeting these requirements 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

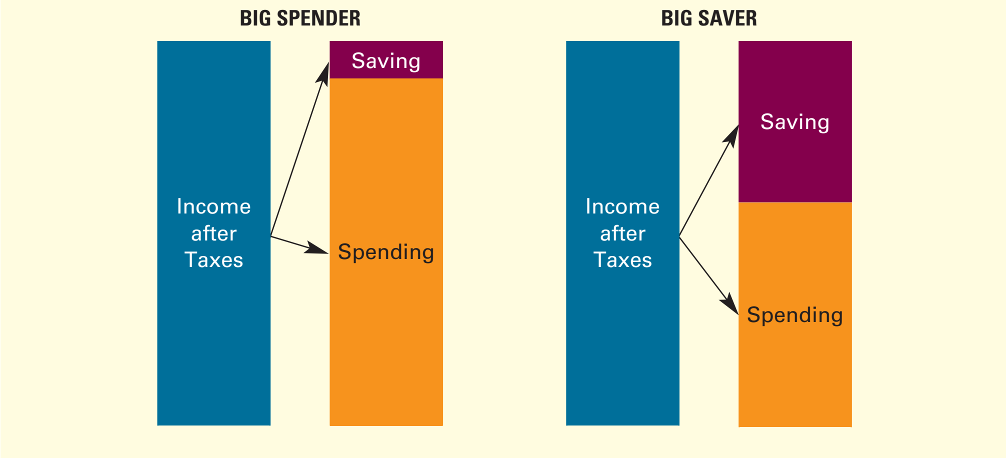
These five components are very different; decisions concerning each component are captured in separate plans that, taken together, form your overall financial plan. To begin your introduction to the financial planning process, let's briefly explore each component.

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 received, spending, and savings 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 reasonable and practical goal for saving each month.

EXHIBIT 1.1 How a Budget Plan Affects Savings



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.

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.

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 pre-career 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 money management habits, through budgeting, and to establish a credit rating. After completing their education, individuals advance to the early earning 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, balancing your savings, 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.

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

EXHIBIT 1.2 Typical Financial Planning Life Stages

	Life Stages					
	Pre-Career	**Early Earning**	**Mid Earning**	**Prime Earning**	**Retirement**	**Post-Retirement**
Age Group	0 to 22	23 to 30	31 to 44	45 to 59	60 to 74	75+
Consider Your Current Financial Position	▪ establish good money management habits ▪ establish a credit rating	▪ follow the pay yourself-first principle ▪ manage your debt, do not let your debt manage you ▪ balance your savings goals ▪ have an adequate amount of property, health, and life insurance ▪ consider a mutual fund, inside or outside an RRSP	▪ consider RESPs ▪ have an adequate amount of property, health, and life insurance ▪ continue with your RRSPs ▪ have a will and power of attorney ▪ investigate and understand your pension plan at work	▪ how much do you need to save? ▪ are all debts paid? ▪ children's education fund? ▪ marriage? ▪ job security? ▪ elder care?	▪ what can you expect from government programs? ▪ RRSP/LIRA maturity options? ▪ review workplace pension benefits ▪ account for all of your assets ▪ retirement income distribution patterns ▪ what happens if a spouse dies?	▪ RRSP/LIRA maturity options? ▪ wealth management: how, who, where? ▪ estate planning
Milestones	▪ Graduation	▪ First job New job/raise	▪ Marriage First house First baby	▪ Empty nest Parental care Ten years to retirement	▪ Retirement Empty nest Travel Parental care	

Source: Adapted from www.bmonesbittburns.com/personalinvest/InvestorLearning/FinancialPlanning/Lifestages/default.asp (accessed June 27, 2007). Reprinted with permission of BMO Nesbitt Burns.

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 studying for your final exam 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 post-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 alternative 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

liquidity
Access to ready cash, including savings and credit, to cover short-term or unexpected expenses.

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.

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

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.

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.

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 that was 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.

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

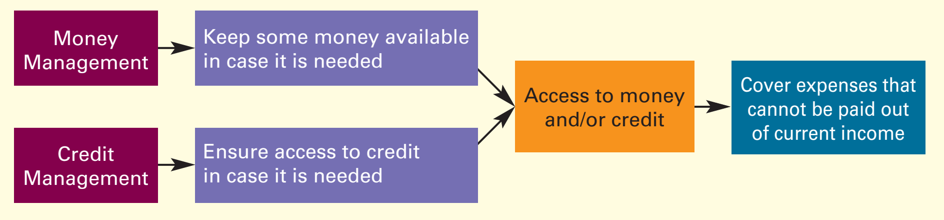
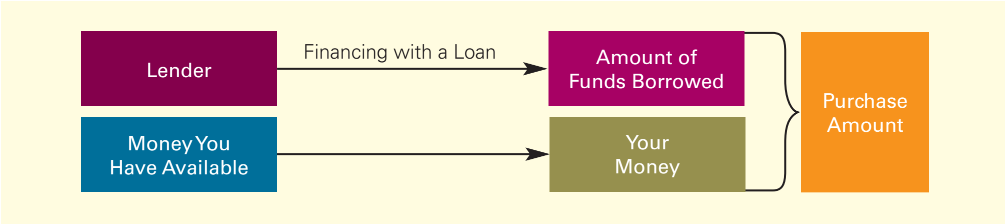


EXHIBIT 1.4 Financing Process



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 is sheltered or tax deferred from taxes until it is withdrawn from the retirement account.

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 the 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 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.

EXHIBIT 1.5 Components of Your Financial Plan

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.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?