Introduction by the Dean

Welcome to the Marriott School of Management project on personal finance. At Brigham Young University’s Marriott School we are concerned about the financial literacy of individuals both inside and outside the university. A solid understanding of basic financial principles and the ability to manage finances wisely are important factors in the well-being of individuals and families. This project is one of our many efforts to increase the financial literacy and self-reliance of our own students as well as of families and friends outside the university.

As you work through this course, I hope you will take the time to do three things. First, read and study the material. Each chapter offers valuable information that will enrich your understanding of personal finance. The chapters have been carefully reviewed by our faculty and staff in the Marriott School. We think they are informative and clearly written. They are organized to be useful to young people with little financial knowledge, people who have extensive experience in financial matters, and everyone in between.

Second, as you read, focus on the principles taught in the course. We emphasize principles because principles don’t change over time. Types of financial assets, investment vehicles, and even financial theories may change, but principles do not. This focus will help you stay on course as you make financial decisions for yourself and your family.

Finally, apply these principles to your life by developing your own Personal Financial Plan. Spencer W. Kimball has counseled, “To be sure your life will be full and abundant, you must plan your life” (Ensign, May 1974, 86). We strongly encourage you to think through and write down your goals, the things you want to achieve in life. Develop a financial plan to help you accomplish your goals and then work to implement your plan. Such planning may be the single most important tool for achieving your personal and financial goals.

Thank you for your interest in this course. May this be the start of even greater learning and understanding as you work toward greater financial self-reliance.

Sincerely,

Lee Perry
Dean, Marriott School of Management
Brigham Young University
Author’s Note

Welcome to this manual (and the accompanying website at http://personalfinance.byu.edu) on Personal Finance. We compiled information on the most important areas of personal finance for students, individuals, and families. We have developed a principles- and applications-based framework that we hope is clear and concise, and that applies the best practices used in the industry. While there may be differences of opinion as to what are the best practices in the areas discussed, this platform was developed to facilitate review and discussion of those practices.

The ideas presented in this manual were written for an audience with a membership in The Church of Jesus Christ of Latter-day Saint (LDS faith); however, the financial principles taught herein can be extended to members of any Christian faith. Readers who are not of the LDS faith may encounter a few unfamiliar terms within this text. While these terms may provide valuable insights to members of the LDS faith, a thorough understanding of these terms is not required to understand the financial principles taught here. If you have questions about any of these terms, feel free to contact me at personalfinance@byu.edu, or visit The Church of Jesus Christ of Latter-day Saints’ website (http://lds.org/topics) for more information.

This manual and website are updated every year for new information, changes to tax laws, and improvements in teaching methodologies. As such, I would appreciate feedback to help make the manual and website better and more useful. While I have tried to present the material in as fair and balanced a framework as possible and am incorporating changes as they become apparent, there may be errors of omission or commission. While this personal finance manual and the website have been approved by Brigham Young University’s Marriott School of Management for distribution, they remain the work of the author. Any errors are solely my responsibility and are not the responsibility of the Marriott School of Management, the faculty, or Brigham Young University.

Bryan L. Sudweeks, Ph.D., CFA

Special Thanks

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Finally, special thanks goes to my wonderful wife, Anne, and our seven children, Kimberly (and Lane and Logan Aldrich), Natalie (and Taylor and Halle Barrett), Laura, Clinton, Emilee, Ashley, and Kaili, for all their love and support. They have been wonderful to put up with a dad who asks too many questions and makes too many comments on the topic of personal finance. Without them and their love and support, this project would not have been possible.

How This Course Is Different

Dave Ramsey, a nationally syndicated radio talk show host, commented, “Personal finance is more personal than it is finance: it is more behavior than it is math” (KNBR, May 23, 2007). Learning about personal finance requires more than learning the languages of finance and math and more than just a change in spending habits—it requires a change in behavior. The three characteristics that make this course different from other courses on personal finance can help effect this change in behavior:

First, we take a different perspective on personal finance. Perspective—the way we look at things— influences our financial self-reliance because it directs the choices we make. Concerning perspective, the historian Will Durant wrote, “We need ‘to seize the value and perspective of passing things. . . . We want to know that the little things are little, and the big things big, before it is too late; we want to see things now as they will seem forever—‘in the light of eternity.’”

Page iii
Our perspective in this manual is unique—our perspective is that personal finance is not separate from our Christian lives; rather, personal finance is simply part of our Christian lives, part of living the gospel of Jesus Christ. This perspective is based on four key principles: 1. Ownership: everything we have is God’s; 2. Stewardship: we are stewards over all that God has blessed us with; 3. Agency: the gift of choice is one of God’s greatest blessings; and 4. Accountability: we will be held accountable for the choices we make, including our financial choices. In this course, our perspective on personal finance is based on a long-term view, on knowing what truly matters. This perspective will guide you as you make financial choices.

Second, we take a principles-based approach to personal finance. Unlike investment theory, investment vehicles, and financial assets, principles never change. A sound understanding of the correct principles of personal finance will act as a compass to guide you as you work toward achieving your personal and family goals. Richard G. Scott commented:

[The] inspired statement, “I teach them correct principles, and they govern themselves,” still applies. The Lord uses that pattern with us. . . . Your consistent adherence to principle overcomes the alluring yet false life-styles that surround you. Your faithful compliance to correct principles will generate criticism and ridicule from others, yet the results are so eternally worthwhile that they warrant your every sacrifice.  

In this course you will learn how principles relate to every aspect of your personal finances. Understanding correct principles makes it easier to follow and apply the concepts discussed in this manual and website to your personal lives.

Finally, we take an applications-based or hands-on approach to personal finance. We learn best when we use the things learn in our daily lives. It is not enough to know what to do—we must do it. Accordingly, the final difference is that we apply the things learned in this manual in the creation of your individual or family Personal Financial Plan.

To help you apply your learning, we offer a companion website, http://personalfinance.byu.edu, which includes PowerPoint presentations, learning tools, and personal finance manuals compiled and developed by the faculty and staff at Brigham Young University. These tools will help you set goals, create a budget, work toward getting out of debt, evaluate different investments, buy a house or a car, invest wisely, save for retirement, and more. You will also receive extensive instructions for developing your own Personal Financial Plan, including helpful examples of completed financial plans.

I believe that changing your perspective, learning the principles that support successful financial management, and applying this knowledge to your own life through the tools we’ve provided will increase your financial literacy and help you achieve the goals that are most important to you and your family. Best of luck to you as you begin this journey toward increased financial self-reliance.

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We also encourage the free use of these materials by educational, non-profit, and other institutions. Please feel free to download and copy these personal finance manuals, Learning Tools, PowerPoint presentations, and all other materials from the website as needed for your schools and colleges. We have also included lesson plans and PowerPoint presentations on the website that are used here at Brigham Young University’s Marriott School of Management to help in the teaching of these materials.

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1 *The Story of Philosophy*, New York: Simon and Schuster, 1927, 1

Page v
# Table of Contents

Introduction by the Dean ................................................................................................................ i
Author’s Note ....................................................................................................................................... ii
Table of Contents .......................................................................................................................... vii

1. Personal Finance: Introduction and Another Perspective ........................................................... 1
   Introduction ..................................................................................................................................... 1
   Objectives ..................................................................................................................................... 3
   Understand the “Whys” of Personal Finance ............................................................................. 3
   Understand the Importance of Perspective ................................................................................. 4
   Understand our Perspective for this Course ............................................................................... 5
   Understand the Key Principles on which Our Perspective is Based ........................................... 6
   Understand the Implications of That Perspective ....................................................................... 8
   Summary ....................................................................................................................................... 13
   Assignments .................................................................................................................................. 14
   Learning Tools .............................................................................................................................. 14
   Review Materials .......................................................................................................................... 14

2. Creating Your Personal Financial Plan and Setting Personal Goals ........................................ 18
   Introduction ................................................................................................................................... 18
   Objectives ..................................................................................................................................... 18
   Learn How Wise Financial Planning Can Help You Achieve Your Goals ...................................... 19
   Understand the Requirements for Your Personal Financial Plan ............................................. 19
   Identify What You Want to Accomplish in Life .......................................................................... 21
   Understand the Three Distinct Types of Goals ......................................................................... 22
   Understand and Apply the Principles of Effective Goal-Setting .............................................. 24
   Summary ....................................................................................................................................... 29
   Assignments .................................................................................................................................. 29
   Learning Tools .............................................................................................................................. 30
   Review Materials .......................................................................................................................... 30

3. Budgeting and Measuring Your Financial Health .................................................................... 32
   Introduction ................................................................................................................................... 32
   Objectives ..................................................................................................................................... 32
   Understand the Principles of Successful Budgeting ................................................................ 33
   Develop and Implement a Budget ............................................................................................ 35
   Calculate Your Net Worth Using a Personal Balance Sheet .................................................... 40
   Develop a Personal Income Statement and Use It to Analyze Your Spending ........................ 44
   Summary ....................................................................................................................................... 48
   Assignments .................................................................................................................................. 48
   Learning Tools .............................................................................................................................. 49
   Review Materials .......................................................................................................................... 49

4. Cash Management ..................................................................................................................... 56
# Table of Contents

Introduction ................................................................................................................................ 56
Objectives ..................................................................................................................................... 56
  Understand the Principles of Cash Management ................................................................. 56
  Understand Cash-Management Options and How to Compare Them ............................... 58
Know the Different Types of Financial Institutions and Understand How They Can Help You Meet Your Financial Goals ................................................................. 63
  Understand the Time Commitment Necessary to Effectively Manage Your Finances ..... 65
Summary ...................................................................................................................................... 66
Assignments .............................................................................................................................. 67
Learning Tools .......................................................................................................................... 67
Review Materials ....................................................................................................................... 68
5. Understanding and Managing Credit .................................................................................... 71
Introduction .............................................................................................................................. 71
Objectives ............................................................................................................................... 71
  Learn About Credit Bureaus, Credit Reports, and Credit Scores ..................................... 71
  Identify Appropriate Uses for Credit Cards and Explain How They Can Help You Achieve Your Financial Goals ................................................................. 74
  Learn How Credit Cards Work and Describe the Costs Involved ..................................... 76
Summary ................................................................................................................................... 79
Assignments ............................................................................................................................ 80
Learning Tools ......................................................................................................................... 80
Review Materials ...................................................................................................................... 81
6. Consumer and Mortgage Loans .......................................................................................... 86
Introduction .............................................................................................................................. 86
Objectives ............................................................................................................................... 86
  Understand How Consumer Loans Can Keep You from Achieving Your Goals ............ 86
  Explain the Characteristics and Costs of Consumer Loans ............................................ 87
  Explain the Characteristics and Costs of Mortgage Loans ............................................. 91
  Understand How to Select the Least Expensive Sources for Consumer Loans and How to Reduce the Costs of Borrowing ......................................................... 95
Summary ................................................................................................................................... 97
Assignments ............................................................................................................................ 97
Learning Tools ......................................................................................................................... 98
Review Materials ...................................................................................................................... 98
7. Debt and Debt Reduction ...................................................................................................... 105
Introduction ............................................................................................................................. 105
Objectives ............................................................................................................................... 105
  Understand What Leaders Have Said Regarding Debt .................................................. 105
  Understand the Debt Cycle and the Reasons People Go into Debt .................................. 106
  Understand How to Develop and Use Personal Debt-Reduction Strategies .................. 109
Summary ................................................................................................................................... 114
Assignments ............................................................................................................................ 115
Learning Tools ......................................................................................................................... 115
Review Materials ...................................................................................................................... 116
8. Time Value of Money 1: Present and Future Value ............................................................... 118
   Introduction .......................................................................................................................... 118
   Objectives .......................................................................................................................... 118
       Understand the Term Investment .................................................................................... 118
       Understand the Importance of Compound Interest and Time ...................................... 119
       Grasp Basic Financial Terminology (i.e., the Language of Finance) ........................... 119
       Solve Problems Related to Present Value (PV) and Future Value (FV) ................. 121
   Summary ............................................................................................................................ 123
   Assignments ...................................................................................................................... 123
   Learning Tools .................................................................................................................. 124
   Review Materials .............................................................................................................. 124
   Introduction ........................................................................................................................ 126
   Objectives .......................................................................................................................... 126
       Explain How Inflation Impacts Your Investments ......................................................... 126
       Understand How to Calculate Real Returns .............................................................. 127
       Understand How to Solve Problems Related to Annuities ......................................... 128
       Solve Problems Related to Amortized Loans ............................................................ 132
   Summary ............................................................................................................................ 134
   Assignments ...................................................................................................................... 135
   Learning Tools .................................................................................................................. 135
   Review Materials .............................................................................................................. 136
10. Beginning Investing 1: Principles ...................................................................................... 139
    Introduction ......................................................................................................................... 139
    Objectives .......................................................................................................................... 139
       Investment Basics ........................................................................................................ 139
       What to Do Before You Invest ..................................................................................... 142
       Factors Controlling Investment Returns .................................................................. 143
       Recognize the 10 Principles of Successful Investing .................................................. 145
       Understand What You Invest In .................................................................................. 152
    Summary ............................................................................................................................ 160
    Assignments ...................................................................................................................... 162
    Financial Plan Assignments .......................................................................................... 162
    Learning Tools .................................................................................................................. 162
    Review Materials .............................................................................................................. 163
11. Beginning Investing 2: Application .................................................................................. 164
    Introduction ......................................................................................................................... 164
    Objectives .......................................................................................................................... 164
       Building an Investment Portfolio .................................................................................. 164
       Select Investment Vehicles Carefully ........................................................................... 166
       Wisely Select Individual Assets .................................................................................... 177
       Final Cautions on Investing ......................................................................................... 180
    Summary ............................................................................................................................ 181
    Assignments ...................................................................................................................... 182
# Table of Contents

**Financial Plan Assignments** ........................................................................................................................................... 182
**Learning Tools** .................................................................................................................................................................. 183
**Review Materials** ............................................................................................................................................................ 183
12. Learning to Give ....................................................................................................................................................... 185
   Introduction ........................................................................................................................................................................ 185
   Objectives ......................................................................................................................................................................... 190
   - Understand the Five Myths of Giving .................................................................................................................. 190
   - Know What the Scriptures Say about Money and Giving ............................................................................. 191
   - Understand the Principles of Wise Giving ........................................................................................................... 192
   - Understand Why We Should Give ....................................................................................................................... 194
   - Understand How to Give Effectively ..................................................................................................................... 195
   Summary ...................................................................................................................................................................... 200
Assignments ........................................................................................................................................................................ 200
Learning Tools .................................................................................................................................................................... 201
13. Decide to Decide ....................................................................................................................................................... 203
   Introduction ...................................................................................................................................................................... 203
   Objectives ......................................................................................................................................................................... 203
   - Realize That Your Future Begins Today ................................................................................................................. 203
   - Understand Some of the Key Decisions You Must Make to Be Truly Successful in Life ....................... 205
   - Understand What Wise Financial Stewards Know ............................................................................................... 208
   - Learn about Resources for Additional Readings on the Subject of Personal Finance .............................. 212
   Summary ...................................................................................................................................................................... 213
Assignments ........................................................................................................................................................................ 213
Review Materials ................................................................................................................................................................. 214
**Personal Finance Glossary** ............................................................................................................................................... 215
**Index** ............................................................................................................................................................................. 225
Introduction

Personal finance: Those two words can bring either fear or excitement into the heart of the reader. Why such varied responses to a simple two-word phrase? There are many different reasons.

One of the most prevalent is a lack of education. It is hard to make important decisions when you feel you are in uncharted territory. Other responses have been due to “misguided” information. Some individuals and companies have used personal finance as a tool to earn huge commissions on selling insurance and investment products without regard to the needs of the investors they supposedly serve, resulting in poor performance for the investors and uncertainty over missed goals. Still others have made unwise decisions based on solely acquiring assets and investments, but to the detriment of their spouses, families, and real success. While they may have acquired financial security, they have lost the things that will bring them what they desire most, which is happiness and joy. Others have learned their available options, determined their key doctrines and principles, followed those principles and applied them to their financial habits and goals, and have accomplished the goals that they have set for themselves and their families, including happiness in this life and in the world to come. The purpose of this manual and the accompanying website is to help you come to understand the process of personal finance or financial planning for yourself and those you love.

Personal finance in this manual is a five-step process. It is decide, educate, commit, believe, and achieve.

Decide. First, you must decide the “why” behind why you are doing this. Why do you want to learn personal finance? This is not as simple as some think. What is the real reason? What do you expect personal finance to bring into your life? What do you hope it will help you accomplish? What problems will it help you avoid? Too often, people get into the “how” of personal finance without knowing the “why,” and it leads to major problems later.

Educate. Second, you must educate yourself to your available options. This is the “what” of personal finance. This is where we come to understand and prioritize the principles. It is not a simple process to become educated in this area. There is much to be learned in this area. Students have commented that education in this area (which includes using this manual) is similar to “drinking out of a fire hose.” Not only is there a lot of information, but much of this information changes every year, including tax rates, tax tables, contribution limits for retirement, contribution limits for education savings, estate tax limits and percentages, etc. The challenge then is how do we keep up with both the large
body of knowledge as well as the information that changes yearly? Notice that this personal finance manual is updated annually to take into account the changing nature of both types of information as I grapple with this same problem.

Commit. Third, once we know the “why” of our actions and the “what” that we need to do, it comes down to choice. We need to determine the goals that will most likely take us to where we want to be. But the challenge for most people is not setting goals. The challenge is how do we commit to really accomplish the goals that we have set? How do we help ourselves and others to set and accomplish the goals that will take us toward what we really want? How do we take responsibility for our choices? We will help address those issues.

Believe. Fourth, we must believe that we can accomplish the things we set out to accomplish. We must have the vision to know that we can accomplish these things if we are willing to put in the effort, work, and prayer. I believe that we who believe in God have an added benefit. If we seek God’s help in setting and committing to our personal and family goals, and then trust in His promises to us, He will help us accomplish them. Not only will we accomplish our goals, but they will be the right goals for ourselves and our families.

Achieve. Finally, we must work to achieve the goals that we have set. We must be willing to make the necessary sacrifices. But we must also be sure that we keep balance in our goals, ensuring that we accomplish our identity, integrity, and temporal goals in a consistent manner.

This course will work to help you accomplish each of these areas.

With “Decide,” we will discuss the critical doctrines and issues in this first chapter. This first chapter discusses the “whys” of learning more about personal finance. These are critical to understand before we begin any other part.

With “Educate,” the purpose of the entire manual is to help you to become educated to the information, data, and sources of information so you can be a wise consumer of financial information. Key in the education process is to understand the principles of each of the respective areas, the “what” of personal finance. If we can understand the key principles, we will be able to do much better in determining what goals we need to set and why. Read each chapter carefully with an emphasis toward how the principles relate to what you want to accomplish.

“Commit” will help us as we determine which goals we wish to accomplish and as we commit to those worthy goals. This is the “how” of personal finance. This is how we are going to get from where we are now to where we want to be. We must decide what is important and then make plans to help ourselves and our families reach these important milestones in our lives. Our second chapter will be instrumental in this area.

With “Believe,” we must believe we can accomplish what we want. We must have the faith of
prophets of old who said: “I will go and do the things which the Lord has commanded, for I
know that the Lord giveth no commandment unto the children of men save he shall prepare a
way for them that they may accomplish the things which he commandeth them.”

Throughout this series, we will be sharing not just the temporal application of information to help you in your
goals, but also the spiritual side which can be an even greater source of power.

Finally, with “Achieve,” we must be willing to go and do the work necessary to achieve what we
set out to do. We will be giving ideas throughout the course to help you in this area. Specifically,
look for the application area of each chapter, including the case studies. These were specifically
developed to help you as you apply the principles to specific situations in your lives.

Objectives

A. Understand the “whys” of personal finance
B. Understand the importance of perspective
C. Understand our perspective for this course
D. Understand the principles upon which that perspective is based
E. Understand the implications of that perspective

Understand the “Whys” of Personal Finance

Before we can decide about wise money management, we must understand and answer two
critical questions. The first is: “Why does the Lord want us to learn personal finance or wise
money management?”

While there are likely many different “whys”, let me share a few thoughts on doctrines of Christ
for why I believe God wants us to learn personal finance.

1. Personal finance can help bring us to Christ.

The ultimate purpose of everything we do, and God does, is to bring us to Christ. C. Max
Caldwell said:

Whatever the problem may be in a person’s life—failure to pay tithing, breaking the Word of
Wisdom, casual church attendance, [or, I add, poor financial habits, the]—real issue is faith in
Jesus Christ. If we can help people obtain the gift of faith in Christ, good works will follow. The
end purpose of any law of God is to bring us to Christ. And how well will the law work? It
depends on what we think of the Author of the law.

We have also been commanded by prophets and the scriptures to be financially wise.

[We] have been counseled for many years to prepare for adversity by having a little money set
aside. Doing so adds immeasurably to security and well being. Every family has a responsibility
to provide for its own needs to the extent possible. . . .
If you have paid your debts and have a financial reserve, even though it be small, you and your family will feel more secure and enjoy greater peace in your hearts.

May the Lord bless you in your family financial efforts.\(^3\)

Whether we view this counsel on being financially wise as a nice thing to do or a commandment of God will provide a great difference in our motivation.

2. Personal finance can help us accomplish our divine missions

We all have divine missions to perform here on earth, and personal finance can help us learn the lessons and develop the skills we need to accomplish those missions. Gene R. Cook said:

I bear testimony of the fact that if you keep the commandments, He nourishes you, strengthens you, and provides you means for accomplishing all things necessary to faithfully finish your divine mission here on earth.\(^4\)

We are all at an important time in our lives, regardless of our age. Ask yourself: Do I really believe that I have a mission here on earth to perform and am I performing it?

3. Personal finance can help us return with our families back to Heavenly Father’s presence

Personal finance helps us keep our priorities in order. We show our love for our Savior as we pay our tithing. We are examples to our children as we put the Lord first and sacrifice through service, hard work, church and temple attendance, tithing, fast offerings and other contributions.

David O. McKay reminded us: “No other success can compensate for failure in the home.”\(^5\)

We will be disappointed in life if we gain the world’s riches and lose our spouses and families. We must learn to better apply personal finance in the Lord’s way, using His plan and obeying His commandments.

4. Finally, personal finance can help us become wiser stewards

Personal finance helps us learn to be wiser financial stewards over the things God has blessed us with. Joe J. Christensen said: “Our resources are a stewardship, not our possessions. I am confident that we will literally be called upon to make an accounting before God concerning how we have used them to bless lives and build the kingdom.”\(^6\)

For some, a critical question at judgment day from our Savior will be: “How well did you use the resources I blessed you with in the service of your fellow men?”

Understand the Importance of Perspective

The dictionary defines *perspective* as “one’s point of view, the choice of a context for opinions, beliefs, and experiences.”\(^7\) The historian Will Durant wrote of the human need “to seize the
value and perspective of passing things. . . . we want to see things now as they will seem forever—“in the light of eternity.”

The challenge then is to see things as they will seem forever. Neal A. Maxwell wrote of those without this perspective:

Living without God in the world brings a functional lack of consistent perspective. If there were no eternal truths, to what principles would mortals look for guidance? If not accountable to God, to whom are we ultimately accountable?

Our perspective—how we look at things—makes a difference in the choices we make. Do we recognize our difference in perspective as we look at the world around us? Do we recognize the implications of our differences in outlook, the differences of our eternal perspective as we go about our daily lives?

The purpose of this section is to articulate “another” perspective on wealth, this eternal perspective. This perspective is critical for us to understand, and it has a major influence on how we make choices.

In this manual and website I take a different view from the world. I disagree with the belief that “money buys happiness.” The media continues to bombard us with the illusion that we have to spend money to be content or that to be happy, a person must be beautiful, sexy, thin, rich, or whatever it is they are selling at the moment.

Most of us are not conscious of the effects of our perspectives on our everyday lives. When we have a proper perspective on life, there is pattern, beauty, and purpose instead of senseless, unconnected fragments. Along with that knowledge of the purpose of life, it is important that we understand correct principles so that we can make good choices.

On the subject of choices, Spencer W. Kimball said:

We hope we can help our young men and young women to realize, even sooner than they do now, that they need to make certain decisions only once . . . We can make a single decision about certain things that we will incorporate in our lives and then make them ours—without having to brood and re-decide a hundred times what it is we will do and what we will not do…. My young brothers [and sisters], if you have not done so yet, decide to decide!

The purpose of this series is to help you in your understanding of perspective as it relates to personal finance and then to help you “decide to decide” to be wise in the management of your personal finances. When we have an eternal perspective, we understand things differently, view events differently, and make choices differently with respect to our families, friends, and our personal finances.

Understand our Perspective for this Course
Our perspective is simple. It is this: *Wise money management is simply living the gospel of Jesus Christ.* It is putting Christ first in our lives, not our pocketbooks. “But seek ye first the kingdom of God, and his righteousness; and all these things shall be added unto you”\(^{11}\)

David A. Bednar talked of doctrines and then related them to principles. He said:

> Principles are doctrinally based guidelines for what we ought to do. Therefore if there is a doctrine of the Atonement, then the first principle of the gospel is faith in the Lord Jesus Christ. Brothers and sisters, doctrine answers the why questions of our lives. Principles provide us with direction about the what and the how.\(^{12}\)

So if money management is simply a doctrine of Christ, are there principles upon which wise money management is based? Let me propose a few principles that are the foundation upon which this perspective is based. I call these my “Principles of Finance.”

### Understand the Key Principles on which Our Perspective is Based

Correct principles are fundamental laws or doctrines, which, if understood, will allow us to live or act according to truth. While easy to find, correct principles may not be easy to live. Richard G. Scott commented:

> [The] inspired statement, “I teach them correct principles, and they govern themselves,” still applies. The Lord uses that pattern with us. You will find correct principles in the teachings of the Savior, His prophets, and the scriptures. While easy to find, true principles are not easy to live until they become an established pattern of life . . . Yet, as you resolutely follow correct principles, you will forge strength of character available to you in times of urgent need.\(^{13}\)

What are those principles to which we must adhere? Let me propose a few principles that relate to understanding and using wealth wisely. These principles have made a major difference in my life and the life of my family.

**Principle 1: Ownership**

The Psalmist wrote: “The earth is the Lord’s, and the fullness thereof; the world, and they that dwell therein.”\(^{14}\) The apostle Paul, writing to the Corinthians, stated the same message: “For the earth is the Lord’s, and the fullness thereof.”\(^{15}\)

We know from scriptures that the Lord was the creator of the earth\(^{16}\), the supplier of our breath\(^{17}\), the giver of our knowledge\(^{18}\), the provider of our life\(^{19}\), and the giver of all we have and are.\(^{20}\)

Nothing we have is our own—it is all God’s. As such, there should be no feeling of pride for the things we have or are. These things do not belong to us, but are on loan from a loving Heavenly Father and His Son, Jesus Christ.
There should be no feeling of pride for the things we have, who we are, or who we will become. Rather, these things are blessings that should encourage us to demonstrate greater obedience to God’s commandments. As we realize that all we have and all that we have become are gifts from a generous Heavenly Father and Son, we will find gratitude and obedience rather than pride.

Principle 2: Stewardship

A steward is one who actively directs the affairs of another. The apostle Paul stated: “Let a man so account of us, as of the ministers of Christ, and stewards of the mysteries of God. Moreover it is required in stewards, that a man be found faithful.”21 The Lord stated, “It is expedient that I, the Lord, should make every man accountable, as a steward over earthly blessings, which I have made and prepared for my creatures.”22

Being blessed with material things in life should not be seen only as a blessing but also as a responsibility. We will be required to give an account of our stewardship to Heavenly Father. In order for us to be wise stewards, it is our responsibility to learn everything we can about our stewardship so we can manage it to the best of our abilities. The purpose of this manual and website is to help you understand and manage your stewardship better as it relates to personal finance.

Principle 3: Agency

The prophet Joshua counseled the people about agency, which is the ability to choose, when he said: “Choose you this day whom ye will serve; . . . but as for me and my house, we will serve the Lord.”23

We were given our agency by a Father in Heaven who gives us our own free will to choose our course in life. This freedom and power to choose is one of the most important stewardships that we have.

David O. McKay wrote: “Next to the bestowal of life itself, the right to direct that life is God’s greatest gift to man. . . . Freedom of choice is more to be treasured than any possession earth can give.”24

We should do everything in our power to thank God for this wonderful right to choose, and then use that agency as wisely as we can.

Principle 4: Accountability

We have been blessed with the wonderful gift of agency, but we will also be held accountable for its use. The Lord counseled, “For it is required of the Lord, at the hand of every steward, to render an account of his stewardship, both in time and in eternity.”25

The blessing of agency is an unconditional gift of God, and how we use that gift shows how much we love Him and His Son Jesus Christ. The first three principles outlined above are God’s gift to us. The fourth principle is our gift to God. We can, through our wise choices, show our
Heavenly Father how much we love Him by obeying His commandments and striving to become more like His Son.

These four principles establish a spiritual foundation for understanding wealth that is based on our dependence on God and our need for financial self-reliance to fulfill His purposes. Everything we have is God’s, and the things we receive are all blessings from Him. They are not ours, but they have been given to us as a stewardship for which we can make choices. We should choose well, as we will be held responsible for what we do.

**Understand the Implications of That Perspective**

The purpose of this section is to help understand the implications of an eternal perspective, which are many and varied, but make a big difference in how we live our lives.

**Implication 1. Life is about others**

Some believe the statement “it’s all about me.” They think life is only about them, that they are the center of the universe, that they decide what they should do, that what they want is right, regardless of what it is, and that they can do whatever they want, because they don’t have to account to anyone. Thoughtful consideration causes us to think about who created us, what our purpose is on earth, and where we can find the most joy.

The more we think deeply, the more we realize that this life is not about us, it is about what we do with our life. Life is a test, a training period or probationary time to show where our heart and our will really are. I believe that if we put Christ first in our lives, we will live eternally with God and our families. If we fail to put Christ first in our lives, in the end it really doesn’t matter what or who we put first.

**Implication 2. It’s About Faith**

Some feel personal finance is all about money. Money is the answer to all our problems. Someone commented: “If you can solve it with money, it is not a problem.” But is it really about money?

In most cases, financial problems are behavioral problems, not money problems. We all know what we should do: live on a budget, spend less than we earn, not go into debt, build a reserve, etc. But other things (ignorance, carelessness, compulsiveness, pride, and necessity) get in the way.

For most, it is not a question of knowledge, but of motivation. How do we motivate ourselves (and others) to do the things we know we should?

Boyd K. Packer answered this when he said: “True doctrine, understood, changes attitudes and behavior. The study of the doctrines of the gospel will improve behavior quicker than a study of behavior will improve behavior.”

Page 8
Moreover, the Lord admonished: “But no temporal commandment gave I unto him, for my commandments are spiritual; they are not natural nor temporal.”

The lesson for us then is to understand doctrine. Then we can apply it to help us do what we should. The “doctrine” is we have been commanded in the scriptures and by living prophets to:

- Live within our means
- Get out of debt
- Build a reserve
- Save for long-term goals, and
- Teach our children.

From this perspective, we see that financial problems are not problems of money, but rather, problems of faith.

**Implication 3. We Can Have God’s Help**

Some think that they have to do all this work on their own to educate themselves about personal finance. They have to figure it out by themselves and they have to do it all themselves.

There are resources that are available that can be helpful in fulfilling this responsibility in personal finance. They key is to choose your help carefully. Ensure they are not trying to sell products or services. Make sure the principles taught are consistent with the principles of the gospel. This manual and website are good resources to help.

Most importantly, as you work and study, seek the help of the Spirit to guide you. Remember since the Lord has commanded us to be wise financially, He will help us to do it.

Our leaders have counseled: “Whatever our calling, regardless of our fears or anxieties, let us pray and then go and do.”

**Implication 4. Finances are a Spiritual Matter**

Many think money matters are only temporal matters. They feel that how they manage their money has nothing to do with their spirituality. They feel that scriptures talk only of spiritual things and not temporal issues such as financial matters. I consider money matters as spiritual matters for four reasons:

a. **All things are spiritual.** In the scriptures the Lord says, “All things unto me are spiritual, and not at any time have I given unto you a law which was temporal.”

b. **Money is a medium of exchange.** Sterling W. Sill said: “We can build temples with money, we can send out missionaries with money, we can erect educational institutions, operate hospitals, and pay our tithing with money. … In many ways we can build up the kingdom of God with money.”
c. There is no true freedom without financial freedom. Many think they are totally free, even when they are in debt to others. They think that it is OK to be in debt. After all, it builds their credit score, doesn’t it?

Ezra Taft Benson said: “No man is truly free who is in financial bondage.”

31

d. Money is a tool to teach gospel principles. Money is a tool to teach us many things, including the following gospel principles.

1. Seeking the kingdom of God first. By paying our tithes and offerings first, we show we love God more than material things.

2. The spiritual and physical creation. Money teaches and reinforces both the spiritual and physical creation, as we develop goals and budgets and work toward them.

3. The Law of the Harvest. We learn this as we invest for retirement and other long-term goals. We cannot cut corners with this law.

4. Christ-like characteristics. We learn Christ-like characteristics of charity as we save for our goals, learn and practice giving, serve and sacrifice for others, and as we give up things now for things greater in the future.

Implication 5. We are Responsible for our Choices and our Finances

Some feel that they are not responsible for their financial lives. It is someone else’s responsibility, their parents, the government, their children, etc. They should not have to think and labor for the things they receive.

We are responsible for all our choices, including our financial choices. We cannot spend our way into financial security. We must learn to and save for our own retirement. We must learn to and save for our long-term goals. If we choose, we must learn to and save to help our children with their missions and education. If we want to serve missions later on in life, we must learn to manage our finances wisely and save.

After children become adults, they are responsible for their finances. Parents are not responsible for their adult children’s finances—the adult children are. Likewise children are not responsible for their parent’s finances. Evidence is apparent that parents who continually support their children financially will find their children will always need support. Please note that it is hard for children to learn financial responsibility if they are continually rescued from their poor financial choices or if they do not have to work for what they get.

Others think money matters are a male responsibility for married couples. Some think if wives become knowledgeable about financial matters, their husbands will be upset. Others reason that since the husband makes the money, husbands get to decide where it goes.
Couples are jointly and equally responsible for their finances. The Proclamation on the Family states:

By divine design, fathers are to preside over their families in love and righteousness and are responsible to provide the necessities of life and protection for their families. Mothers are primarily responsible for the nurture of their children. In these sacred responsibilities, fathers and mothers are obligated to help one another as equal partners.32

Control of money by one spouse as a source of power or failure by a partner to be a part of financial management are both incorrect attitudes. Marvin J. Ashton said:

Management of family finances should be mutual between husband and wife in an attitude of openness and trust. Control of the money by one spouse as a source of power and authority causes inequality in the marriage and is inappropriate. Conversely, if a marriage partner voluntarily removes himself or herself entirely from family financial management, that is an abdication of necessary responsibility.33

When culture or other traditions go counter to this equality, it must be changed. Husband and wife are equal partners in the Lord’s view.

Implication 6. Consumer Debt is an Addiction

Some consider it is OK for them to go into debt for things, especially things they really want. You can’t have a car without a car payment, can you? It is OK to borrow, if you really want it, isn’t it?

Consumer debt is bad. It stops growth and savings, and is expensive, both economically and spiritually. James E. Faust stated: “Over the years the wise counsel of our leaders has been to avoid debt except for the purchase of a home or to pay for an education. I have not heard any of the prophets change this counsel.”34 Sadly, consumer, auto, and credit card debt not paid off monthly are not included in that short list.

Perhaps the debt problem is more a problem of pride than it is of money? Don’t think of it as “I am going into debt.” Think of it as “I’m spending my children’s mission and education money” or “I am disobeying the teachings of my Savior.” Putting these financial decisions in this perspective may be helpful in making better choices.

Implication 7. Every Family Should have a Budget

Some feel that living on budgets is only for college students and those that need to be careful with their money, not more “mature” people like ourselves. We do not need to have a budget because we know where the money goes (it goes to pay our bills).

Spencer W. Kimball counseled:
Chapter 1. Personal Finance: Introduction and Another Perspective

Every family should have a budget. Why, we would not think of going one day without a budget in this Church or our businesses. We have to know approximately what we may receive, and we certainly must know what we are going to spend. And one of the successes of the Church would have to be that the Brethren watch these things very carefully, and we do not spend that which we do not have.\textsuperscript{35}

**Implication 8. We Cannot Judge or Compare**

Some judge others by the outward appearance, by how much money they have, how they are using that money, or by the assets they own or control. They think that appearances are more important than the heart and that they have all the facts necessary to judge.

In the parable of the talents,\textsuperscript{36} the Lord gave different talents to different people. They each took the talents given them, took responsibility for those talents, and they used the talents to the best of their abilities. They each made different returns on their talents. But the end result was the same wonderful blessing: “Enter thou into the joy of thy lord,”\textsuperscript{37} regardless of the amount given.

None are in a position to judge based on the talents (or blessings) given them by God. We have been commanded: “Judge not, that ye be not judged. For with what judgment ye judge, ye shall be judged: and with what measure ye mete, it shall be measured to you again.”\textsuperscript{38}

Some, such as parents, bishops or other Church leaders must make judgments as part of their stewardships. The counsel to them is equally important, that they should judge by the “light of Christ.” The counsel is equally strong: “And now, my brethren, seeing that ye know the light by which ye may judge, which light is the light of Christ, see that ye do not judge wrongfully; for with that same judgment which ye judge ye shall also be judged.”\textsuperscript{39}

Just as we are in no position to judge others (or even ourselves) based on what we perceive based on financial blessings, we are in no position to judge or compare with others. Judgment and comparisons are Satan’s tools, not Christ’s. They come from, and lead to, pride, self-aggrandizement, and feelings of being better (or worse) than others. These are not part of Christ’s gospel where “all are alike unto God.”\textsuperscript{40}

**Implication 9. We Must Learn to be Financially Wise**

The prophet Malachi said: “Bring ye all the tithes into the storehouse, . . . and prove me now herewith, saith the Lord of hosts, if I will not open you the windows of heaven.”\textsuperscript{41} Doesn’t it say that if I pay my tithing, the windows of heaven will open and I will get all the financial blessings that I need, regardless of any learning, education, thought, application, hard work or effort on my part?

The prophet Malachi promised that God will open the windows of heaven. However, there is no promise that the windows of heaven will be financial blessings or that paying tithing will eliminate all our financial problems. We still are stewards over what we have and are, and must learn to live in this increasingly challenging financial world. There are still more commandments.
which relate to finances in addition to just paying your tithing, i.e., living with your means, avoiding debt, teaching your children, building a reserve, preparing for retirement, missions, etc.

Here are some interesting statistics:

- Average per household debt in the U.S. is $14,500 excluding mortgage debt in 2007
- Credit card users pay 12–20% more than cash users
- 40% of American families spend more than they earn
- The typical family pays $1,200 per year in interest
- About 60% of all active credit card accounts are not paid off monthly
- Most couples indicate that finances are a major stress on their marriages

Over the remaining chapters in this book and through the tools, PowerPoints, and videos available on the website at http://personalfinance.byu.edu, we will work together to share what you can do to become more financially wise and better financial stewards, to help you to “decide” and “educate” so that you can “commit,” “believe,” and “achieve.”

Summary

We have talked about many things regarding another perspective on wealth as it relates to personal finance. While we haven’t talked about the real “nuts and bolts” yet, we have talked about critical concepts. The most critical question is why does God want us to learn personal finance? I believe it is due to four reasons:

1. Personal finance can help bring us to Christ.
2. Personal finance can help us accomplish our divine missions.
3. Personal finance can help us return with our families back to Heavenly Father’s presence.
4. Finally, personal finance can help us become wiser stewards.

Perspective is important in studying personal finance. Our perspective is simple. It is that personal finance is simply living the gospel of Jesus Christ; it is putting Christ first in our lives. Our view of the Savior, the way we look at life, at ourselves and others will have an important impact on how we utilize the blessings we have been given by God. It is critical that we have a correct perspective, as perspective impacts our choices.

Four key principles constitute the principles on which this perspective is based. They are:

1. Ownership.
2. Stewardship.
3. Agency.
4. Accountability.

Finally, it is our responsibility to be financially wise. The purpose of this manual and accompanying website, PowerPoints and learning tools is to help you accomplish that purpose.
Assignments

Financial Plan Assignments

Think about the things we have discussed regarding the purpose of wealth in our lives. The world has a different perspective on wealth – generally an incorrect perspective. To become truly wealthy, we must first have a correct perspective and understand the key principles for using wealth wisely. The scriptures state: “For God so loved the world, that he gave his only begotten Son, that whosoever believeth in him should not perish, but have everlasting life.” This is the true kind of wealth. Think about what is necessary to have this correct perspective on wealth.

Read and discuss the following three important chapters that help us with perspective on wealth and our understanding of its key principles: 1 Timothy 6, Jacob 2, and Doctrine and Covenants 6. These chapters are available online at http://scriptures.lds.org/.

Learning Tools

The following Learning Tool will also be helpful as you prepare your Personal Financial Plan:

1. Personal Financial Plan (PFP) Table of Contents

   This is a recommended table of contents for your Personal Financial Plan.

Review Materials

Review Questions

1. Why is it important to “decide to decide” now? What problems can it help us avoid?

2. Why does God want us to learn wise money management?

3. What is our perspective and why is it important?

4. What are the four key principles on which that perspective is based? Why are they important? What can we do to incorporate these principles into our lives now?

5. Some have asked, “If wealth is so bad, should we seek for riches?” What did Jacob say about this question in Jacob 2:18–19? What should we seek for first?

Case Studies

Case Study 1

Data
Brenda came from a family that had few worldly goods, but there was a lot of love in the home. She has come to talk with you about her finances because she respects you for the wonderful example you have set at work.

Application

She asks you, “What is the purpose of wealth in our lives?”

Case Study 1 Answers

You have lots of good ideas, but you share the following: Jacob shared with us one view of the purpose of wealth in our lives. He counseled us that if we seek wealth, we should do it for the right reasons, and it is OK to do so only after we seek the kingdom of God. The purpose of wealth is not to build ourselves up, and its possession does not allow us to think we are better than other people. Rather, it is to help us bless our families, serve our fellow men, and build the kingdom of God.

Case Study 2

Data

Brenda continues to ask you questions regarding your perspective and principles for using wealth wisely. She is intrigued by your thoughts and answers. She asks if there are principles that you know and have lived that have made a difference in your life.

Application

Share the four key principles for using wealth wisely discussed in this chapter. Why is each principle important? What can we do now to incorporate each principle into our lives now?

Case Study 2 Answers

There are several good answers for these questions. You might respond with:

Our perspective is simple. It is that personal finance is simply living the gospel of Jesus Christ. That perspective is based on four key principles:

1. Ownership: Everything we have or are is a gift from God.
   - It is important because the things we have are not ours but are on loan from a loving Father in Heaven.
   - We can incorporate this principle into our lives by learning that when we share with others, we are only giving back to God what was His in the first place.

2. Stewardship: We are stewards over the things the Lord has blessed us with.
Chapter 1. Personal Finance: Introduction and Another Perspective

- It is important because we must learn to be better stewards over our blessings because we will be held accountable for what we do with these blessings.
- We can incorporate this into our lives by learning as much as we can about the things we need to do so we can become the best stewards we can over the blessings our Heavenly Father shares with us.

3. Agency: The gift of “choice” is man’s most precious inheritance.
   - It is important because we need to use this gift wisely so we can return and live with God eternally.
   - We can incorporate this into our lives by studying all areas of our decisions and decision-making processes so we can have the information needed to make the best decisions possible.

4. Accountability: We are accountable for our choices.
   - We are the final decision-makers in life.
   - It is important because we must learn to choose wisely.
   - We can incorporate this into our lives by setting good goals and then by making wise choices to help us attain those goals—goals that our Heavenly Father would have us seek for.

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1 1 Nephi 3:7.
7 In en.wikipedia.org/wiki/perspective, May 1, 2007
8 The Story of Philosophy, New York: Simon and Schuster, 1927, p. 1
9 “Take Especial Care of Your Family,” Ensign, May 1994, 88
11 Matt. 6:33.
12 David A. Bednar “Teach them to Understand,” Ricks College campus Education Week Devotional, June 4, 1998, Rexburg, Idaho.
14 John 1:3
15 Acts 17:24-25
16 Moses 7:32
17 Acts 17:28
18 Mosiah 2:21
20 Joshua 24:15.
21 Conference Report, Apr. 1950, p. 32; italics added.
22 Doctrine and Covenants 72:3.
24 D&C 29:35.

Page 16
Chapter 1. Personal Finance: Introduction and Another Perspective

29 D&C 29:34.
36 Matthew 25:14-30
37 Matthew 25: 21, 23.
38 Matt 7:1-2.
39 Moroni 7:18.
40 2 Nephi 26:33.
41 Malachi 3:10.
42 John 3:16.
Chapter 2. Creating Your Personal Financial Plan and Setting Personal Goals

Introduction

Once you have a correct perspective on wealth and understand the key principles for using wealth wisely, the next important step is to begin your Personal Financial Plan (PFP) and to set personal and family goals.

Ezra Taft Benson counseled:

Plan for your financial future. As you move through life toward retirement and the decades which follow, we invite all . . . to plan frugally for the years following full-time employment. Be even more cautious . . . about “get-rich” schemes, mortgaging homes, or investing in uncertain ventures. Proceed cautiously so that the planning of a lifetime is not disrupted by one or a series of poor financial decisions. Plan your financial future early; then follow the plan.¹

My purpose is to help you write down your wishes, help you transform those wishes into goals, and encourage you to accomplish those goals. In this chapter, I will share a few steps I have found helpful as I have considered my own life goals. I hope these suggestions will be useful in your life.

Setting personal goals is not simply writing a list of things you would “like” to accomplish. Rather, it is a process of understanding yourself, your aspirations, your desires, and your values and then trying to understand what God wants you to accomplish. Once you have determined these things, you must then combine your understanding of yourself and what God desires for you into a plan of action to help you become your best self. Marvin J. Ashton commented, “True happiness is not made in getting something. True happiness is becoming something. This can be done by being committed to lofty goals. We cannot become something without commitment.”²

Objectives

There are four objectives for this chapter:

1. Learn how wise financial planning can help you achieve your goals.
2. Understand the requirements for your Personal Financial Plan.
3. Identify what you want to accomplish in life.
4. Understand and apply the principles of effective goal-setting.
Chapter 2. Creating Your Personal Financial Plan and Setting Personal Goals

Learn How Wise Financial Planning Can Help You Achieve Your Goals

Financial planning is the process of planning how to make use of your available resources to achieve your personal and family goals. The purpose of financial planning is to help you use your resources more wisely. Financial planning will help you determine where you are personally and financially, where you want to be, and how you will get there.

While financial planning may not help you make more money (although it likely will), it will help you make better choices and become a better steward over the things you have been blessed with.

Financial planning is not easy. Some people are uncomfortable discussing financial matters and need help in overcoming this barrier. As you work through the material in this manual, you will learn how to get beyond this fear of finance. Motivation and time are required to complete an accurate financial plan and to accomplish the many things you must do each day in regard to personal finance. Good record-keeping is also necessary, both before and during the planning period. This course includes a variety of tools to help with record-keeping so you can become more financially self-reliant.

As a result of financial planning and this course, you will be able to:

- Manage the unplanned.
- Accumulate wealth for special purposes.
- Save for retirement.
- Protect your assets.
- Invest intelligently.
- Minimize your tax payments.

Understand the Requirements for Your Personal Financial Plan

Your Personal Financial Plan (PFP) is a document that accounts for all critical areas of your personal financial life. It is your individual roadmap for achieving your personal and family goals. It is a critical part of Ezra Taft Benson’s admonition to plan our financial futures early, and then live our plans. It requires you to think through what you want, determine where you are now, set goals for where you want to be, develop a plan to get you there, and then implement and revise the plan as needed.

I recommend a six-step process for putting together your Personal Financial Plan:

**Step 1: Decide What You Want**

Deciding what you want establishes what is important to you. It expresses your core values and beliefs. Think through the things you need to decide. What is truly important to you? What do you feel Heavenly Father wants you to do or be? How would you like to be remembered when
you leave this life? What do you want to accomplish with your life? These are probably the most important questions you will ever ask and answer.

**Step 2: Evaluate Your Financial Health**

Evaluating your financial health helps you determine where you are financially. If you don’t know where you are, how can you determine how to get to where you need to be? To evaluate your financial health, develop a balance sheet, an income statement, and a budget, and calculate your financial ratios. Determine where you are financially right now – are you financially healthy? Are you solvent (do you have sufficient cash in your wallet or in your checking account to pay your bills)? How much debt do you have? How much are you saving each month and year?

**Step 3: Define Your Personal and Financial Goals**

Once you know what is important to you and where you are financially, it is critical to define your personal goals. You will achieve what you set your mind to, and you will accomplish the goals that are important to you.

But, the first step is to write your goals down. Attach a cost to each goal. Remember, there are more costs than just financial costs. What are the true costs of your goals in terms of time, money, and effort?

It is also important to determine potential obstacles. By identifying the obstacles early in the analysis, you increase your ability to plan for, avoid, and overcome those obstacles.

Set a date for when your goals are to be completed. In what time-frame can the goal be reasonably accomplished? Make your goals SMART: specific, measurable, achievable, reportable, and time-bound. Then, share them with others so they may hold you accountable for your goals.

**Step 4: Develop a Plan of Action**

Know what you should work on and when. Your plan should be:

- Flexible—it should be able to change as your situation in life changes.
- Liquid—it should have the ability to convert non-cash assets into cash with relative ease and without excessive costs.
- Protective—it should be able to meet unexpected large expenses without difficulty for the inevitable challenges that will come.
- Tax efficient—it should pay the government only that which is owed and not a penny more.

Think long term and consider future needs. Develop a spending plan (also called a budget), and use it wisely. Plan for big-ticket purchases, such as houses and cars. Plan for managing debt, and remember that debt is the enemy to growth. Plan for insurance and protect yourself. Determine
and write your Investment Plan and follow that plan. Plan for the expenses of children, missions, and college. Plan for retirement. Most importantly, plan your financial future early; then live your plan.

**Step 5: Implement Your Plan**

Once you have your plan, implement it. Use common sense and moderation in the things you do. Set wise goals and work toward them each day.

Use wisdom in your plan, and stay positive. Remember that your plan is a goal to set your sights on, not a stick to beat yourself with. Realize that detours will come, but stay on track after the detours. We all encounter detours, but good things come to those who hang in there!

**Step 6: Revise Your Plan as Necessary**

Revision is an important part of your plan. Remember that people and goals change—you need to account for this. Review your goals annually at a minimum, and make sure your plan still matches your goals. If necessary, fine tune your plan. Remember, your plan is etched in paper, not in stone.

Much of your plan is personal and challenging as you try to understand yourself, your family, and the things you want to accomplish. The purpose of this course is to help you identify critical areas and make important decisions.

**Identify What You Want to Accomplish in Life**

As an undergraduate student at Brigham Young University, I read a poem by Jessie B. Rittenhouse that had a major impact on how I felt about goals:

I bargained with Life for a Penny, and Life would pay no more,  
However I begged at evening, when I counted my scanty store.  
For Life is a just employer, He will give you what you ask,  
But once you have set the wages, why, you must bear the task.  
I worked for a menial’s hire, only to learn, dismayed,  
That any wage I had asked of Life, Life would have willingly paid.  

I worry that too many of us do not think about what we want to get out of life. Instead, we wander aimlessly through life and forget who we are. We set our wages too low—settling for just a single penny. Unless we make some changes, we will be disappointed with the penny we receive from life. Ezra Taft Benson said:

Every accountable child of God needs to set goals, short- and long-range goals. A man who is pressing forward to accomplish worthy goals can soon put despondency under his feet, and once a goal is accomplished, others can be set up. Some will be continuing goals. . . Now there is a lifetime goal—to walk in his steps, to perfect ourselves in every virtue as he has done, to seek his
face, and to work to make our calling and election sure.⁴ The gospel can give us wonderful direction in our lives if we will follow the teachings of Christ. Following Christ’s teachings has made all the difference in my life. His teachings have helped my family and me put our most important priorities first as we have set our major goals. The scriptures tell us: “Be thou humble, and the Lord thy God shall lead thee by the hand, and give thee answer to thy prayers.”⁵

We can get more out of life if we put this scripture into action. As we dedicate our lives to understanding ourselves, our goals, and our desires, and as we learn and do God’s will, He will help us understand the direction our lives should take.

Goal-setting is not easy, but it is doable. All goals have costs in terms of time, effort, or money, or a combination of the three.

Time costs refer to the time you spend on your goals. For example, some goals require a certain number of hours or minutes of your day to accomplish. My second daughter, Natalie, just signed up to run a marathon in six months. She will need time to train and get ready. She is planning on spending four to six hours a week to prepare for her 26.2-mile run.

Effort costs denote intermediate goals you must accomplish so you can achieve your overall goal. My wife and I have a goal to run each morning at 5:00 a.m. To do this, we have set another goal to get to bed each evening before 9:30 p.m. so we get sufficient sleep to allow our bodies to function.

Financial costs refer to the amount of money necessary to achieve a specific goal. My son, age 13, would like a car when he gets his license. To achieve his goal of purchasing an automobile, he will need to save a specific amount of money each month for the next 36 months.

There is no difference between financial and personal goals. Financial goals are personal goals with a monetary cost attached.

**Understand the Three Distinct Types of Goals**

To best understand goals, we must look to the Master and ask: “What is God’s ultimate goal for His children?” As we read and study, His ultimate goal for us is eternal life. We all likely have a similar goal—eternal life for ourselves and our families. So we have our first and overall goal, eternal life with our families. The rest of our goals are then intermediate goals to help us to our overall goal.

A wise philosopher over a century ago said: “We are not human beings having a spiritual experience. We are spiritual beings having a human experience.”⁶ The key then is to keep both the spiritual and the temporal balanced in our personal and family goals.

As we think of goals, I believe there are three different types of goals we should be aware of: goals related to identity, integrity, and temporal measures.⁷ Identity goals are goals that relate to
our long-term view of how we see ourselves. These goals help us be better in our long-term view of what we are and what we want to become.

- We are children of God
- We may be spouses
- We may be parents to our children
- Regardless, we must never lose sight of who we are.

Integrity goals relate to the characteristics and standards you want to achieve in the work and service you provide. These goals relate to:

- How we will work
- What we will and will not do
- Characteristics and skills we wish to attain.

We must strive to have integrity in all we do, regardless of the temptations and enticements which beset us. We must always be willing to accept responsibility for our choices and to be held accountable.

Temporal goals relate to the temporal measures of success that we hope to accomplish. These goals relate to:

- Money, title, or fame
- Influence, rank or power
- Assets, investments, or possessions.

We must be vigilant as temporal goals are generally the most visible and easily measured of our goals, and hence may be worked on more than some of the more important goals.

These types of goals allow us to have balance in our goals. Balance is important. Temporal goals, if unchecked, might override more lasting and eternal goals of identity and integrity. They also, if not balanced, may lead to trade-offs, such as working longer hours, spending less time with family, or taking assignments inconsistent with personal values due to “extenuating circumstances.” If not careful, life can easily become an “unending stream of extenuating circumstances.”

Goals in other areas could also cause concern if not worked toward in a balanced manner.

We have been given counsel to help us in our process of setting goals. Steven Wheelwright counseled:

First, align your goals regarding your personal identity with those the Lord has for each of us as a beloved son or daughter of God, and then pursue a righteous lifestyle consistent with that identity. Second, set standards for your own efforts, endeavors and work that are consistent with the integrity exemplified in the life of our Savior. Third, seek heavenly counsel and guidance as you make choices regarding temporal goals and
 accomplishments. Be diligent in "seeking the Kingdom of God first," serving the one and only true master, and "laying up treasures in Heaven."\(^9\)

**Understand and Apply the Principles of Effective Goal-Setting**

An important part of your Personal Financial Plan is to set your personal and family goals. Understanding goal-setting is one of the biggest challenges in life, and understanding how to set good goals is even more challenging. M. Russell Ballard indicated possible pitfalls of not setting goals:

I am so thoroughly convinced that if we don’t set goals in our life and learn how to master the techniques of living to reach our goals, we can reach a ripe old age and look back on our life only to see that we reached but a small part of our potential. When one learns to master the principles of setting a goal, he will then be able to make a great difference in the results he attains in this life.\(^10\)

The challenge, then, is learning to master the principles of setting goals. In my own experience, I have found the following nine principles helpful in setting realistic and effective goals—goals that will make a great difference in the results we attain in this life.

1. **Strive to Learn What Heavenly Father Wants You to Do or Be**

Learning what Heavenly Father would have you do or be is one of the most important tasks you will ever accomplish. John H. Groberg said:

What is your mission in life? What does God expect you to accomplish during your sojourn here upon the earth? And are you doing it? To help answer these questions, I hope the Spirit of the Lord will impress upon us all the importance of at least these three eternal truths: 1. God, our Father in Heaven, does have a specific mission for all of us to fulfill and perform while we are here upon this earth. 2. We can, here and now, in this life, discover what that mission is. 3. With his help we can fulfill that mission and know and have assurance, here and now, that we are doing that which is pleasing to him. With the help of the Spirit of the Lord we can understand these truths and move the course of our life in tune with them.\(^11\)

Finding out what He would have us do is not easy, nor does it happen in a short amount of time. But we can come to know and have God’s guidance in our lives, if we seek it. We have been promised: “Ask, and it shall be given you; seek, and ye shall find; knock, and it shall be opened unto you.”\(^12\)

I have also found that if we do what Heavenly Father wants us to do first, He will help us accomplish what we want to do, and we will do it better because we have His help.
My wife and I made this discovery as a newly married PhD student in Washington, D.C. I was attending school full-time in the afternoon and evenings, working part-time at the Capital Market Department of the World Bank, and trying to be a good husband and father. Then, the leader of our local congregation asked me to teach seminary, an early morning scripture study class for high school students each weekday morning.

I remember discussing this with my wife and thinking how easy it would be to justify declining the request to teach. But we also realized that if we wanted God’s help with my PhD program, we needed to serve where He wanted us. So we accepted the calling. I enjoyed teaching seminary, and while I filled this calling, I was able to complete the PhD program in less than three years.

2. Seek Heavenly Father’s Help in Setting Goals

God would like to help all of us understand what He would have us do. The scriptures note “Trust in the Lord with all thine heart; and lean not unto thine own understanding. In all thy ways acknowledge him, and he shall direct thy paths.”

H. Burke Peterson wrote:

Do you think for a moment that Heavenly Father would have sent one of His children to this earth by accident, without the possibility of a significant work to perform? . . . If you will let Him, I testify that our Father in Heaven will walk with you through the journey of life and inspire you to know your special purpose here.

With the Lord’s help, not only can you reach your goals, but more importantly, you will have the confidence that the goals you set are the right goals for you. We have been admonished to “counsel” with the Lord:

Counsel with the Lord in all thy doings, and he will direct thee for good; yea, when thou liest down at night lie down unto the Lord, that he may watch over you in your sleep; and when thou risest in the morning let thy heart be full of thanks unto God; and if ye do these things, ye shall be lifted up at the last day.

In order to receive Heavenly Father’s help, we must be worthy and willing to hear the promptings of the Spirit. How do we do that? The following are five steps I recommend to help you as you seek Heavenly Father’s help in setting goals:

A. Study the scriptures. The scriptures will give you both general and specific direction for which way you should go. I know that all of life’s questions can be answered through prayerful study of the scriptures. Read them daily and remember that they were written for us.

B. Seek guidance through prayer. Prayer is one of the most underused yet most incredible powers in the universe. God truly loves us and wants us to be successful. However, to receive guidance from the Lord, we must be brave enough to ask, humble enough to listen, and wise enough to act on the guidance we receive. Make prayer a part of your
daily routine. “Be thou humble and the Lord thy God shall lead thee by the hand, and give thee answer to thy prayers.”

C. **Read your patriarchal blessing.** A patriarchal blessing is a blessing given by an ordained patriarch to LDS Church members to give guidance and help from God. It provides specific counsel for you that can benefit you throughout your life. On the subject of patriarchal blessings, Ezra Taft Benson said:

> Receive a patriarchal blessing. Study it carefully and regard it as personal scripture to you—for that is what it is. A patriarchal blessing is the inspired and prophetic statement for your life’s mission together with blessings, cautions, and admonitions as the patriarch may be prompted to give . . . Receive your patriarchal blessing under the influence of fasting and prayer, and then read it regularly that you may know God’s will for you.

What does your patriarchal blessing say you should do? What cautions does it give you? What advice does it share? Ponder these things and write them down, perhaps in a journal or notebook. I am teaching at BYU because of one line in my patriarchal blessing that admonished me to “get a doctorate.” I am extremely grateful that I followed that admonition. It has made a major difference in my life.

D. **Remember fathers’ and priesthood blessings.** In the scriptures, we read of fathers blessing their children and posterity (Genesis 49:28, Deuteronomy 33:1). If you haven’t received a father’s or priesthood blessing in a while and you feel it would be beneficial, ask for one from your father or a Church leader. I have received a father’s blessing every year since I was a child, up until my father passed away in 2008.

Father’s blessings and blessings from other priesthood holders have been very important in my decision-making process throughout my life. When I went back to school in 1984, I asked my father for a father’s blessing. In it, I was promised that if I lived close to the Spirit, I would be blessed with the ability to “work beyond my natural abilities.” Those words caused me to pause and think: “Since God gave me my abilities, couldn’t He help me work beyond them as well?” I tried to obey the commandments, live close to the Spirit, and work as hard as I possibly could, and I feel that blessing was realized.

E. **Attend your church, temple, or other places of worship.** Much of the inspiration we need to keep our lives on the right track can be revealed to us as we attend church and other places of worship. If you can, don’t let your education, your job, or anything else get in the way of regular church and temple attendance. Attending these places is a wonderful use of your time.

As you study the scriptures, make prayer a part of your daily routine, read your patriarchal blessing, seek father’s and priesthood blessings, and attend church and other places of worship, God will guide and help you.
3. Start with the End in Mind

When I read Stephen R. Covey’s book *The 7 Habits of Highly Effective People*, I particularly liked the habit “Begin with the end in mind.” Start by writing your obituary. How do you want to be remembered? Do you want to be remembered for your money and fame, or for your integrity?

Next, pretend you have only a week left to live. What would you want to do? Would it be to work more hours at the office? Would it be to buy that new car? Would it be to renew an old friendship? Would it be to finish your personal history? How would you spend that last week?

Now, pretend you have only a month to live. What would you do differently today if you knew you had only one month to live? Now pretend you have only a year to live, five years to live, and finally a life to live; write down what you would do in that time. Starting with the end in mind will help you prioritize your goals and realize what things are important to you.

4. Write Down Your Goals

As a common adage states, “A goal not written is only a wish.” Write down your goals as you think about them. What do you enjoy doing? What do you like doing with your family and friends? What makes you really love life? Write these things down and begin working on them.

I remember reading in high school about a man who wrote down 150 major goals in high school and accomplished over 130 of them during his lifetime. Each goal was carefully thought out, and through continuous review and planning, the man was able to accomplish most of his goals.

Once you have written down your goals, think and pray about them. Are they what you should be working toward? If not, revise your list and continue thinking and praying about them. Once you have a list of goals you feel good about, put fire and desire into them. You must be willing to work toward your goals, which is probably one of the most difficult things you will do.

5. Keep Your Goals SMART

SMART is an acronym that may help as you strive to set effective goals.

S = Specific. Goals should be specific. They should answer the questions of who, what, where, when, and why. A general goal would be to get in shape. A specific goal would be to run three miles three times a week.

M = Measurable. Goals should be measurable. You must be able to track progress toward your goal. A non-measurable goal would be to save for retirement. A measurable goal would be to have an annuity that pays you $50,000 per year in retirement.

A = Achievable. Goals should be achievable. Achievable goals are goals that your attitudes, abilities, skills, and interests can help you accomplish.
R = Reportable. Reportable goals are goals that you can and are willing to report on each period: to yourself, to a spouse or friend, and to God.

T = Time-bound. Time-bound goals have a specific time frame. A goal is time-bound if you set a specific date it is to be achieved by. A non–time-bound goal would be to gain an education. A time-bound goal would be to earn a bachelor’s degree in four years.

6. Review Your Goals Often

That which we remember and review often, we are more likely to accomplish. Write down your goals and review them often. I recommend that you set aside time to periodically review and update your goals on either a daily or a weekly basis. The more important the goal, the more often we should review it.

I also recommend that you write down your goals and place them where you will see them often, perhaps on the refrigerator door or bathroom mirror. The more often we are reminded of our goals, the better our chances of achieving them.

7. Remember Your Goals Will Change

Times change and so will you. That doesn’t mean that goal-setting is a useless or unimportant exercise—it simply means that your goals must be flexible, just like you. Keep your major goals in mind, and remember that some of them will change over time. If you always keep your major goals in mind and work toward them, you will be able to accomplish them.

8. Set Fun Goals

Life is too short to be serious all the time, so I make a point to set some fun goals. I want to take my whole family to China to walk 20 miles on the Great Wall of China. I want to take my family river rafting through the entire Grand Canyon (I took my wife last year). I want to take my family back to Kauai, Hawaii, for a family reunion. I want to climb Pilot Peak in Nevada. Fun goals are an important part of life.

9. Remember, Success Is Not Measured by Achievement, but by Striving

While goals are an important part of life, we should be careful not to make the achievement of goals our only criteria for success. Marvin J. Ashton counseled:

Set your goals—without goals you cannot measure your progress. But don’t become frustrated because there are no obvious victories. Remind yourself that striving can be more important than arriving. If you are striving for excellence—if you are trying your best day by day with the wisest use of your time and energy to reach realistic goals—you are a success.
Chapter 2. Creating Your Personal Financial Plan and Setting Personal Goals

Summary

The most important question you will ever ask is “What does God want me to do or become?” Answering this question is the key to setting “real” goals. If you know what He wants you to do or become and you become that, you can achieve no higher goal.

His goal is to help us to become like Him because He loves us. Remember the following counsel from the Lord as you proceed through this series: “Seek not for riches but for wisdom, and behold, the mysteries of God shall be unfolded unto you, and then shall you be made rich. Behold, he that hath eternal life is rich.”

We discussed the importance of setting goals, and the blessings that can come. We discussed the three types of goals: identity, integrity and temporal goals, and how we needed balance in our goals. We then discussed nine principles of effective goal-setting:

1. Strive to learn what God wants you to do.
2. Seek God’s help in setting goals.
3. Start with the end in mind.
4. Write down your goals.
5. Keep your goals SMART.
6. Review your goals often.
7. Remember your goals will change.
8. Set fun goals.
9. Remember, success is not measured by achievement, but by striving.

As you develop your Personal Financial Plan, think about your future. Think about what you want to accomplish in every aspect of your life—not just the financial aspects. Put thought and prayer into it. Write your goals out in detail and then include those goals as part of your Personal Financial Plan. While it may not seem very pertinent, determining what you want to accomplish in life will probably be one of the most important exercises you will do in this series.

Assignments

Financial Plan Assignment

Your assignment is to think through the things you want to accomplish in life. This is not a short-term assignment, and it is likely the most important part of your entire financial plan. The purpose of this assignment is to write down your goals for your future and determine where you want to be in the next day, week, month, year, or in 50 years. Thomas S. Monson stated: “When we deal in generalities, we rarely have success; but when we deal in specifics, we rarely have a failure.”

Be very specific with the goals you set.

As you think through your goals, recognize that there are many different ways to organize them. You can organize them by time frame: short-term, less than one year; medium-term, more than one year and fewer than 10 years; and long-term, more than 10 years. You can organize them by
responsibility: family, work, education, church, and so on. Or you can organize them by priorities, with your highest-priority goals first.

Write about your top three goals in detail. Goals and house plans are very similar: the more detailed the house plans, the closer the completed house will be to the planned house, and likely, the better the house. Likewise, the better and more thought-out the goals, what you actually become will be much closer to what you planned to be.

Next, answer the question: What do you think God wants you to do or become? If we truly believe that Heavenly Father knows us intimately and only does what is best for us, then we can become nothing better than what He wants for us. The challenge, then, is to come to understand His will for us and to try to become that. While it often takes a lifetime to truly understand what He wants for us, we can know, through study, prayer, and hard work, some important information about the direction our lives should take.

Finally, write your obituary. What do you want to be remembered for? If we think about how we want to be remembered, we can better live our lives in that direction.

Learning Tools

The following are examples of some goals to help you set your personal goals:

2A or 2B. Complete Personal Financial Plan

This is an example of a completed Personal Financial Plan. It includes an example of goals from a student who took this course previously.

Review Materials

Review Questions

1. What is the role of financial planning in your life? What can it help you achieve?
2. Why is it so important to set goals? What does setting goals help you do? Why is it important to write down your goals?
3. What is the difference between a goal and a wish?
4. What are two basic things required to complete an accurate financial plan?
5. Why is record-keeping an important part of completing an accurate financial plan?
6. What are the different costs associated with setting a goal?
7. According to M. Russell Ballard, what is one of the dangers of not setting goals?

1 “To the Elderly in the Church,” Ensign, Nov. 1989, 4, italics added
3 Quoted in Think and Grow Rich, Napoleon Hill, 1960, p. 40
Chapter 2. Creating Your Personal Financial Plan and Setting Personal Goals

5 Doctrine and Covenants 112:10
6 Pierre Teilhard de Chardin
9 Ibid.
12 Matthew 7:7-8
13 Proverbs 3:5-6
14 “Your Life Has a Purpose,” *New Era*, May 1979, pp. 4–5
15 Alma 37:37
16 D&C 112:10
17 “To the ‘Youth of the Noble Birthright’,” *Ensign*, May 1986, 44–45
18 “Choose the Good Part,” *Ensign*, May 1984, 9
19 Doctrine and Covenants 6:7
20 “Seven Steps to Success with Aaronic Priesthood Youth,” *Ensign*, Feb. 1985, 22
3. Budgeting and Measuring Your Financial Health

Introduction

Once you have a correct perspective on wealth, have begun your Personal Financial Plan, and have set your personal goals, the next step is to determine how you are going to attain your goals. Although some goals require only discipline and time, many goals also require careful financial planning. For these goals, it is essential to determine what resources you currently have, how much time until the resources are needed, and what additional resources are needed to help you attain those financial goals.

The purpose of this chapter is to help you measure your financial health and then create a plan to improve it. Before you can determine what you must do to get where you want to go, you must first determine where you are currently. To determine your current financial status or health, you must learn how to prepare various financial statements and learn what they represent. Once you identify from your financial statements where you are financially, and from your goals where you want to be, you can develop a plan for accomplishing your goals.

Objectives

Once you have completed this chapter, you should be able to do the following:

1. Understand the principles of successful budgeting
2. Develop and implement a budget
3. Calculate your net worth using a personal balance sheet
4. Develop a personal income statement and use it to analyze your spending

To determine where you are financially, you must first understand financial statements. Financial statements are documents that accurately reflect your personal financial position at a specific point in time. These statements help you evaluate your financial health.

There are several different kinds of financial statements. A budget records expected income and spending for the future, generally for a month or a year. A balance sheet records your assets (what you own) and liabilities (what you owe) at a specific point in time, usually at the end of a month, quarter, or year. An income statement records spending over a specific period of time, generally a month or a year. A budget is planning for the future, a balance sheet is a record of the present, and an income statement is a record of the past.
Every company uses financial statements to determine how to manage themselves so as to achieve their shareholders’ goals. Similarly, individuals and families can use financial statements to help them understand where they are financially and to help them meet their goals.

**Understand the Principles of Successful Budgeting**

Using a budget effectively will likely have a greater impact on whether or not you will achieve your financial goals than any other change you could make to your financial habits. As such, it is a critical topic. On this topic, Spencer W. Kimball said:

> Every family should have a budget. Why, we would not think of going one day without a budget in this Church or our businesses. We have to know approximately what we may receive, and we certainly must know what we are going to spend. And one of the successes of the Church would have to be that the Brethren watch these things very carefully, and we do not spend that which we do not have.  

If one of the reasons for the successes of large organizations, such as the LDS Church, is that those responsible watch budgets carefully, shouldn’t we, as individuals and families, watch our own budgets carefully as well?

In addition to keeping a record of expected income and expenses for the coming month or year, a budget is a way of making sure your financial resources are being used for the things that matter most to you—your personal and family goals.

While it is fairly easy to record your cash inflows and outflows and to make plans for achieving your financial goals, it takes discipline and sacrifice to actually follow through on the plans you outlined in your budget. While not easy, the results are apparent. Research has shown that those who effectively budget accumulate more wealth than those who do not.

The principles of effective budgeting are simple:

1. Spend less than you earn.
2. Keep good records for spending, taxes, and other purposes.
3. Use a budgeting method that meets your individual and family needs and objectives.

Whatever method you choose, it should accomplish the above three principles.

There are five main types of budgeting methods to help meet your needs and objectives:

1. The Envelope Method
2. The 60% Rule
3. Spreadsheets
4. Budgeting Software
5. DNAH-ial Methods (Do Nothing and Hope)
Chapter 3. Budgeting and Measuring Your Financial Health

The Envelope Method. The requirements for this method are few and inexpensive. You prepare envelopes for each category. The logic is to plan your spending for each month, take the money planned for each category, and place that money in individual envelopes. Once a bill comes, take the money from the corresponding envelope and pay the bill. Once the money is gone from one envelope and you need more, you must shift money between other envelopes or make do with what you have. The key is there is no getting money outside the system. It is simple and very effective if done correctly.

The 60% Solution. This method requires a journal or spreadsheet. The logic is to determine your gross salary each month and then take 60% of that amount and only spend that amount each month. You then take 20% of your salary and save it for long-term goals and 20% of your salary and save it to pay your taxes at year-end. Once you have spent your money, you cannot go outside the method for more money. While not as effective, as long as individuals stick to the 60% rule it can help in the savings process.

Spreadsheet Methods. This method requires a computer and spreadsheets. The logic is to determine your gross salary and take home pay each month after taxes and other deductions. You then determine spending by categories (rows) and dates (columns), and prepare a budget for each category. As bills come in, you pay the bills and input the spending on each date (column) and row (category). If done well, you plan in adequate amounts for a financial reserve and for long-term goals. This method can be useful if it is updated regularly and reviewed often.

Computer Software Methods. The requirements for this method are more expensive. They require a computer and personal finance software, such as Mint.com (free), Quicken, Mvelopes, etc. The logic is to determine your gross salary and take home each month after taxes and other deductions. Then you determine your spending by category, and budget each category in the software program. The key is to work within your budget for each spending category. As the software obtains receipts and credit card information from financial institutions directly via the Internet, you categorize the information. You can plan in adequate amounts for a financial reserve and for long-term goals. If set up correctly, this method can save significant time and effort and can be a great tool to help you achieve your goals.

DNAH-ial Methods (Do Nothing and Hope). This is the method used by most individuals, and it is the cheapest and least time consuming. It requires nothing. Individuals deny there is a concern, and hope things work out. They only respond when things get so bad that they have to act. The downside is that there is no planning, no preparation for long-term goals and objectives, and likely no savings.

Which is the best method? In my experience, the best plans are those that

1. Are low cost and relatively easy to use;
2. Allow downloading of bills from banks and credit card companies—makes data entry easier;
3. Allow adequate categorization of spending for income, spending, reporting and tax purposes; and
4. Minimize the time spent in doing finances (I spend roughly 1-2 hours per week).

Individuals and families should use whatever method is best for them. However, what I recommend for most individuals and families is Mint.com for those starting out, spreadsheets for the Excel wizards among us, and Quicken for more advanced users.

**Develop and Implement a Budget**

There is a process to creating an effective budget:

1. Know what you want to accomplish.
2. Track spending.
3. Develop a cash budget.
4. Implement your budget.
5. Compare your budget to your actual expenses and make changes where necessary to achieve your goals.

An example of a budget is found in Chart 1. In addition, examples of more detailed budgeting spreadsheets can be found in the Learning Tools section of the website (Learning Tools 4 and 31).

**Step 1: Know What You Want to Accomplish**

The first step in creating an effective budget is to know what is important to you and then write it down in the form of goals. In the previous section, you thought about what you wanted out of life, and you wrote down your goals. You should be working toward these goals. It is not enough to just want to save money—you should know what you are saving for. Your goals must be SMART: specific, measurable, achievable, reportable, and time-bound.

**Step 2: Track Spending (Your Expenses)**

The second step in creating an effective budget is generating a statement that accurately reflects your income and expenses for a month or for another specified period of time.

Certain methods of payment are easier to track than others. Checks and credit cards, for example, leave an automatic paper trail that is easy to examine at the end of a week or a month. Cash, on the other hand, is more difficult to track because an automatic physical record is not created each time it is used. To accurately track all expenses, you must keep a notebook in which you record all expenditures paid for in cash, or, better yet, record them electronically.

Budgeting software may also be helpful as you track your expenses. Software such as Intuit, Quicken, Microsoft Money, and the free Mint.com can reduce the time necessary to follow your
finances. Such software is especially useful if it is tied to your bank, credit card companies, or investment accounts through the Internet. Budgeting software is a great investment that can save you time if it is set up and runs properly and in a timely manner, but it is not required to become financially self-reliant.

**Chart 1. Budget Example**

<table>
<thead>
<tr>
<th>Monthly Budget for the Month of ________ 20XX</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income:</strong></td>
</tr>
<tr>
<td>--------------------------------------------</td>
</tr>
<tr>
<td>Wages/Salaries (After Taxes)</td>
</tr>
<tr>
<td>Actual</td>
</tr>
<tr>
<td>Difference</td>
</tr>
<tr>
<td>Other Income</td>
</tr>
<tr>
<td>Total Income</td>
</tr>
<tr>
<td><strong>Expenditures:</strong></td>
</tr>
<tr>
<td>Tithes and Offerings</td>
</tr>
<tr>
<td>Savings</td>
</tr>
<tr>
<td><strong>Food</strong></td>
</tr>
<tr>
<td><strong>Mortgage or Rent</strong></td>
</tr>
<tr>
<td><strong>Utilities</strong></td>
</tr>
<tr>
<td><strong>Transportation</strong></td>
</tr>
<tr>
<td><strong>Debt Payments</strong></td>
</tr>
<tr>
<td><strong>Insurance</strong></td>
</tr>
<tr>
<td><strong>Medical</strong></td>
</tr>
<tr>
<td><strong>Clothing</strong></td>
</tr>
<tr>
<td><strong>Other</strong></td>
</tr>
<tr>
<td><strong>Total Expenditures</strong></td>
</tr>
<tr>
<td><strong>Income minus Expenditures</strong></td>
</tr>
</tbody>
</table>

To develop a cash budget, you must first determine your annual income. One way to do this is to examine last year’s total income and make adjustments for the current year for any additional expected work or sources of income. You should also estimate your tax liability for the current year and your monthly take-home pay.

Next, you must determine your expenses. To complete this step, refer to the record you made while tracking your expenses. First, identify all fixed expenses. Be sure your fixed expenses are truly fixed expenses. Fixed expenses are expenses those you don’t directly control; they are often (but not always) monthly or semiannual expenses. Examples of fixed expenses include mortgage payments, rent, tuition and books, and life and health insurance costs. While some might consider cable TV or cell phone plans fixed expenses, they are generally variable expenses.
After you have identified your fixed expenses, identify your variable expenses. Variable expenses are expenses those you have control over—you can modify or eliminate the amount you spend on these things. Variable expenses include things like food (to a degree), entertainment, fuel, clothing, magazine subscriptions, and cable TV (contrary to some people’s beliefs, you can live without cable TV, the internet, or an iPad).

If reviewing your fixed and variable expenses shows that your expenditures exceed your income, or if you find that you live month to month and do not put money into some sort of savings account, look for ways to reduce your fixed expenses and reduce or eliminate your variable expenses.

One of the worst uses of your hard-earned income is paying interest, particularly on credit card and consumer loans. Carefully consider how credit card or loan payments will impact your future income. Pay off your credit card debt and avoid consumer debt! You want to be earning interest on investments, not paying it on debts.

Heber J. Grant said:

> If there is any one thing that will bring peace and contentment into the human heart, and into the family, it is to live within [one’s] means. And if there is any one thing that is grinding and discouraging and disheartening, it is to have debts and obligations that one cannot meet.  

I would like to recommend a better way to budget. Many individuals determine how much they will save according to how much money is left at the end of each month. They receive their paychecks, pay their tithes and expenses, and then save what they do not spend during the rest of the month. This is an incorrect pattern for budgeting monthly income because individuals are paying themselves last. I recommend a different pattern. After you have paid your tithes and offerings to the Lord through your church, **pay yourself a predetermined amount or percentage directly into savings**, then budget and live on the remaining income. Using this pattern will help you keep your priorities in order (see Chart 3).

**Chart 3. Budgeting: The Better Way**

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Page 37
Gordon B. Hinckley stated:

> In managing the affairs of the Church, we have tried to set an example. We have, as a matter of policy, stringently followed the practice of setting aside each year a percentage of the income of the Church against a possible day of need. I am grateful to be able to say that the Church . . . is able to function without borrowed money. If we cannot get along, we will curtail our programs. We will shrink expenditures to fit the income. We will not borrow.³

From my work with students, I have found that the average student cannot account for about 20 percent of what he or she spends each month. Many students are not sure what is important to them, so they spend money on many different things in an attempt to find out what makes them happy. Once they understand what is important to them, write down their goals, and begin working toward those goals, they find that saving between 10 and 20 percent of their income is not a difficult challenge. They begin spending their money on things that really matter—things that take them toward their personal and family goals.

L. Tom Perry suggested something similar to this new pattern for budgeting when he wrote:

> After paying your tithing of 10 percent to the Lord, you pay yourself a predetermined amount directly into savings. That leaves you a balance of your income to budget for taxes, food, clothing, shelter, transportation, etc. It is amazing to me that so many people work all of their lives for the grocer, the landlord, the power company, the automobile salesman, and the bank, and yet think so little of their own efforts that they pay themselves nothing.⁴

I strongly recommend that students, after graduating, set a goal to save between 10 percent and 20 percent of every dollar they make after college. My wife and I set that goal nearly 30 years ago, and it has made a significant difference in the life we live today.

**Chart 2. Budgeting: The Old Way**

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Page 38
Step 3: Develop a Cash Budget (A Better Way)

The third step in creating an effective budget is to develop a cash budget. A cash budget is a plan for controlling cash inflows and outflows. Its purpose is to balance income with expenditures and savings. The old method for preparing a cash budget is found in Chart 2.

Step 4: Implement Your Budget

The fourth step in creating an effective budget is to try your budget for a month. Record all income and expenses in their proper categories; accurate record-keeping is a crucial part of good budgeting. Add up all the amounts listed in each category, and make a note of how much you have left over in each category at the end of each week. Be financially prudent—don’t buy things you don’t need or haven’t budgeted for.

Adjust your plan as necessary to make it work for you. Try to be financially prudent, and use each month as a learning experience to help you do better the next month.

Chart 4. Budget Example with Differences

<table>
<thead>
<tr>
<th>Income:</th>
<th>Budget</th>
<th>Actual</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages</td>
<td>2,875</td>
<td>2,760</td>
<td>-115</td>
</tr>
<tr>
<td>Taxes</td>
<td>375</td>
<td>360</td>
<td>15</td>
</tr>
<tr>
<td>Wages/Salaries (After Taxes)</td>
<td>2,500</td>
<td>2,400</td>
<td>100</td>
</tr>
<tr>
<td>Other Income</td>
<td>200</td>
<td>250</td>
<td>50</td>
</tr>
<tr>
<td>Total Income</td>
<td>2,700</td>
<td>2,650</td>
<td>-50</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Expenditures</th>
<th>Budget</th>
<th>Actual</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tithes and Offerings</td>
<td>325</td>
<td>318</td>
<td>-7</td>
</tr>
<tr>
<td>Savings</td>
<td>405</td>
<td>398</td>
<td>-7</td>
</tr>
</tbody>
</table>

Monthly Living Expenditures

<table>
<thead>
<tr>
<th>Item</th>
<th>Budget</th>
<th>Actual</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>300</td>
<td>320</td>
<td>20</td>
</tr>
<tr>
<td>Mortgage or Rent</td>
<td>700</td>
<td>700</td>
<td>0</td>
</tr>
<tr>
<td>Utilities</td>
<td>300</td>
<td>325</td>
<td>25</td>
</tr>
<tr>
<td>Transportation</td>
<td>180</td>
<td>165</td>
<td>-15</td>
</tr>
<tr>
<td>Debt Payments</td>
<td>50</td>
<td>50</td>
<td>0</td>
</tr>
<tr>
<td>Insurance</td>
<td>150</td>
<td>150</td>
<td>0</td>
</tr>
<tr>
<td>Medical</td>
<td>40</td>
<td>40</td>
<td>0</td>
</tr>
<tr>
<td>Clothing</td>
<td>150</td>
<td>100</td>
<td>-50</td>
</tr>
<tr>
<td>Other</td>
<td>100</td>
<td>75</td>
<td>-25</td>
</tr>
<tr>
<td>Monthly Living Expenditures</td>
<td>1,970</td>
<td>1,925</td>
<td>-45</td>
</tr>
<tr>
<td>Total Expenditures</td>
<td>2,700</td>
<td>2,641</td>
<td>-59</td>
</tr>
</tbody>
</table>
Chapter 3. Budgeting and Measuring Your Financial Health

Total Income minus Expenditures: 0 - 9 = -9

For income, negative is under budget and positive is over budget. For taxes and expenses, negative is under budget and positive is over budget.

If you can’t figure out where you are, the best map in the world can’t help you get where you want to go. A well-developed budget that is based on your current financial situation can be your best road map to financial freedom. Marvin J. Ashton stated:

Some claim living within a budget takes the fun out of life and is too restrictive. But those who avoid the inconvenience of a budget must suffer the pains of living outside of it. The Church operates within a budget. Successful business functions within a budget. Families free of crushing debt have a budget. Budget guidelines encourage better performance and management.⁵

**Step 5: Compare Your Budget to Your Actual Expenses and Make Changes Where Necessary to Achieve Your Goals**

The fifth step in creating an effective budget is to compare your budget to your actual spending (see Chart 4). As necessary, adjust the amounts you have budgeted for different expenses to create a more effective budget. As you make adjustments, don’t reduce payments to God or to yourself.

Creating a budget is a learning experience. You will not create a perfect budget right away, but you can refine it after each month.

If your budgeting plan fails repeatedly, the “envelope system” may work.

**Calculate Your Net Worth Using a Personal Balance Sheet**

The second thing you must do to determine where you are financially is to calculate your net worth using a personal balance sheet, which is a snapshot of your financial position on a given date, usually the end of a month or year. It lists the dollar amounts of your liabilities (what you owe to others) and of your assets (what you own of monetary value).

How do you calculate your net worth? Your net worth (also referred to as equity) is the difference between your assets and your liabilities.

There are multiple ways to appraise each type of asset or liability. Calculate the value of each asset or liability correctly, because if you do not, you will have an incorrect view of your financial position. Having an incorrect view of your financial position may result in making bad financial decisions.
An example of a balance sheet is found in Chart 5. In addition, a balance sheet template can be found in the Learning Tools section of the website (Learning Tool 4: Budget Balance Sheet and Income Statements).

**Assets: What You Own**

Your assets are not limited to the total amount of money you have on hand; rather, they include all the valuable goods you own. Their value is based on the assumption that you could sell these goods and receive their market value. Assets come in many forms, including monetary assets, investment assets, and retirement assets; assets also include real estate, vehicles, personal property, and so on.

Assets can be subdivided into four categories: income-generating assets, appreciating assets, depreciating assets, and income-consuming assets. Income-generating assets are the best type of assets. These assets generate income or capital gains, which may eventually allow you to have income without having to work. Included in this category are financial assets such as stocks, bonds, or mutual funds; rental properties that are structured well; and even some types of insurance.

Appreciating assets are those that may have historically appreciated in value. Examples include your home, education, and certain types of business assets.

Depreciating assets depreciate in value. Often, the minute you take ownership of these assets (e.g., drive a car off the lot), they drop in value. This category includes assets such as automobiles, recreational vehicles, boats, etc.

Finally, income-consuming assets are those that require a constant infusion of cash to keep operative. Examples include automobiles (which require maintenance, fuel, and insurance), homes (property taxes, repair, upkeep, and insurance), and recreational properties (property taxes, repair, upkeep, and insurance), etc.

Different types of assets fulfill different needs for an individual or family, such as liquidity, protection, and capital appreciation.

**Monetary (or current) assets** include cash and other financial assets that can easily be converted into cash. This characteristic is known as liquidity. Liquidity is important in case of an emergency because it means that funds can be accessed in a relatively short period of time. Examples of monetary assets include cash, savings accounts, certificates of deposit, money market deposit accounts, and other financial assets that can be easily accessed in times of need. The value of a monetary asset is usually calculated according to its current market value—the price at which it could be sold. Monetary assets are also called current assets.

**Investment assets** are similar to monetary assets in that they can be redeemed for cash; however, they are generally less liquid and are used to save for a particular long-term goal. These assets
provide mid- to long-term capital appreciation for the investor. Examples of investment assets include stocks, bonds, and mutual funds that an individual or family purchases now with the hope that the investments will be worth more in the future. The value of an investment asset is usually calculated according to its current market value.

**Retirement assets** are a particular type of investment asset in which money is specifically set apart to be used after retirement. These assets are used both to save and to earn a return for retirement. They are designed to provide funds that will allow you to live comfortably after you retire. Be aware that there are significant penalties (i.e., taxes and fees) if you use these assets before you turn retirement age as defined by the government (59½ for qualified retirement plans). Examples of retirement assets include company pensions, IRAs, and traditional and Roth 401(k) plans. The value of a retirement asset is usually calculated according to its current market value.

**Housing or real estate assets** include tangible assets such as land, dwellings, vacation homes, and rental properties. For many people, housing assets represent the bulk of their savings. These assets are often, but not always, the place where you live and will eventually retire. People often purchase housing assets to fulfill personal goals or to earn capital appreciation and income. The value of a housing asset is based on its current market value or its appraised value; the appraised value is established by an independent appraiser who takes into account similar houses in the neighborhood or city.

**Automobiles and other vehicle assets** include tangible assets such as cars, trucks, and recreational vehicles, which typically must be inspected and licensed. These assets provide transportation, recreation, and other benefits. The value of a vehicle asset is based on its current market value or its book value. The value of this type of asset usually depreciates each year.

**Chart 5. Balance Sheet Example**

<table>
<thead>
<tr>
<th>Bill and Suzy Smith</th>
<th>Balance Sheet as of: _____________, 20XX</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets:</strong></td>
<td><strong>Liabilities:</strong></td>
</tr>
<tr>
<td>Current (or Monetary) Assets</td>
<td>Current Liabilities</td>
</tr>
<tr>
<td>Cash and Checking</td>
<td>$1,000</td>
</tr>
<tr>
<td>Savings/CDs</td>
<td>5,000</td>
</tr>
<tr>
<td>Other Assets</td>
<td>0</td>
</tr>
<tr>
<td>Investments</td>
<td>Current Unpaid Balances$200</td>
</tr>
<tr>
<td>Stocks/Bonds</td>
<td>Visa/MasterCard 500</td>
</tr>
<tr>
<td>Mutual Funds</td>
<td>Long-Term Liabilities</td>
</tr>
<tr>
<td>Other Investments</td>
<td>Mortgage Loan 0</td>
</tr>
<tr>
<td>Retirement Plans</td>
<td>Auto Loans 500</td>
</tr>
<tr>
<td>401k, 403b, 457 Plans</td>
<td>College Loans 3,000</td>
</tr>
<tr>
<td></td>
<td>Other Debts 0</td>
</tr>
</tbody>
</table>

Page 42
Personal property assets include tangible assets such as boats, furniture, and clothing that are purchased to meet specific individual needs or wants. The value of a personal property asset is determined by its current market value, which typically depreciates each year.

Other assets include any other tangible or intangible assets, such as business ownership, collections, and hobbies. These assets differ greatly, but they are all generally used to fulfill specific personal or business objectives. The value of these assets is usually calculated according to current market value or appraised value; however, because of the individual nature of these assets, they are often difficult to appraise and may have value only to their owner.

Add up the values of all your different types of assets to determine their total dollar value.

Liabilities: What You Owe

While liabilities also come in many forms, there are two major forms of liabilities: current and long-term.

Current liabilities are debts that must be paid off within the next year; they are usually debts for the short-term expenses of your home or business. Current liabilities include debts related to credit cards, utility bills, tuition and books, and non-mortgage housing expenses. These liabilities should be recorded on your personal balance sheet at the current amount owed plus any accrued interest.

Long-term liabilities are debts that must be paid off at a date farther away than one year from now; these debts are typically used to cover long-term expenses, such as student loans, auto loans, and home mortgages. These liabilities should be recorded on your personal balance sheet at the current amount owed.

Net Worth: What You Are Worth Financially

The difference between your assets and liabilities is known as your equity, or net worth. Do you owe more than you own? If so, you are technically insolvent!
Chapter 3. Budgeting and Measuring Your Financial Health

What is a good level of net worth? The word *good* is relative when it comes to net worth. Your optimal level of net worth will depend on your age, your goals, and where you are in the stages of your financial life. These stages include the wealth-accumulation stage, the approaching-retirement stage, and the retirement stage of your life. As a general rule, a good level of net worth means that your assets are greater than your liabilities. As you age, the difference between your assets and liabilities should increase, with your assets always being the greater of the two.

The question of where you are now versus where you should be is a personal question that you must answer for yourself. As you try to answer this, ask yourself the following questions:

- What does my balance sheet show?
- Is my net worth growing?

The answers to these questions often depend on the stage you are at in life. For example, if you just graduated from high school or college, you are most likely in the accumulation stage of your life; therefore, your net worth should be growing. If you are retired, then you are probably using your savings for retirement expenses. In this case, your net worth is likely decreasing. Ask yourself these important questions:

- Am I reaching my personal goals?
- Am I planning for emergencies?
- Do I have adequate liquid assets?
- Am I out of credit card and consumer debt (other than using my credit card for convenience and paying off the balance each month)?
- Am I saving sufficiently for retirement and for my other financial goals?

If you can answer each of these questions affirmatively, you are likely financially “healthy.” However, remember that we all can—and should—improve!

**Develop a Personal Income Statement and Use It to Analyze Your Spending**

A personal income statement is like a financial motion picture of your cash inflows and outflows. This type of statement is based entirely on actual cash flows, not accruals. An example of an income statement is found in Chart 6. If the statement looks familiar, it is because the income statement is just the “actual” column of your budget.

**Chart 6. Income Statement Example, Bill and Suzy Smith**

Monthly Income Statement for the Month of ______, 20XX

<table>
<thead>
<tr>
<th>Income:</th>
<th>Actual</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages/Salaries (After Taxes)</td>
<td>2,400</td>
</tr>
<tr>
<td>Other Income</td>
<td>250</td>
</tr>
<tr>
<td>Income Available for Living Expenses</td>
<td>2,650</td>
</tr>
<tr>
<td>Expenditures for Donations/Savings</td>
<td></td>
</tr>
</tbody>
</table>

Page 44
Tithes and Offerings 318  
Savings 398  

Expenditures for Living Expenses
- Food 320  
- Rent 700  
- Utilities 325  
- Transportation 165  
- Debt Payments 50  
- Insurance 150  
- Medical 40  
- Clothing 100  
- Other 75  

Total Expenditures for Living Expenses 1,925  
Total Living Expenses and Offerings/Savings 2,641  
Total Income minus Expenditures 9

**Income: Cash Inflows**

Income includes cash inflows such as wages, tips, royalties, salaries, and commissions. Income is the amount you earn, which is not necessarily equal to the amount you receive. This is because some expenses, such as taxes, health-care costs, 401(k) contributions, and so on, are deducted from your check before you receive it.

**Expenditures: Cash Outflows**

As discussed in the Chapter 2 section, “Develop and Implement a Budget,” *fixed expenses* are expenses that you don’t directly control, and *variable expenses* are those that you have control over.

There may be differences of opinion concerning what constitutes a fixed versus a variable expense. For example, while one spouse might consider dates each weekend a fixed expense, another might consider it a variable expense. Be careful that variable expenses are not considered fixed expenses. Realize also that most fixed expenses are variable over longer periods of time; for example, you can buy a smaller house or get by with a used instead of a new car.

**Using Ratios to Analyze Your Spending**

Once you have completed your personal balance sheet and your personal income statement, use your financial statements to answer the following three questions.

**Question 1: Do I have adequate liquidity in case of emergency?** Two ratios can help you determine whether or not you have enough monetary assets to pay for a large, unexpected expense or to tide you over in case of a period of reduced or eliminated income: the current ratio and the “month’s living expenses covered” ratio.
Chapter 3. Budgeting and Measuring Your Financial Health

The current ratio tells you how many times over you could pay off your current liabilities with the cash you have on hand. To calculate your current ratio, divide the amount of your monetary assets (your current assets) by the amount of your current liabilities. The more times you can pay off your current liabilities, the better off you are financially. A ratio greater than two is recommended. Track the trend of this ratio; if it’s going down, you need to make changes to improve your financial situation.

The second important ratio is the “month’s living expenses covered” ratio. This ratio tells you how many months you could survive financially if you lost all current sources of income. To calculate this ratio, divide the amount of your monetary assets by the amount of your monthly living expenses. Realize that your living expenses should not include charitable contributions, taxes, or savings, because if you lost your job, you would not have these expenses or savings. A ratio that allows you to pay your living expenses for three to six months is recommended. The ratio should be equal to at least as many months as it would take to get a new job if you lost your current job. Again, track the trend of this ratio—it should be improving. If it isn’t, you need to make some changes to improve your financial situation.

In the example above, the current ratio is calculated as current assets divided by current liabilities. Bill and Suzy have $6,000 in current assets divided by $700 in current liabilities, or a current ratio of 8.57. Bill and Suzy could pay their current bills 8.6 times with the money they have in their savings. They are well above the recommended ratio.

Their “month’s living expenses covered” ratio is calculated as monetary assets divided by monthly living expenses. Bill and Suzy have $6,000 in current or monetary assets divided by $1,925, which is their monthly living expenses, or a ratio of 3.1 times. Bill and Suzy could pay 3.1 months of living expenses with their existing monetary assets. They are within the recommended range of three to six months, although they are on the lower side.

**Question 2: Can I meet my debt obligations?** The debt ratio and the long-term debt coverage ratio can help you determine whether or not you can meet your current or long-term debt obligations.

Your debt ratio tells you whether you could pay off all your liabilities if you liquidated all your assets. This ratio is equal to your total liabilities divided by your total assets and represents the percentage of assets that are financed with borrowed money. Track this trend; this ratio should go down as you grow older.

Your long-term debt coverage ratio tells you how long you could continue to make payments on your long-term debt based on the amount of money you have for living expenses. To calculate this ratio, divide the amount you have available for living expenses (i.e., wages minus taxes) by the amount of your long-term debt payments. The higher this ratio, the better; a higher ratio indicates that you could cover your debt payments for a longer period of time. Track this trend; this ratio should go up over time.
In the example above, Bill and Suzy’s debt ratio is $4,200 divided by $14,450 or 29 percent. Roughly 29 percent of their assets are financed with borrowings, and most of that is with student loans. Once Bill and Suzy buy their first home, this ratio will likely increase. A good goal is to make this ratio zero percent, meaning you have paid off all your liabilities, including your mortgage.

Their long-term debt coverage ratio is $2,650 divided by $50, or a ratio of 53 times. They have very little debt and are doing well. Debt coverage ratios should be higher than 2.5. Because they are renting and don’t have a mortgage, this ratio is very low.

The inverse of the long-term debt coverage ratio is called the debt service ratio. The debt service ratio is long-term debt payments divided by monthly living expenses. Ideally, this ratio should be very low—at least less than 40 percent. In Bill and Suzy’s case, their long-term debt payments are $50 divided by money available for monthly living expenses, or $2,650. Their ratio is 1.9 percent. Only 1.9 percent of their income goes to paying long-term debts. Taking one divided by the long-term debt coverage ratio of 53 gives the same result.

**Question 3: Am I saving as much as I think I am?** The net savings ratio and the gross savings ratio can help you determine whether you are saving as much of your income as you think you are.

Your net savings ratio tells you what proportion of your after-tax income you are saving. To calculate this ratio, divide the amount of income you save by the amount of income you use to cover living expenses. In the United States, the average ratio has ranged between negative 2 percent and 8 percent; however, your ratio may vary from this average depending on your current financial stage and your personal goals. As always, track the trend of this ratio—if it is decreasing, make the necessary changes.

Your gross savings ratio tells you what proportion of your before-tax income you are saving. This ratio is equal to your total savings divided by your total income. I recommend that, at a minimum, this ratio should be 10 percent. For most students, I recommend between 10 and 20 percent. As you get older, this savings ratio should also increase.

In the example given, Bill and Suzy’s net savings ratio is calculated as their monthly savings divided by their total income after taxes, or $398 divided by $2,650, giving a ratio of 15 percent. They are saving 15 percent of their net pay.

Bill and Suzy’s gross savings ratio is calculated as the monthly savings divided by their total income before taxes, or $398 divided by $2,760, or 14 percent. They are saving 14 percent of their total pay. While 14 percent is good, I recommend you set a goal to save 20 percent of your gross income, if possible.
Chapter 3. Budgeting and Measuring Your Financial Health

Summary

Before you can attain your goals, you must first understand where you are financially. To do this, you must prepare the various financial statements described in this chapter. Of these financial statements, the most important is your budget. Following your budget is critical to living within your means. You must know what income you have coming in and what income you are spending.

In this chapter, I have recommended a new way of budgeting. Instead of saving what is left over at the end of the month, I have suggested that you determine your income, pay the Lord first, pay yourself second (between 10 percent and 20 percent), and then budget and live on the remainder. This practice will help you save for your goals much more quickly and will greatly improve your chance of attaining them.

I also explained the importance of using your personal balance sheet to create a snapshot of where you are financially and to help you calculate your net worth. Remember, your net worth will change depending on where you are in life, and ideally, it should get better over time.

Finally, I touched on the personal income statement and explained specific ratios that can help you see how well you are doing with regard to liquidity, debt, and savings. Ideally, these ratios should also be improving over time.

Joseph B. Wirthlin commented:

I advise you to be patient in financial matters. Avoid rash or hurried financial decisions; such decisions require patience and study. Get-rich-quick schemes seldom work. Beware of debt. Be especially careful of easily obtained credit even if the interest is tax deductible. You young couples should not expect to begin your married lives with homes, automobiles, appliances, and conveniences comparable to those your parents have spent years accumulating.6

Assignments

Financial Plan Assignments

While the previous chapter helped you determine where you wanted to be, this chapter helps you see where you are right now. Financial statements help you understand your current financial position.

If you are not already living on a budget, your assignment is to begin today. Begin keeping a record of all your expenses, using the recording method of your choice. Your budget is probably the single-most important tool that will help you attain your goals. Use it wisely and refer to it often. It is important to remember that recording expenses alone is not budgeting. Recording
expenses is just record-keeping. You need to plan where your money should go and then see that you follow your plan.

In addition to making a budget, put together your own personal or family balance sheet. Be conservative in evaluating your assets, and be exact in evaluating your liabilities. Follow the methods discussed in this chapter and see where you are financially.

Finally, calculate your financial ratios regarding liquidity, debt, and savings. Are your assets as liquid as they should be? Are you reducing debt as you should? Are you saving as much as you should?

**Learning Tools**

The following Learning Tool may be helpful as you prepare your personal financial statements.

4. **Budget, Balance Sheet, and Income Statements**

   This is an excel spreadsheet that includes a one-year budget, a two-period balance sheet, an income statement, and financial ratios for determining where you are financially.

**Review Materials**

**Review Questions**

1. Why is it necessary to understand financial statements? Why is it necessary to create your own personal financial statements?
2. According to Spencer W. Kimball, who should have a budget? Why?
3. What is the process of creating an effective budget?
4. What is the main difference between the “old way” and the “new way” of budgeting (see Chart 1 and Chart 2)? Why is this so important to the success of your financial plan?
5. Why is it important to calculate your net worth? What does your net worth say about your financial position? What is a “good” net worth?

**Case Studies**

**Case Study 1**

**Data**

Steve and Mary Jo, both 35 years old, own a house worth $150,000 and have a yearly income of $50,000, monetary assets of $5,000, two cars worth $20,000, and furniture worth $10,000. The house has a $100,000 mortgage, they have college loans of $10,000 outstanding, and the cars have outstanding loans of $10,000 each. Bills totaling $1,150
for this month have not been paid ($1,000 is to pay off their credit card that they use for bills). They are requesting your help.

Calculations
Using the data above, create a balance sheet to calculate Steve and Mary Jo’s net worth. How are they doing?

Case Study 1 Answers
The balance sheet for Steve and Mary Jo should look like this:

Assets
- Primary Residence $150,000
- Monetary Assets $5,000
- Automobiles $20,000
- Furniture $10,000
- Total Assets $185,000

Liabilities
- Current Bills $1,150
- First Mortgage $100,000
- College Loan $10,000
- Automobiles (2 * $10,000) $20,000
- Total Liabilities $131,150
- Net Worth (Assets – Liabilities) $53,850

Generally, they are doing OK. While they have a positive net worth, most of that value is from the equity of their home.

Case Study 2

Data
Steve and Mary Jo, who make $50,000 per year, calculated their average tax rate at 15 percent. They contribute 12 percent of their income to charity and pay themselves 10 percent of their income. They have 25 years and $100,000 remaining on their 6-percent mortgage ($7,730 per year), three years and $20,000 remaining on their 7-percent auto loan ($7,410), and 10 years and $10,000 remaining on their 3-percent college loan ($1,160). In addition, utilities and property taxes were $2,270 per year, food was $6,000, insurance was $1,500, and other expenses were $5,430.

Calculations
Calculate their income statement using the “better” method, and round values to the nearest $10. How are they doing?

Case Study 2 Answers
Their income statement should look like this:

Annual Income
Wages $50,000
Taxes (15%) 7,500
Income for Living Expenses 42,500
Paying the Lord (12%) 6,000
Paying Yourself (10%) 5,000
Total Income $31,500

Expenses
Mortgage $7,730
Utilities, Taxes 2,270
Food 6,000
Insurance 1,500
College Loan 1,160
Car Payment 7,410
Other Expenses 5,430
Total Living Expenses $31,500

They seem to be doing OK; they are saving money, and it appears that they are living within their income. We need more information though.

This is the way Steve and Mary Jo calculated their annual expenses. (For information on using a financial calculator, see Learning Tool 3: Financial Calculator Tutorial, and Learning Tool 12: Excel Financial Calculator.)

Mortgage PV = $100,000, I = 6%, N = 25 * 12, PMT = ? * 12 = $7,730
College Loan PV = $10,000, I = 3%, N = 10 * 12, PMT = ? * 12 = $1,160
Car PV = $20,000, I = 7%, N = 3 * 12, PMT = ? * 12 = $7,410

Case Study 3

Data
Steve and Mary Jo would like you to help them understand where they are financially. You have Steve and Mary Jo’s balance sheet and income statements, which were prepared earlier.

Calculations
They ask for help to calculate each of the six key liquidity, debt, and savings ratios.

Application
Using the data and calculations, comment on how well they are doing. What can and should they be doing to improve?

Case Study 3 Answers

Liquidity Ratios
Current ratio = current assets / current liabilities
$5,000 / 1,150 = 4.35 times

Month’s living expense covered ratio = monetary assets / (annual living expenses / 12)

$5,000 / (31,500 / 12) = $5,000 / 2,624 [(M + F + I + CL + CP + OE) / 12] = 1.9 months (Living expenses do not include charity, taxes, or paying yourself because if you were not earning money, you would not pay these expenses.)

Steve and Mary Jo are somewhat liquid. They have a good current ratio (>2) but could only cover annual living expenses for less than two months (>3–6+ months is much better). They need to cut expenses and reduce debt.

Debt Ratios

Debt ratio = total liabilities / total assets

$131,150 / 185,000 = 70.9%

Long-term debt coverage ratio = income available for living expenses (wages – taxes or W – T) / long-term debt payments (debt you would not pay off in 12 months)

$42,500 (W – T) / (7,730 + 1,160 + 7,410) (M + CL + CP) = $42,250 / 16,300 = 2.6 times

Their debt service ratio or inverse of the long-term debt coverage ratio is $16,300 / 42,500 = 38.6%.

They have lots of debt—71 percent of their assets are financed, and their long-term debt ratio is 2.6 times, just above the 2.5 times caution level. Thirty-nine percent of their total income available goes to cover just debt payments. Just think—they could be investing that money instead of paying it!

Savings Ratios

Savings ratio = income available for savings and investment / income available for living expenses

$5,000 (PY) / 42,500 (W – T) = 11.8%

Gross savings ratio = income available for savings and investment / gross salary

$5,000 / 50,000 = 10%

They are saving 11.8 percent of their income available for living expenses, and 10 percent of their gross salary. This is OK, but it should be the minimum amount. I hope students taking this class will save much more, perhaps 20 percent of their gross salary.

Ratio Summary

<table>
<thead>
<tr>
<th>Overall Situation</th>
<th>Actual</th>
<th>Recommended</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td>4.4 Times</td>
<td>&gt; 2</td>
</tr>
</tbody>
</table>

Page 52
Chapter 3. Budgeting and Measuring Your Financial Health

Month’s LEC Ratio 1.9 Times > 3 – 6+

Debt

Debt Ratio 70.9% 0% (See Note 1)
LT Debt Coverage Ratio 2.6 Times > 2.5
% Income to Pay Debt 38.0% 0% (See Note 1)

Savings

Savings Ratio 11.8% > 10%
Gross Savings Ratio 10.0% 10% Min (See Note 2)

Notes:
1. It depends on your age. Ideally, it should decrease to zero.
2. While the minimum is 10 percent, it should increase as the situation allows.

Recommendations:

Liquidity—Steve and Mary Jo are somewhat liquid, but they do not have enough monetary assets. They need to significantly increase their monetary assets by saving more. They should set a goal to have an LEC ratio of at least three to six times. To conserve cash, they need to reduce spending, and perhaps sell some assets. They are paying so much on debt payments that they cannot build their savings and emergency fund. They likely need a stricter budget.

Debt—Steve and Mary Jo are carrying way too much debt. Seventy-one percent of their assets are financed by debt. They are very close to the danger range of a debt coverage ratio of 2.5 times. Currently, 38 percent of their income is used for long-term debt payments. While they have equity in their home, that is where most of their net worth currently resides. Given the recent housing crisis, the amount of equity in their home has likely dropped. They should cut expenses, reduce their debt, and perhaps sell their expensive cars and purchase cheaper ones.

Savings—Steve and Mary Jo are saving 10 percent of their income, which is good. However, their total investment assets are only $5,000. Having $5,000 in monetary assets at a savings rate of $5,000 per year means they only began saving within the last year. While they can’t do anything about the fact that they should have begun saving earlier, they need to save more now. I would encourage them to reduce their spending and increase their savings goal to 20 percent, if possible, which is what I recommend for my students. After a three-to-six month emergency fund, I would help them to take additional funds and use it to pay off debt.

1 Conference Report, April 1975, pp. 166–167
2 Gospel Standards, compiled by G. Homer Durham, 1941, 111
3 “To the Boys and to the Men,” Ensign, Nov. 1998, 51
5 “It’s No Fun Being Poor,” *Ensign*, Sept. 1982, 72; italics added
6 “Patience, a Key to Happiness,” *Ensign*, May 1987, 30
4. Cash Management

Introduction

The term “cash management” used to mean putting your money into a checking or savings account. Since each bank had similar interest rates, there was little benefit to shopping around for slightly higher returns. However, times have changed. An increase in competition and a reduction in banking regulations have resulted in a much different environment for managing cash and short-term liquid assets today.

The institutional environment has also changed. Previously, only banks could offer checking accounts, and only brokerage houses could sell financial assets such as stocks, bonds, and mutual funds. Now banks can offer financial services, including financial assets, and brokerage houses can offer checking accounts and other services. The challenge now is for you to understand the different alternatives available and to choose the alternatives that will help you achieve your financial goals the fastest.

Objectives

When you have completed this chapter, you should be able to do the following:

1. Understand the principles of cash management
2. Understand cash-management alternatives and how to compare them
3. Know the different types of financial institutions and understand how they can help you meet your financial goals
4. Understand the time commitment necessary for you to effectively manage your finances

Understand the Principles of Cash Management

Cash is important; it provides needed protection because of its liquidity. Liquidity means that your funds are immediately accessible; having liquid funds protects you from having to sell less-liquid, long-term investments at substantial discounts or losses.

The principles of cash management were best summed up by Benjamin Franklin when he wrote “A penny saved is a penny earned.” We are stewards over the resources we have, not only the large stewardships, but also over the small stewardships as well, i.e. the pennies. And as we take care of the small stewardships, we will find that the larger stewardships (the dollars) take care of themselves.
There are three main trade-offs regarding cash management. The first is the risk-return trade-off: higher liquidity means less risk and, therefore, lower returns. Generally speaking, the more liquid the financial asset, the lower the return you can expect to receive on the asset.

The second is the spending-investment risk trade-off: cash on hand is easier to spend than other financial assets.

The third is the return-time expended trade-off: since returns are smaller with cash-management assets, the time you spend managing those assets should be much less than the time you spend managing other types of financial assets.

In spite of these three trade-offs, you can still impact your portfolio in significant and positive ways by using your liquidity wisely. The key to using your liquidity wisely is relating cash management to your personal goals.

What goals do you want to accomplish? Let cash management help you. For example, do you want to save more money? Automate your savings account and pay yourself at specified intervals. Arrange for your bank or financial institution to transfer a specific amount of money each week or month into your savings or mutual fund account. Contribute to your company retirement plan each month with a specific amount that goes directly to that account.

Do you want to cut down on the time you spend working on your personal finances? Use cash-management software, such as Intuit’s Quicken or Mint.com. When properly set up, these programs can substantially reduce the amount of time necessary to manage your finances.

Cash management is an essential part of your emergency fund. Your emergency fund is a resource you can use to meet unexpected needs for cash. The general rule of thumb for an emergency fund is to have sufficient liquid assets to cover three to six months of expenses. I recommend that you substitute the term “income” for the term “expenses” because your income should be higher than your expenses. Keeping three to six months of income in your emergency fund means there is a greater chance you will not need to tap into long-term savings to meet short-term cash needs.

Is it still wise to have an emergency fund in this world of credit cards and home equity lines of credit? The answer is yes, absolutely! It may even be more necessary than it was in the past. Credit cards and home equity lines of credit may be canceled if you lose your job or have a debilitating accident. Secure, available funds that can be accessed quickly provide peace of mind in a troubling world. Gordon B. Hinckley stated:

May the Lord bless you, my beloved brethren, to set your houses in order. If you have paid your debts, if you have a reserve, even though it be small, then should storms howl about your head, you will have shelter for your wives and children and peace in your hearts.
Being able to provide for one’s family and to feel secure financially are great goals for cash management.

Understand Cash-Management Options and How to Compare Them

There are many options for helping you manage your cash, and each has its own benefits and costs. Traditional cash-management alternatives include checking accounts and savings accounts. Less traditional, but still important, options for cash management include money market deposit accounts, certificates of deposit, money market mutual funds, U.S. Treasury bills, U.S. Series EE bonds, and U.S. Series I bonds.

The best way to evaluate cash-management alternatives is to review the characteristics of each type of account, such as liquidity, required minimum balances, interest rates, safety, costs, and benefits. Liquidity refers to how quickly and easily you can access your money. Required minimum balance refers to how much money must be in the account in order for you to qualify for specific benefits, such as a low interest rate or check-writing privileges. Interest rate refers to the Annual Percentage Rate (APR) of return received on the money in the account. Safety refers to the guarantee that the assets will be protected by either a direct guarantee (i.e., FDIC or NCUA insurance) or an indirect guarantee (i.e., the asset is a liability of the U.S. government). Costs are the costs associated with holding the account, including late fees, overdraft protection fees, and minimum balance fees. Benefits include special tax incentives that could make your earnings tax free at the state or federal level.

Checking Accounts

Checking accounts are the most common form of cash-management alternatives. Checking accounts generally come in two forms: (1) non-interest-bearing accounts and (2) interest-bearing accounts, also called negotiable order of withdrawal accounts (NOW). Because checking accounts allow immediate access to your funds, they are among the most liquid of all cash-management alternatives. However, with that high liquidity come low interest rates or even no interest at all. The rates on interest-bearing accounts are generally low and fixed.

Minimum balances on checking accounts are generally low, but there is some variation depending on the type of account. Checking accounts from banks are very safe; they are insured by the FDIC, and they carry no penalties for early withdrawal. Banks, credit unions, and other financial institutions can give you more information about setting up a checking account.

Savings Accounts

Savings accounts, also called time deposits, are next on the cash-management list. In the past, withdrawals and other transactions that affected a savings account would be registered in a “passbook”; hence the term “passbook savings” was coined. Savings accounts are now called statement accounts, and the customer receives a monthly statement from the financial institution.
Money in a savings account is deposited for a specific term (e.g., a day, week, month, or quarter) and hence is less liquid than money in a checking account. However, with the reduction in liquidity there is usually a slight increase in interest rate. Required minimum balances are low in savings accounts, although the amount does depend on the type of account. Savings accounts are very safe and are generally FDIC-insured; however, there are penalties for early withdrawal. Information on setting up savings accounts is available from banks, credit unions, and other financial institutions.

In addition to checking accounts and savings accounts there are other, less-traditional alternatives you should evaluate and understand.

**Money Market Accounts (MMA)**

An MMA is similar to a savings account, but instead of having a fixed rate of interest, its interest rate varies with the current level of market interest rates. Such accounts are also known as money market demand or deposit accounts.

MMAs are liquid and give you the ability to add and withdraw funds on a daily basis. Even though liquidity is high in MMAs, interest rates are variable and are generally higher than rates on savings accounts. Required minimum balances may be much higher than those required for savings accounts, from $500 to $1,000 depending on the account. MMAs are safe and are generally FDIC-insured. Other features of these accounts may include limited check-writing ability. There are generally no penalties for early withdrawal from an MMA, as long as your balance does not drop below the account’s minimum balance. Information on money market accounts and how to purchase them can be found in the *Wall Street Journal* and at various financial institutions and brokerage houses.

**Certificates of Deposit (CDs)**

Certificates of deposit pay a fixed rate of interest for keeping funds in your account for a fixed period of time. They are similar to savings accounts and time deposits. Interest rates are fixed for the life of the deposit, and the longer the term of the deposit, the higher the interest rate.

CDs are less liquid than other cash-management alternatives because the money must be deposited for a certain amount of time; however, with that reduction in liquidity comes a higher interest rate. The required minimum balance for a CD account is generally higher than it is for a savings or checking account. CDs are very safe and are generally FDIC-insured. CDs enforce penalties if you withdraw money before the end of the specified term. Information on CD rates and how to purchase CDs is available from the *Wall Street Journal* and various financial institutions.

**Money Market Mutual Funds (MMMFs)**

Money market mutual funds are not bank instruments; they are actually funds managed by mutual fund companies. These companies pool funds from many investors to buy a portfolio of
securities. Because they are working with pooled assets, mutual fund companies can usually purchase higher-yielding investments that give higher returns to investors. Investments can be either taxable securities or tax-advantaged securities, such as municipal bonds, which are federal tax free.

MMMFs are liquid—you can generally deposit and withdraw money every day. While the increased liquidity results in lower interest rates, rates are still competitive (the rates depend on the individual funds). Minimum balances for MMMFs are much higher than for checking or savings accounts and may exceed $3,000. While MMMFs are generally considered safe, they are not FDIC- or NCUA-insured. Other features of such accounts may include limited check-writing ability. MMMFs are bought by the share and carry an administrative fee. There are no penalties for early withdrawal. Information on money market mutual funds can be found at various brokers and at www.bankrate.com.

MMMFs may be either taxable or tax free depending on the type and location of the securities the MMMF invests in. If the MMMF invests only in government securities, the interest earned (but not the capital gains) is state tax-free. If the MMMF invests only in municipal securities, then the interest is federal tax-free. If the MMMF invests only in municipal securities from your state, the interest may be both federal and state tax-free.

**U.S. Treasury Bills**

Treasury bills (T-bills) are short-term notes of debt that are issued by the federal government. They can take from one to 12 months to mature, and investors do not receive explicit interest on these assets. T-bills are purchased at a discount, and when the bill matures, investors receive the full face value.

T-bills can be very liquid, depending on maturity. Even though they are liquid, interest rates are competitive with current market rates. As the maturity of the T-bill increases, its interest rate generally increases. The required minimum balance of $1,000 is high. T-bills are very safe assets, even though they are not guaranteed by the FDIC, because they are government debt. Other benefits to T-bills include their exemption from state and local income tax; also, since T-bills are purchased at a discount and do not yield explicit interest payments, you do not pay taxes on interest until the bill matures. There are penalties for early withdrawal. Information on T-bills and how to purchase them is available from the *Wall Street Journal*, [www.treasurydirect.gov](http://www.treasurydirect.gov), and various brokerage institutions.

**U.S. Series EE Bonds**

U.S. Series EE bonds are government savings bonds that are issued by the Treasury in small denominations (as small as $25); these bonds have variable interest rates. Bonds are purchased at face value, and when the bonds mature, principle and interest is paid. The interest rate paid on EE bonds is fixed for six months; interest rates are set biannually.
Series EE bonds are liquid in the sense that they can be cashed at any time after one year. Ideally, you should hold them for at least five years to ensure there will not be an interest penalty; after five years, these bonds can be cashed at any bank. Interest rates are competitive. Required minimum balances are low, and these bonds can be purchased in denominations from $25 to $10,000. Series EE bonds are very secure because they have an implicit government guarantee. Other features include interest being exempt from state and local income tax; interest may even be federal tax-free if the interest and principal are spent on eligible college expenses (mainly tuition and fees). One drawback to Series EE bonds is that there is a three-month interest penalty if you withdraw funds before the five-year term is over. Information on rates and how to purchase Series EE bonds can be found at www.savingbonds.gov. Investors can purchase savings bonds for up to $10,000 per year in electronic bonds and another $5,000 per year from their IRS tax refund. If your Modified Adjusted Gross Income (MAGI) is above specified limits in the year you cash the bonds, you cannot exclude the interest income from your income taxes for EE and I Savings bonds (see Table 1).

<table>
<thead>
<tr>
<th>Year</th>
<th>Filing Single</th>
<th>Married Filing Jointly</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>$69,950–84,950</td>
<td>$104,900–134,900</td>
</tr>
<tr>
<td>2010</td>
<td>$70,100–85,100</td>
<td>$105,100–135,100</td>
</tr>
<tr>
<td>2011</td>
<td>$71,100–86,100</td>
<td>$106,650–136,650</td>
</tr>
<tr>
<td>2012</td>
<td>$72,850–87,850</td>
<td>$109,250–139,250</td>
</tr>
<tr>
<td>2013</td>
<td>$74,700–89,700</td>
<td>$112,050–142,050</td>
</tr>
</tbody>
</table>

Your Modified Adjusted Gross Income is your adjusted gross income with certain items added back, such as foreign income, foreign-housing deductions, student-loan deductions, IRA contribution deductions, and deductions for higher-education costs.

**U.S. Series I Bonds**

U.S. Series I bonds are government savings bonds that are also issued by the Treasury in small denominations (as small as $25). Series I bonds have variable interest rates that are linked to inflation and a specified real rate of return.

Series I bonds, like Series EE bonds, are liquid in the sense that they can be cashed at any time. Ideally, you should hold them for at least five years to ensure there will be no interest penalty; after that they are very liquid and can be cashed at any bank. Interest rates are variable and change with inflation. Required minimum balances are low, and bonds can be purchased in denominations ranging from $25 to $10,000. Series I bonds are very secure because they have an implicit government guarantee. There is a three-month interest penalty if you cash these bonds before five years. Other features include interest being exempt from state and local income tax; interest may even be federal tax-free if the interest and principal are spent on eligible college expenses (mainly tuition and fees). Because interest is not paid until maturity, there are no taxes on interest until the bond is redeemed. Information on rates and how to purchase Series I bonds can be found at www.savingbonds.gov. Series I bonds have the same MAGI limits as Series EE bonds above (see Table 1).
Comparing Cash-Management Alternatives

When comparing cash-management alternatives, it is critical to understand and accurately compare the following five areas:

1. **Interest rates**: Certain cash-management assets are compounded annually, others are compounded quarterly, and still others are compounded daily. Use a consistent method of comparing interest rates when considering cash-management alternatives. Because of the Truth in Savings Act of 1993, financial institutions are required to report the rate of interest using the annual percentage yield (APY). Look for this yield when comparing alternatives. It includes the impact of different compounding periods. The APY = \((1 + \frac{APR}{\text{Periods}})^{\text{Periods}} - 1\).

2. **After-tax returns**: While certain assets may have lower returns, these same assets may be exempt from federal, state, and local taxes. Consider tax advantages and after-tax returns. The after-tax return equals your before-tax return (the reported APY) times one minus your marginal tax rate (the tax rate of each additional dollar of earnings).

   \[
   \text{After-Tax Return} = \text{Before-Tax Return} \times (1 - \text{Marginal Tax Rate})
   \]

   Your marginal tax rate equals your federal marginal tax rate plus your state marginal tax rate (if applicable) plus your local tax rate (if applicable).

   If any of the cash-management assets have tax advantages, meaning they are federal and/or state tax-free, calculate the equivalent taxable yield (ETY). The ETY is the yield you would have to make on an equivalent taxable asset to give you the same after-tax return as the tax-advantaged asset.

   To calculate the ETY, first calculate the after-tax return of the tax-advantaged asset. Second, divide that after-tax return by one minus your marginal tax rate (your marginal federal, state, and local tax rates).

   \[
   \text{ETY} = \frac{\text{After-Tax Return}}{(1 - \text{Marginal Tax Rate})}
   \]

   To gain a better understanding of after-tax returns and equivalent taxable yields, see **Learning Tool 26: After-Tax, ETY, and Other After-Inflation Returns** in the Learning Tools section of the website.

3. **Inflation**: Remember, it is not what you earn but what you keep after taxes and inflation that makes you wealthy. Calculating the return after inflation, or the “real return,” is important. The real return is calculated using the following equation:

   \[
   \text{Real Return} = \left(\frac{1 + \text{nominal return}}{1 + \text{inflation}}\right) - 1
   \]

   If inflation is a concern for you, there are inflation-linked bonds, such as U.S. Government Series I bonds and Treasury Inflation-Protected Securities (TIPS), that take changes in inflation into account to determine yields.
4. Safety: Some investors consider all deposits at financial institutions to be safe. However, some banks and other financial institutions have historically made decisions that are not consistent with proper fiscal responsibility, and some investor deposits have been lost. FDIC and NCUA insurance are available for up to $250,000 per depositor (not per account). If your assets are greater than $250,000 and you want more insurance, deposit your assets in multiple federally insured institutions.

Although MMMFs are not insured, they may be invested in a diversified portfolio of government bonds, which are guaranteed by the government. MMMFs may also be invested in short-term corporate bonds, which have very little risk. A certain degree of safety exists because of this broad diversification and because this debt is very short-term (often less than 90 days). While there may be some concern for safety with MMMFs, it is not generally a major concern.

5. Maturity and interest-rate adjustment periods: When considering cash-management alternatives, consider the maturity of the investment. Some of these assets require the investment to be held for a minimum amount of time, e.g., CDs and EE/I bonds. In addition, consider how often the interest rate could change and the potential impact of those rate changes on your financial situation.

In summary, your choice of cash-management assets depends on five areas. First, your goals and risk tolerance: What is the purpose for the money you are investing? Second, the type of asset preferred: Are you investing in CDs, MMAs, MMMFs, or savings bonds? Third, your tax situation: What is your marginal tax rate? Fourth, the location of the financial assets: If they are municipal securities, are they municipal bonds from your state or from another state, and is there a state income tax in your state? And fifth, your use of the funds from savings bonds: Will the principal and interest be used for tuition at a qualified school?

Know the Different Types of Financial Institutions and Understand How They Can Help You Meet Your Financial Goals

There are many different types of financial institutions that offer the various cash-management alternatives we have just discussed. The distinction is blurring between which services are offered by traditional banks and which are reserved for non-bank financial institutions.

There are two major types of financial institutions: banks (i.e., deposit-type financial institutions) and non-banks (i.e., non-deposit-type financial institutions). The choice of institution you use depends on which institution will best serve your needs and help you achieve your goals the fastest.

Deposit-type financial institutions (i.e. banks) mainly fall under four classifications: commercial banks, savings and loan associations, credit unions, and Internet banks.

- Commercial banks generally compete by offering the widest variety of services; however, they usually do not offer the highest interest rates on deposits or the lowest interest rates on loans.
Savings and loan associations have slightly different ownership arrangements than banks but are similar to commercial banks. Savings and loan associations may offer slightly higher rates on deposits and somewhat lower rates on loans than commercial banks.

Credit unions are similar to savings and loan associations, but they are not-for-profit organizations and are owned by their members. They can sometimes offer higher rates on savings accounts and lower rates on loans because they are not driven to provide a profit to shareholders.

Internet banks are electronic banks that do not have traditional brick-and-mortar branches. Because they have fewer branches, employees, and capital expenditures than traditional banks, they can generally pay higher interest rates on deposits and charge less for loans than traditional banks do.

Non-deposit-type financial institutions (i.e. non-banks) consist of two main kinds: mutual fund companies and brokerage firms.

Mutual fund companies have broken into the banking arena. With many mutual fund companies, you can now write checks against your mutual fund account. Brokerage firms have also gotten into the act. Many brokerage firms now issue credit cards and ATM cards, make loans, and allow you to write checks. Brokerage firms offer these and many other account features that were once reserved for traditional banks.

Both banks and non-banks offer online financial services, which allow you to access bank balances and other resources 24 hours a day. With the blurring of roles between deposit and non-deposit institutions, banks can now offer investment services, and non-banks can offer check-writing privileges, credit cards, and savings accounts.

Choosing a financial institution is a challenge. The key is to consider what you want to accomplish (your goals) and then to consider what the financial institution can provide. What do you look for in a financial institution? Your choices should ultimately and most importantly reflect your understanding of yourself and your investment needs. Consider these questions:

- Are you looking for low costs, low fees, and high returns on deposits?
- What services are important to you?
- Do you need loans, mortgages, or working capital for a small business?
- How important is safety for your deposits?
- Do you require government insurance? If so, know that this factor limits the types of institutions you can choose.
- What services does the financial institution provide? If all you require is a high return on your cash-management assets, then your choices are much broader.

The main goal of cash management is to give you sufficient liquidity to help you achieve your financial goals. Only you can determine which goals are most important to accomplish now. Please note that you do not need to limit yourself to just one financial institution to help you.
achieve your goals. You can use more than one financial institution to take advantage of each institution’s strengths.

**Choosing a Financial Institution**

In choosing a financial institution, consider the traditional three Cs of banking: costs, convenience, and consideration.

**Cost:** How expensive is it? What are the monthly fees? Minimum balances? Charges per check? Balance-dependent scaled fees? Interest rates received on deposits? Interest rates charged on loans?

**Convenience:** How convenient is it for you to work with the institution? What is the availability of branches and ATMs? Are they close to your home and work? Does the institution offer overdraft protection, safety deposit boxes, credit cards, etc.?

**Consideration:** Does the institution offer personalized financial advice and give attention to detail? How important is it that a bank officer remembers your name and is happy to work with you?

The options for choosing a financial institution are many and varied. It is critical that you understand your goals and then work with the institution—or institutions—that offer you the most benefits. Note that whichever institution or institutions you choose, it is your responsibility to make sure that they do what they say they will and that they do it correctly.

**Understand the Time Commitment Necessary to Effectively Manage Your Finances**

The authors of *The Millionaire Next Door* point out:

People who become wealthy allocate their time . . . in ways consistent with enhancing their net worth. [They] allocate nearly twice the number of hours per week to planning their financial investments as [those who do not become wealthy] do.²

If those who become wealthy allocate nearly twice as many hours per week to planning their financial investments as those who do not become wealthy, shouldn’t we, who are trying to become financially self-reliant, do the same?

We all have the same 24 hours in each day to spend however we see fit. It is important that you plan and spend sufficient time on your financial responsibilities each week to ensure you are moving toward your financial goals. Unless you are spending one or two hours per week on your financial responsibilities, such as your goals, budget, insurance, retirement, and investment framework, it may be difficult for you to reach your personal and financial goals.

Set aside time once a week to review and update your goals and review what you want to accomplish in life. Update your budget. How are you doing with maintaining your budget?
Balance your cash-management accounts and ensure that all charges and balances are correct by comparing them to your credit card and electronic fund transfer statements. Be alert to the possibility of human error and computer problems; these kinds of mistakes can happen quite often.

Use wisdom in your cash-management framework. Never deposit cash in an ATM; there is no way to confirm that deposit. If you do find mistakes in your statement, contact your financial institution quickly and correct the error. Write or call your institution within 60 days of receiving your statement, state the problem, and correct the error. If the problem cannot be resolved, write to the address below:

Board of Governors of the Federal Reserve System  
Division of Consumer and Community Affairs  
20th Street and Constitution Avenue, N.W., Stop 801  
Washington, D.C. 20551

Summary

Cash management refers to how you manage your cash and liquid assets. Liquid assets allow you to invest your money and earn an acceptable return while at the same time keeping your assets available to pay bills or cover emergencies. While liquid assets are low-risk and are great for emergency funds, their return is generally very low. The challenge of cash management is to balance the risk of lower returns with the need for liquidity.

Good cash management is important because it will help you earn more income on your liquid assets; in this way, cash management can help you achieve your personal goals. There are three main trade-offs regarding cash management. The first is the risk-return trade-off: higher liquidity means lower returns. The second is the spending-investment risk: cash on hand is easier to spend than other financial assets. The third trade-off is the return–time expended risk: since returns are smaller with existing liquid assets, the time you spend managing those assets should be much less than the time you spend managing other types of financial assets. In spite of these three trade-offs, you can still influence your portfolio in a positive and significant way by using your liquidity wisely.

Traditional cash-management alternatives include checking accounts and savings accounts. Less traditional, but still important, alternatives include money market deposit accounts, certificates of deposit, money market mutual funds, asset-management accounts, U.S. Treasury bills, U.S. Series EE bonds, and U.S. Series I bonds. While rates for each of these assets can change from day to day, you can find current rates at major financial Internet sites and in the pages of most financial newspapers, such as the Wall Street Journal.

When you are comparing cash-management alternatives, it is critical to accurately evaluate four areas. First, use a consistent method for comparing interest rates. Cash-management assets can be compounded annually, quarterly, or daily. Use a consistent method of comparing interest rates when considering cash-management alternatives.
Second, use a consistent method of comparing after-tax returns. While certain assets may have lower returns, these same assets are often exempt from state and local taxes, and they may be exempt from federal taxes if the assets are used for college tuition. Consider tax advantages and after-tax returns. If the assets have tax advantages, calculate the equivalent taxable yield; the taxable yield is the yield you would have to make on a taxable asset to give you the same after-tax return as the tax-advantaged asset.

Third, consider inflation. Remember, it is not what you earn but what you keep after taxes and inflation that makes you wealthy. Calculate the “real return” of each of your assets.

Fourth, consider safety. FDIC and NCUA insurance are available for amounts up to $250,000 per depositor (not per account).

We concluded by discussing different types of financial institutions that offer the various types of cash-management alternatives. The distinction is gradually blurring between which services are offered by traditional banks and which services are reserved for non-bank institutions.

There are two major types of financial institutions: banks (deposit-type financial institutions) and non-banks (non-deposit-type financial institutions). Which institution you use depends on which will serve your needs the best and which will help you achieve your goals the fastest.

Deposit-type financial institutions generally fit into four categories: commercial banks, savings and loan associations, credit unions, and the newer Internet banks. The two main types of non-bank financial institutions are mutual fund companies and brokerage firms.

**Assignments**

**Financial Plan Assignments**

Your assignment is to review your current cash-management framework. What interest rate(s) are you earning on your savings account(s)? What are you paying in fees and expenses on your savings account(s)?

What interest rate(s) are you earning on your checking account(s)? What are you paying in fees and expenses on your checking account(s)?

Which cash-management vehicles should you be using to help you get higher interest rates on savings or checking accounts and still maintain adequate liquidity to meet your needs for cash? Are there less-traditional alternatives, such as Internet banks, that can give you a higher return with the same amount of liquidity and safety?

**Learning Tools**

The following Learning Tool may be helpful as you prepare your Personal Financial Plan:
26. After-Tax, ETY, and After-Inflation Returns

This document is an example of a spreadsheet you can use to calculate your after-tax returns, equivalent taxable yields on tax-advantaged assets, and after-inflation returns on all assets.

Review Materials

Review Questions

1. What are the three main trade-offs regarding cash management?
2. What is the key to using liquidity wisely? Why?
3. What is an emergency fund? Why should you have one? How much should you have in your emergency fund?
4. What are six account characteristics that can be used to analyze cash-management alternatives?
5. What are the four key areas used to compare cash-management alternatives?

Case Studies

Case Study 1

Data
Bill is an investor in the 15-percent federal marginal tax bracket and 7-percent state tax bracket. Suzie is an investor in the 35-percent federal tax bracket and 7-percent state tax bracket. They are each considering purchasing one of the following bonds for their investment portfolios:
1. A 6.5-percent corporate bond (all taxable)
2. A 4.75-percent municipal bond (federal tax free)
3. A 5.0-percent treasury bond (state tax free)

Calculations
Calculate the after-tax returns for each of the above bonds for both Bill and Suzie. Which bonds should Bill and Suzie purchase and why?

Case Study 1 Answers

Calculations
Bill (Taxable return * (1 – tax rate) = after-tax return)
CB: 6.50% * (1 – (.15 + .07)) = 5.07%
MB: 4.75% * (1 – .07) = 4.42%
TB: 5.00% * (1 – .15) = 4.25%
Suzie
CB: 6.5% * (1 – (.35 + .07)) = 3.77%
MB: 4.75% * (1 – .07) = 4.42%
TB: 5.0% (1 – .35) = 3.25%
Recommendations

The corporate bond is the best for Bill. The municipal bond is the best for Suzie.

Case Study 2
Data

Kaili and Taylor are in the 25-percent federal and 7-percent state tax bracket. They have a $3,000 wedding gift that they will invest either for school tuition or for a vacation.

Calculations
If they invest the $3,000 in a U.S. Series I bond that earns 4.8 percent, what is the equivalent taxable yield (ETY) if the principal and interest are
A. used to pay for law school tuition?
B. used to pay for a family vacation?

Case Study 2 Answers
Calculations
A. If Kaili and Taylor use the principal and interest for tuition, the bond is both federal and state tax exempt. The formula is
Return after tax = return before tax * (1 – tax rate)
Since this asset is federal and state tax free, the equivalent yield on a taxable bond would be the tax-free return divided by 1 minus the tax rate, which includes both federal and state taxes (mathematically, you divide both sides of the equation by (1 – tax rate)).
4.8% = x * (1 – (.25+.07)) or x = 4.8% / .68
x = 7.06%

B. If Kaili and Taylor use the principal and interest for a family vacation, it is only state tax-free.
The after-tax rate yield is
After-tax rate = 4.8% * (1 - .25) or 3.6%
The equivalent taxable yield is
ETY = 3.6% / (1 – (.25 + .07))
x = 5.29%

Case Study 3
Data

Your buddy Paul asks you about real returns. After you show him the correct method for calculating real returns, he wants to know what his real return is on his money market account. He shows you his brokerage statement, where he is earning a 4.5-percent yield. He also estimates that inflation will be 3.5 percent this year. Paul is in the 35-percent federal and 7-percent state marginal tax brackets.

Calculations
What is his after-tax, after-inflation return?
Recommendations

What are the implications of this result for cash-management decisions?

Case Study 3 Answers

Calculations

\[
\text{After-tax return} = \text{before-tax return} \times (1 - (\text{federal} + \text{state marginal tax rate}))
\]

\[
4.5\% \times (1 - (.35 + .07)) = \text{The after-tax return is 2.61}\%
\]

\[
\text{Real Return} = \left[\left(1 + \text{after-tax return}\right) / (1 + \text{inflation})\right] - 1
\]

The after-tax, after-inflation return is: \((1.0261/1.035) - 1 = -.86\%\)

Note: You must take out taxes before you take out the impact of inflation.

Implications

- It is very difficult to do much more than keep up with taxes and inflation with liquid assets.
- Only the amount needed to meet immediate emergency needs and short-term goals should be invested in this account.

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5. Understanding and Managing Credit

Introduction

Credit is a wonderful tool that has allowed many people to achieve goals they might not have otherwise been able to achieve, such as buying a home or paying for higher education. However, credit has also been the downfall of many people who have not used it wisely. Understanding both the positive and negative aspects of credit will help you be wise as you pursue your financial goals.

The credit card can become a very destructive financial instrument if not carefully watched and controlled. If credit card debt gets out of control, it can cause not only financial troubles but personal heartache as well. Gordon B. Hinckley said, “Debt can be a terrible thing. It is so easy to incur and so difficult to repay. Borrowed money is had only at a price, and that price can be burdensome.”

Objectives

This chapter focuses on the following four objectives to help you better understand credit reports and credit cards:

1. Learn about credit bureaus, credit reports, and credit scoring
2. Identify appropriate uses for credit cards and explain how they can help you achieve your financial goals
3. Learn how credit cards work and describe the costs involved
4. Learn how to manage credit cards and open credit

Learn About Credit Bureaus, Credit Reports, and Credit Scores

Credit bureaus are private companies that collect and report information from creditors, public records, and various institutions. There are over 1,000 different credit bureaus; the three major ones are Equifax, Experian, and TransUnion.

Credit reports are files of information that credit bureaus compile about specific individuals. Most individuals who have any type of credit (credit cards, checking accounts, loans, etc.) have a credit report.

The information on your credit report is very detailed. It includes personal demographics, such as your age, social security number, previous addresses, employment history, and criminal convictions. The report also includes information about your credit history, including a list of any inquiries you have made about your credit in the last two years. Factors that determine your
Chapter 5. Understanding and Managing Credit

credit worthiness include your annual income, how long you have lived at your current residence, how long you have been employed at your current job, and how many bank accounts and credit cards you have. Other factors that determine your credit worthiness include your age, your employment history, and your credit history.

Although the information gathered by the credit bureaus is about you, it may not always be correct. It is estimated that 70 percent of Americans have at least one negative remark on their credit reports, and almost half of all credit reports contain incorrect or obsolete information.

You have specific rights related to your credit reports. If you are ever denied a line of credit, you can request a free copy of your credit report from each of the credit bureaus. If you would like to review your credit report, you can request a free copy once a year from each of the three major credit reporting agencies by going to www.annualcreditreport.com and filling out several forms.

You should review your credit report from each credit bureau once a year to make sure there are no mistakes on it. Even simple mistakes can result in a lower credit score, which may prevent you from getting a mortgage or a consumer loan; these mistakes may even increase the cost of your auto insurance.

When you are reviewing your credit report, look for open lines of credit that you were not aware of and other indications that someone may be committing fraud by using your information. If you think there are mistakes on your credit report, you need to have them investigated. If an investigation does not clear up a mark on your credit report, but you still disagree with it, you can add a personal statement of up to 100 words to your credit report explaining what happened with a specific creditor. When you apply for credit, potential lenders can see your explanation of what happened and consider it when they make their lending decisions.

Credit evaluation is the process potential creditors use to determine whether or not an individual deserves to be given credit. This evaluation is based on an analysis of specific financial information from various sources.

A credit score is the result of that credit evaluation. Financial institutions developed credit scores as a way of determining which borrowers are most likely to repay their loans. While for students a GPA is based on grades, for borrowers a credit score is based on factors such as credit history, length of credit, repayment history, and types of credit owed.

Your credit score takes into account specific factors surrounding your debt and debt habits. You are assigned a single score that lending institutions use to base their decisions on whether you qualify for credit. Your credit score also determines what interest rate you will pay on the credit an institution offers you. Generally, the higher your credit score, the lower the interest rate you will have to pay.

One of the most important investments that may be affected by your credit score is a loan for a new home purchase. Your credit score can have a significant impact on whether or not you get this type of loan: nearly 75 percent of all mortgage loans are sorted according to credit scores.
Your credit score may also affect the cost of your insurance. For these and many other reasons, understanding credit and maintaining a high credit score are important to your overall financial health.

Research by E-Loan showed the following statistics on how credit scores affected what interest rate consumers paid on loans (see Table 1).

Table 1. Credit Scores and Interest Rates Paid\textsuperscript{2}

<table>
<thead>
<tr>
<th>Credit score range</th>
<th>Interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Above 760</td>
<td>3.27 percent</td>
</tr>
<tr>
<td>From 700 to 759</td>
<td>3.49 percent</td>
</tr>
<tr>
<td>From 680 to 699</td>
<td>3.67 percent</td>
</tr>
<tr>
<td>From 660 to 679</td>
<td>3.88 percent</td>
</tr>
<tr>
<td>From 640 to 659</td>
<td>4.31 percent</td>
</tr>
<tr>
<td>From 620 to 639</td>
<td>4.86 percent</td>
</tr>
</tbody>
</table>

For a $300,000, 30-year loan with monthly payments, the difference in how much someone with a credit score of 760 (3.27 percent) paid in interest compared with how much someone with a credit score between 620 and 639 (4.86 percent) paid was significant; there was an increase in interest payments over the life of the loan of $99,275 on a $300,000 loan. There is a direct correlation between your credit score and the interest rate you pay.

What Is a FICO Score?

The most common type of credit score is the FICO score, which was developed by Fair, Isaac, and Company of San Rafael, California. Fair, Isaac, and Company is not the only credit scoring company, but lending institutions use FICO scores more often than the credit scores provided by other companies. Lenders usually base your interest rate on your FICO score, which can range from 300 to 850. Generally, the higher your FICO score, the lower the interest rate lenders will charge you.

Before 2001, consumers were not allowed to see their credit scores. However, in March 2001, new legislation allowed the public to access their credit information for a price. You can now purchase a copy of your FICO credit score from www.myfico.com or purchase credit scores from other credit scoring and reporting companies, such as Experian, TransUnion, and Equifax. I generally recommend purchasing a FICO credit score as these are most used in the industry. Please also note that promotional codes for MyFICO are generally available on the Internet (search “MyFICO promotional code”). Getting a copy of your credit report and credit score does not affect your credit score.

How Is Your Credit Score Determined?

There are a number of different institutions that calculate credit scores. Since the FICO score is the most common, this chapter will discuss how your credit score is determined based on the FICO scoring methodology.
About 35 percent of your credit score is based on your payment record. This is why it is important to pay your bills on time. Do what the scriptures and our leaders have counseled: do not get into debt in the first place, if possible. If you are in debt, make timely payments, and get out of debt as soon as you can.

Another 30 percent of your credit score is based on the total amount you owe as a percent of your available credit or credit limit. Generally, try to keep your usage of credit below about 15 percent of your available credit limit. Keep your balances low, especially on revolving debt. If you are hoping to get a mortgage loan in the future, it may be wise to pay off your revolving credit every week so that the amount you owe is a small percentage of your total available credit.

Around 15 percent of your credit score is based on the length of your credit history. You should keep your oldest accounts open whenever possible to show you have learned to manage credit over a longer period of time. However, you do not want to have too many accounts open at one time.

Approximately 10 percent of your credit score is based on your application history. Do not apply for credit too often. If you are applying for a new credit card every quarter, the question arises as to what you are doing with your available credit. For most people, one to three credit cards is generally sufficient. Realize that each time you apply for credit it is noted on your credit report.

Finally, 10 percent of your credit score is based on a credit mix. You do not want to have too many of the same kind of card. Having a Sear’s, a Nordstrom’s, and a Kohl’s card may actually bring down your credit score because they are all similar stores. Be cautious of retail stores that offer a 10- to 20-percent discount on your first purchase if you apply for their store credit card. These types of cards can have negative effects on your credit score.

**What Should You Do Regarding Your Credit Score?**

Just as you manage your assets carefully, you should manage your liabilities carefully. You must take an active role in managing your credit score. Ideally, you should review your FICO score every two years and review your credit reports annually; do these things more often if you are planning to take out a loan for a house within the next 12 months. By planning ahead, you can resolve any inaccuracies on your credit report before you apply for a loan; planning ahead can help you get the highest credit score—and the lowest interest rate—possible.

**Identify Appropriate Uses for Credit Cards and Explain How They Can Help You Achieve Your Financial Goals**

There are five main benefits for using credit cards:

1. **Emergencies:** Credit cards can be useful when you don’t have cash on hand and need to pay for something immediately, such as an auto repair or an insurance co-payment.

2. **Reservations:** Credit cards can be used to guarantee hotel rooms, rental cars, and other rental items. This is an important use, especially if you travel.
3. **Convenience:** With a credit card, you can buy things over the phone or on the Internet. Credit cards make purchasing things very easy. They also provide you with a record of everything you spend, an important bookkeeping benefit.

4. **Cash flow and timing:** If something is on sale, and you know you have the cash coming in a week, you can actually buy the item before you pay for it. In this way, you can take advantage of sales (but remember, you do not save money by spending).

5. **Free services:** Often, credit cards offer rewards, such as extended warranties, travel insurance, airplane miles, gasoline rebates, and cash rebates—all of which can reduce the overall cost of some items.

While there are benefits to using credit cards, there are drawbacks as well. Credit cards must be used wisely to avoid problems. The following is a list of some of the problems associated with using credit cards:

**Increased spending:** People don’t take as much time to think about how much they’re spending when they use a credit card. Research has shown that, on average, people spend 30 percent more with a credit card than they do with cash.

**Losing track of spending:** It’s easy to lose track of what you spend with your credit card. It requires discipline to track the charges you make.

**Interest and other costs:** Interest charges can range anywhere from 8 percent to 25 percent. In addition to these interest charges, you must take into account compounding periods, annual fees, and other miscellaneous fees, such as cash advance fees and balance transfer fees. Often, the costs of using credit cards are double or triple the costs of using other types of loans.

**Obligations on future income:** Most importantly, when you use credit cards, you put obligations on future income. As you take on more debt, you not only obligate future income, but you also limit future flexibility should emergencies arise.

**Using a Credit Card Effectively**

The following are some important keys to using your credit card effectively:

1. **Know your personal and family goals.** What do you want to accomplish individually and as a family? What do you want to accomplish financially? A leading financial publication recently reported that the average baby boomer will pay $1,200 in interest annually. That is a lot of money. Instead of paying interest, why not use that money to attain your financial goals?

2. **Spend money only on things planned for in your budget.** If you understand your goals, and if your budget is consistent with your goals, you will buy only things you have planned for in your budget. If expenses you hadn’t planned for arise and you decide they...
are necessary expenses, you will have to go back and revise your budget to make them work.

3. **Do not go into debt.** It is wise to not go into debt except for a home or an education. Follow this advice and avoid credit card debt whenever possible.

4. **Use wisdom in deciding what to buy.** Use wisdom in your expenditures. Learn to get away from the “buy now, pay later” mentality, and adopt the “save now, buy later” mentality.

### Learn How Credit Cards Work and Describe the Costs Involved

Companies issue credit cards to earn money. Annual fees can be anywhere from $0 (no fee) to $300 a year. Interest rates are high: some are as high as 25 percent before compounding! Balance transfer fees can also be very high—they can start at 3 percent and increase with each transfer. Cash advance fees usually start at 4 percent and can go higher. Often, these fees can’t be paid back until the original, less costly debt is paid back; this results in even higher costs to you. Penalty rates sometimes exceed 25 percent, and late fees are also high. All of these charges are added on top of a 1.5 to 5 percent charge to merchants.

### How Credit Cards Work

A credit card is one type of open credit. Open credit is an agreement you make with a financial institution (in this case, a credit card company) that allows you to borrow money up to a specific limit; it is expected that you will pay back the loan at a specific interest rate and pay other attached fees as well. Many factors determine how much open credit will cost you annually: the balance owed, the interest rate, the balance calculation method, the cash advance costs, the annual fee, and the additional penalty fees.

By understanding how open credit works, you can avoid the pitfalls this type of credit can present. There are several key factors you should understand about open credit before you apply for this type of loan:

**Interest rate:** Credit card companies state the interest rate as an annual percentage rate, or APR. This is the true, simple interest rate that is charged over the life of the loan. However, the APR does not take into account compounding periods or the time value of money (see Chapter 9—*Time Value of Money*). You should also watch out for teaser rates. Teaser rates are introductory rates used to attract new customers (some are as low as 2.9 percent) but these rates change after a specified period of time. Don’t be fooled—read the fine print.

**Compounding period:** The compounding period is how often interest is charged to your account. Most credit card companies compound interest daily. It’s interesting to note that when you save money, interest is compounded monthly, but when you borrow money, interest is compounded daily. Any time you borrow money, remember that you are paying interest, not earning it.
Balance calculation methods: You should understand that credit card companies use three main balance calculation methods: average daily balance, previous balance, and adjusted balance. The most commonly used method of calculating your balance is the average daily balance. This method adds up your average daily balances for each day during the month, divides the total by the number of days in the month, and multiplies the result by your monthly interest rate (your APR divided by 12). The previous balance method is the most expensive method. This method takes the previous balance you owed last month and multiplies it by your monthly interest rate. The last method, the adjusted balance method, is the least expensive. This method takes your previous balance, subtracts your payments, and multiplies the total by your monthly interest rate.

Cash advances: Avoid using cash advances. Cash advances are an extremely expensive way to borrow money. Interest begins to accrue as soon as you get a cash advance because they are not considered normal credit card charges. Generally, the interest rate charged on cash advances is higher than the interest rate charged on purchases. In addition, there is usually a cash advance fee of between two and four percent of the cash amount advanced. Moreover, some cards require you to pay the purchase balance before you can pay the cash advance balance so that the credit card company earns the higher interest rate for a longer period of time.

Grace period: A grace period, or period over which you do not pay interest on new purchases, normally lasts from 20 to 25 days. The grace period excludes cash advances and often doesn’t apply if you carry over a balance from a previous month. If you do not owe a balance for the previous month, a grace period means that you could avoid paying for a purchase for nearly two months. However, you need to watch out because not all credit cards offer a grace period.

Credit card philosophy: Before you apply for open credit, you should determine your personal credit card philosophy. What kind of credit card user will you be? There are three main types of credit card users: credit users, convenience users, and combined convenience and credit users. If you use your credit card to borrow money you don’t have, you are a credit user. Credit cards are one of the most expensive ways to borrow. Credit users typically carry a balance from month to month. If you are a credit user (it is not a good idea to be one), look for a card with a low APR.

If you use your credit card only because it’s convenient, you are a convenience user. Convenience users generally pay off their credit card balance each month. If you are a convenience user, look for credit cards that offer low annual fees, long interest-free grace periods, and free benefits.

Combined convenience and credit users need to balance the interest rate and the annual fee to obtain the lowest overall cost for the card. Find the card that best matches your needs.

Learn How to Manage Credit Cards and Open Credit

Open credit can be either good or bad, depending on how you use it. There are five keys to managing your open credit:
Chapter 5. Understanding and Managing Credit

1. Reduce Your Balance

If you have a balance, commit to reducing it each month. Do not take on any additional debt. You need to set a goal to reduce your balance and then just do it. Commit to remaining debt-free.

2. Protect Yourself against Fraud

You should save your credit card receipts. At the end of the month, compare your receipts to your statement. Once you have done this, you can destroy the receipts. Use caution when giving out your credit card number, especially over the phone. In addition to these precautions, be aware of where your cards are at all times. Never leave a store without your credit card.

If your credit cards are lost or stolen, there are a number of things you must do, and you must do them quickly. First, you should call your credit card company immediately. Make sure you have a photocopy all of your credit cards, front and back, and keep the toll-free numbers for your credit card companies handy so you can report any loss or theft. Put your credit card information in a safe place.

Second, you should immediately file a police report in the jurisdiction of the loss. This shows the credit card company that you are serious, that you are diligent, and that you are trying to find your credit card.

Third, you should call the three national credit-reporting organizations and the Social Security Administration to place a fraud alert on your name and social security number. The phone numbers for all four organizations are listed below:

- Equifax: 800-525-6285
- Experian: 888-397-3742
- TransUnion: 800-680-7289
- Social Security Administration fraud line: 800-269-0271

3. Be Aware of Signs of Trouble in Credit Card Spending

Consider the following questions:

- Do you make only the minimum payment each month?
- Have you reached your credit limit on any of your cards?
- When you dine with friends, do you pay the entire bill on your credit card and then have your friends reimburse you with cash?
- Do you wait for your monthly bill to determine how much you have charged?
- Do you get cash advances because you do not have enough in your checking account to pay bills or other expenses?
- Have you been turned down for credit or had a card canceled by a credit card company?
- Have you withdrawn money from savings to pay off credit card bills?
• Do you think it is too much trouble to figure out how much of your credit card bill is interest?
• Does your stomach start churning when you get your credit card bill?

If you answered “yes” to any of these questions, you may be having some trouble managing your credit card spending.

4. Control Your Spending

Part of controlling your spending is committing to always live on less than you earn. If you have problems doing that, cut up your credit cards. If nothing else works, use the envelope method of budgeting. The envelope method involves placing money for each budget category in an envelope. When the cash in the envelope for a particular budget category is gone, you have nothing more to spend in that category.

5. Opt Out

One final option is to “opt out.” Do you want to stop receiving credit card applications in the mail? There is a national credit opt-out number you can call to take your name off the mailing lists of all four major credit-reporting agencies. Dial 1-888-567-8688 (1-888-5OPTOUT). You will be asked for your home telephone number, name, and social security number. You will then be sent a form to fill out and sign. After doing this, you will have much less junk mail. You can also opt out on the Internet by going to www.optoutprescreen.com. After you fill out the information on the site, you will be immediately removed from the mailing list for credit card applications for five years.

Opting out is easy and painless and can also help eliminate some types of credit card and identity fraud.

Summary

We have discussed credit evaluations, credit reports, and credit scores. Understanding how these matters impact you is critical, especially if you are looking to buy a house. Your credit score not only influences how much you will pay for a mortgage (or other types of credit) but it also influences your insurance costs.

There are appropriate uses for credit cards, and they can be useful in helping you attain your personal goals. Credit cards can be used for emergencies, reservations, convenience, cash flow, and free services.

There are several drawbacks to having credit cards. When you have credit cards, you are more likely to spend more, lose track of spending, pay higher interest rates and fees, and obligate future income. You need to be very careful if you use credit cards.
Before you apply for a credit card, consider the interest cost (or APR), compounding period, balance calculation method, costs for cash advances, and grace period. Depending on the reasons behind why you use credit cards, you are either a credit user, one who uses the card for borrowing; a convenience user, one who uses the card only for convenience; or both a credit and a convenience user.

Open credit can be either good or bad, depending on how you use it. The five keys to managing your open credit are

1. Reduce your balance.
2. Protect yourself against fraud.
3. Beware of trouble signs in credit card spending.
4. Control your spending.
5. Opt out.

Understanding credit and using it wisely are important parts of the modern financial world.

Assignments

Financial Plan Assignments

Your assignment is to evaluate how you are doing in managing credit. Since credit evaluation and credit scoring are important tools in the acquisition of a home and other important purchases, it is important that you understand where you stand.

Your first assignment is to get a copy of your credit report. If you are from the United States, you can, by law, obtain one free copy of your credit report each year from one of the major credit report suppliers (Experian, TransUnion, or Equifax). Go to www.annualcreditreport.com and supply the necessary information. You will select one of the major providers and input the necessary identification information, and the credit reporting agency will provide you a copy of your credit report online. You can also go to www.myfico.com; for about $15, you can get both a copy of your credit report (from your choice of supplier) and your FICO credit score.

Once you have your credit report, read it thoroughly and ensure it is accurate. If there are problems, follow the process we discussed to improve your score and remove inaccuracies from your credit reports.

Next, review your credit score. Read through your credit score report in detail. Write down the things you can do to improve your credit score and work on them.

Learning Tools

The following Learning Tools may be helpful as you prepare your Personal Financial Plan:

18. Credit Card Repayment Spreadsheet
This Excel spreadsheet helps you determine how long it will take you to pay off a specific credit card or loan based on the balance owed, annual percentage rate, compounding periods, and payments per month.

9. Debt Amortization and Prepayment Spreadsheet

This Excel spreadsheet is a debt amortization and prepayment schedule to help you reduce and eliminate your debt.

20. Debt Elimination Schedule with Accelerator

This spreadsheet allows you to input your different debts and interest rates. It then prioritizes that debt based on interest rates and creates a repayment plan based on the minimum payments due each month. This repayment plan is consistent with Marvin J. Ashton’s plan in the article “One for the Money.” This spreadsheet also allows you to include an accelerator amount and an amount in addition to your normal monthly payments; you will be able to see how long it will take you to pay off your debt.

Review Materials

Review Questions

1. What is the difference between a credit evaluation and a credit report?
2. How can you obtain one free credit report per year from each of the three credit bureaus (Equifax, TransUnion, and Experian)?
3. What should you do if you find an error on your credit report?
4. What are the benefits of having and maintaining a high credit score?
5. What are the five most important factors in determining your credit score?

Case Studies

Case Study 1

Data
Steve and Adrianna Tanner recently graduated from college and started their first jobs. Based on their combined salary of $90,000, the bank pre-approved them for a home loan, and they found the perfect house. However, when they went in to finalize the loan, they were told they did not qualify for the loan because of their low credit scores.

Application
A. What didn’t this couple do?
B. What should they have done?
C. What can they do to remedy the situation?
Case Study 1 Answers

A. Steve and Adrian Tanner did not determine their credit score before applying for a loan. Do not leave things to chance! If you know your credit score, you may be able to get a lower rate for your loan.

B. They should have reviewed their credit reports and tried to resolve any problem areas before applying for a loan. They also should have gotten their credit score to see how they were perceived by the financial community.

C. They can get their annual credit report free from each of the three agencies we discussed, and they can pay to get their credit score. They should then work to improve their credit score so they can get the lowest rate possible for a loan.

Case Study 2

Data
Steve carried an average daily balance of $600 this month. His balance last month was $1,000, and he made a $900 payment on the 15th of this month.

Calculations
Calculate the monthly interest charges for credit card accounts that charge interest rates of 10 percent, 16 percent, 18 percent, and 24 percent.

Fill in the following chart:

<table>
<thead>
<tr>
<th></th>
<th>10%</th>
<th>16%</th>
<th>18%</th>
<th>24%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average daily balance</td>
<td>$5.00</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Application
Since the average daily balance is the most commonly used method of calculating balance, how important is it to get a low interest rate?

Case Study 2 Answers

Calculations
The formula for calculating your finance charge is your average daily balance multiplied by the interest rate divided by 12 months.

<table>
<thead>
<tr>
<th></th>
<th>10%</th>
<th>16%</th>
<th>18%</th>
<th>24%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average daily balance</td>
<td>$5.00</td>
<td>$8.00</td>
<td>$9.00</td>
<td>$12.00</td>
</tr>
</tbody>
</table>

Application
If you use credit cards to finance spending (which is not recommended), it is important that you get a low interest rate on your card.
Case Study 3

Data
Bill was reading about the importance of keeping a high credit score and got his FICO score of 690. He heard a rumor that to improve his FICO score, he needed to reduce the number of cards in his name. Bill canceled three of his five credit/bank cards that he had not used in a long time. The next time he got his FICO score he discovered it had dropped by 40 points.

Analysis
A. List three possible reasons why his score may have dropped.
   B. What should he have done to make sure the canceled cards helped, and not hurt, his score?
   C. What might he do to improve his score?

Case Study 3 Answers

A. There are three possible reasons his score may have dropped:

1. **History**: One of the cards he canceled had the longest history. His score may have dropped as his time with credit was lessened due to the dropped card.

2. **Available credit**: Each of the canceled cards had a large amount of available credit. When these were canceled, they decreased his total available credit and increased his percentage usage each month, resulting in a lower score.

3. **Mix**: Perhaps the cards canceled resulted in a mix of credit that was biased toward one type of card. This may have lowered his score.

B. He should have done the following to make sure his score did not drop:

1. **History**: He should have made sure the cards he canceled did not have the longest credit history.

2. **Limit**: Before dropping the cards, he should have gone to his existing credit/bank card companies and requested an increase in credit limit, at least to match the amount he had previously. If they would not increase the limit, he should have kept the old cards.

3. **Mix**: Even though the cards may not have been used, if they had given a better mix, it may have been wise to keep them. He should have avoided having too many of the same types of cards.

C. The following are things he might do to improve his credit score:
1. **Payment record:** Tighten his budget and save 20 percent of his income. Pay bills on time and don’t miss!

2. **Amount owed:** Use that 20 percent and any additional money to pay down debt (after he has started his emergency fund). This will reduce his amount owed and his usage of available balances.

3. **Limits:** Call his credit card companies and request an increase in credit limits. This will help his use of available balances.

4. **Credit history:** Ask his parents to include him on one of their credit cards (I am not sure I would do this). This will increase his credit history (this is called piggybacking, and it works only for families, not individuals).

5. **Application history:** Do not apply for new cards. Generally, I recommend between two to four cards for most individuals. Do not get new cards just for store credit.

6. **Credit mix:** Do not apply for too many of the same type of cards.

**Case Study 4**

**Data**

Bethany, a BYU student, was reading about the importance of having a high credit score. She went to [www.annualreport.com](http://www.annualreport.com) but found she has no credit history. She pays her bills on time, has a checking account, and has a debit card.

**Questions**

A. Why might she not have a credit report?
B. What can she do to improve her credit history?
C. Does a debit card help build credit?
D. If banks will not allow her to get a credit card, what could she do?
E. How could she get a secured credit card?

**Case Study 4 Answers**

A. She may not have credit history because she has not had much credit. Even though she pays her bills on time, the bills may be in other students’ names. She may also be an international student without a social security number.
B. She could try to get a credit card. This would be helpful to her in improving her credit history.
C. A debit card does not help build credit.
D. If she cannot get a credit card, she should (carefully) look into a secured credit card. If she can find one with low fees, she will put money into the card and can charge up to
the amount of money on the card. Credit reporting agencies cannot tell the difference between a credit card and a secure credit card.

E. She should check with her bank or [www.bankrate.com](http://www.bankrate.com) for a card that does not charge an application or insurance fee and that has a low annual fee.

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1 “Thou Shalt Not Covet,” *Ensign*, Mar. 1990, 4
2 [http://myfico.com](http://myfico.com), 2 May 2012
Introduction

For many years, inspired religious leaders have urged their followers to get out of debt and live within their means. Gordon B. Hinckley spoke directly to members of the Church of Jesus Christ of Latter-day Saints in the October 1998 conference when he said:

I am suggesting that the time has come to get our houses in order. . . . I am troubled by the huge consumer installment debt which hangs over the people of the nation, including our own people. I recognize that it may be necessary to borrow for a home, of course. But let us buy a home that we can afford and thus ease the payments which will constantly hang over our heads without mercy or respite for as long as 30 years. . . . I urge you to look to the condition of your finances. I urge you to be modest in your expenditures; discipline yourselves in your purchases to avoid debt to the extent possible. Pay off debt as quickly as you can, and free yourselves from bondage.¹

As Gordon B. Hinckley points out, excessive debt is one of the financial problems that many people struggle with today. This chapter aims to explain exactly what consumer debt is. This chapter also offers tips to help you better manage consumer debt throughout your life.

Objectives

When you have completed this chapter, you should be able to do the following:

1. Understand how consumer loans can keep you from achieving your goals
2. Explain the characteristics and costs of consumer loans
3. Explain the characteristics and costs of mortgage loans
4. Understand how to select the least expensive sources for consumer loans and how to reduce the costs of borrowing

Understand How Consumer Loans Can Keep You from Achieving Your Goals

Consumer loans are loans you obtain to pay for items that are fairly expensive and that you usually don’t need (at least not urgently). Such items include electronics, automobiles, furniture, and recreational vehicles. Consumer loans are very expensive and should rarely be used. They encourage you to buy now rather than to save for the future. Committing future earnings to today’s consumption may keep you from achieving more important long-term personal goals. Consumer loans also reduce the amount of money you can save for your goals because they require you to pay interest with money you might otherwise have saved and invested. Most importantly, loans are almost always unnecessary unless their purpose is to pay for an education or a home.
When should you obtain a consumer loan? The following are a few questions to ask yourself if you are thinking of borrowing:

1. Do I really need to make this purchase? Is this a need or a want? Separate these two categories.
2. Is this item in your budget and/or your financial plan? Most items should be saved for, not borrowed for.
3. Can I pay for this item without borrowing? What is the after-tax cost of borrowing versus the after-tax cost of using savings and losing your return on those savings? Compare these two alternatives.
4. What is the total cost of this loan, including interest costs, fees, and its impact on your other goals? Can you maintain sufficient liquidity and still achieve your other goals? Choose wisely.
5. Will this purchase bring you closer to your personal goals or take you further away from them? If the purchase brings you closer to your goals, including your goal of obedience to God’s commandments (including the commandment to get out of debt), make the purchase. If the purchase takes you further away from your goals, don’t make it.

If you answer these questions honestly, it will be much easier to determine whether you should take out a consumer loan or not.

**Explain the Characteristics and Costs of Consumer Loans**

It is important to understand that different consumer loans have different characteristics—there isn’t just one type of consumer loan. Some of the different types of loans, which we will compare and discuss in the following paragraphs, include single-payment and installment loans, secured and unsecured loans, variable-rate and fixed-rate loans, and convertible loans. The following is a list of these different types of consumer loans and their characteristics:

**Single-payment loans** are also known as balloon loans. Normally, these loans are used for short-term lending of one year or less. They may also be used to temporarily finance a purchase until permanent, long-term financing can be arranged; this is why these loans are sometimes called bridge loans or interim loans. This type of loan is repaid in one lump sum, including interest, at the end of the specified term—for example, at the end of one year.

Lending institutions calculate interest on a single-payment loan using the simple-interest method. With the simple-interest method, the principal and interest are due when the loan matures. Simple interest is equal to your average amount borrowed multiplied by your interest rate multiplied by the time (in years) that you hold the loan. Your average amount borrowed for a single payment loan is the same as your principal. If there are no fees, your APR and your simple interest rate are the same. The APR formula is:

$$\text{APR} = \left( \frac{\text{Interest payments} + \text{fees}}{\text{number of years}} \right) / \text{Average amount borrowed}$$
Suppose you take out a $1,000 loan for one year for 12 percent. Assume you pay fees of $20 for a credit check and $20 for a processing fee. Your interest rate is 12 percent. However, your APR = [($120 in interest + $40 in fees) / 1 year] / 1,000 (your average amount borrowed) = 16 percent.

Now suppose this loan was for two years. Would your APR be different? The calculation would be:

\[
\text{APR} = \frac{($240 \text{ in interest} + $40 \text{ in fees}) / 2 \text{ years}}{1,000} = 14 \text{ percent.}
\]

The APR is lower with a two-year loan because you are allocating that $40 in fees between two years instead of only one.

**Installment loans** are loans that are repaid at regular intervals—for example, every month. Each payment includes part of the principal and some interest. An installment loan amortizes over the length of the loan, which means that with each monthly payment you make, more of your payment goes toward paying off the principal and less goes toward paying for interest. The amount of interest you pay each month is calculated based on simple interest. Installment loans are typically used to finance purchases of houses, cars, appliances, and other expensive items.

**Table 1. Simple Interest Method**

<table>
<thead>
<tr>
<th>Amount</th>
<th>$1,000</th>
<th>Stated Interest</th>
<th>12%</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/Y</td>
<td>12</td>
<td>PMT Using Excel Function</td>
<td></td>
</tr>
<tr>
<td>Years</td>
<td>1</td>
<td>Payment</td>
<td>$88.85</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Amount</th>
<th>Payment</th>
<th>Interest</th>
<th>Principal</th>
<th>Remaining Principal</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000.00</td>
<td>$88.85</td>
<td>10.00</td>
<td>$78.85</td>
</tr>
<tr>
<td>2</td>
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<td>$79.64</td>
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<td>3</td>
<td>$841.51</td>
<td>$88.85</td>
<td>8.42</td>
<td>$80.43</td>
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<td>$761.08</td>
<td>$88.85</td>
<td>7.61</td>
<td>$81.24</td>
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<td>$88.85</td>
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<td>7</td>
<td>$514.92</td>
<td>$88.85</td>
<td>5.15</td>
<td>$83.70</td>
</tr>
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<td>8</td>
<td>$431.22</td>
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<td>9</td>
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<td>11</td>
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</tr>
<tr>
<td>12</td>
<td>$87.97</td>
<td>$88.85</td>
<td>0.88</td>
<td>$87.97</td>
</tr>
</tbody>
</table>

**Average = $551.55**  **Total Interest = $66.19**  **Actual APR = 12.0%**

The total paid is $66.19 interest and $40 in fees. This is divided by one year and then divided by $551.55, the average amount borrowed. This calculation gives us an APR of 19.3 percent.

Because of the complexity of this type of loan, it is best to calculate your payments using either a financial calculator or a spreadsheet program. **Learning Tool 18: Credit Card Repayment Spreadsheet** can help you determine your payments and interest costs. With this spreadsheet you can also calculate how long it will take to pay off a specific credit card or loan based on the balance owed, annual percentage rate, compounding periods, and payments per month. **Learning**
Tool 9: Debt Amortization and Prepayment Spreadsheet can help you calculate how long it will take to pay off your debt as well.

For example, assume the same $1,000 loan as above, but instead of a single-payment, we will pay for it monthly. How do you calculate the APR for installment loans? The formula is the same. From your spreadsheet, I will build a simple loan amortization table from which you can calculate two different items: average amount borrowed and interest rate paid (see Table 1).

Secured loans use one of your assets, such as a home or a car, as collateral to guarantee that the lending institution will get the amount of the loan back, even if you fail to make payments. Examples of secured loans include home equity loans and car loans. Because these loans are backed by collateral, they usually have lower interest rates.

Unsecured or signature loans do not require collateral and are generally offered only to borrowers with excellent credit histories. Unsecured loans typically have higher interest rates, which may range between 12 and 26 percent—sometimes even higher.

Fixed-rate loans maintain the same interest rate for the duration of the loan. The majority of consumer loans are fixed-rate loans. Normally, lenders charge higher interest rates for fixed-rate loans than they do for variable-rate loans. This is because lenders can lose money if market interest rates increase, leaving the loan rate lower than the current market interest rate.

Variable-rate loans have an interest rate that is adjusted at different intervals over the life of the loan. There is usually a maximum interest rate, or cap, that can be charged on the loan as well as a maximum amount that the interest rate can increase each year. The interest rates on these loans may change monthly, semiannually, or annually. The interest rate is adjusted based on an index, such as the prime rate or the six-month Treasury bill, as well as on an interest-rate spread. Lenders usually charge a lower interest rate up front for variable-rate loans because the lender will not lose money if the overall market interest rates increase.

Convertible loans are loans in which the interest-rate structure can change. For example, a convertible loan may start off having a variable interest rate and then switch to having a fixed interest rate at some predetermined time in the future; the opposite process may occur as well.

The Loan Contract

The loan contract is the most critical document of the loan process. It describes what the lender requires of you once you are granted the loan. Whenever you borrow, you put your future into someone else’s hands; therefore, you need to know what you are doing. Read the entire contract and make sure you fully understand the details of the loan before you sign the loan agreement.

One of the most important things you should remember about loan contracts is that none of the clauses in the contract are in your favor. Let’s talk about four clauses you should be aware of:

1. The insurance clause requires you to purchase life insurance that will pay off your loan in
the event of your death. It benefits only the lender and increases the total cost of the loan. This clause is often used in mortgage loans.

2. The acceleration clause requires you to pay for the entire loan in full if you miss just one payment. This clause is often—but not always—disregarded if you make a good-faith effort to catch up on your missed payment, but it is still a risk.

3. The deficiency clause stipulates that if you do not pay back the loan, and the company takes your collateral, you must pay any amount in excess of the collateral’s value; this clause takes effect if the money earned through the sale of your collateral does not satisfy the loan. You must also pay any charges incurred by the lender that are associated with the disposal of your collateral.

4. The recourse clause allows the lender to collect any outstanding balance via wage attachments and garnishments. This clause may also allow the lender to put liens on other properties you own (these properties can act as secondary collateral) should you fail to repay your loan.

**Special Types of Consumer Loans**

There are a number of special types of consumer loans that are different from traditional consumer loans. These include home equity loans, student loans, and automobile loans.

**Home equity loans** are also known as second mortgages. In a second mortgage, you use the equity in your house (i.e., the difference between what you paid for the house and what for the house is worth today) to secure your loan.

The benefits of a home equity loan are that you can usually borrow up to 80 percent of the equity in your home, and the interest payments may be tax-deductible. With this type of loan, you can also get a lower interest rate because the house is secure—it can’t be moved. One disadvantage of this type of loan is that it limits your future financial flexibility because you can have only one outstanding home equity loan at a time. Moreover, a home equity loan puts your home at risk: if you default on a home equity loan, you can lose not only your high credit score but your home as well.

**Home equity lines of credit (HELOC)** are also second mortgages that use the equity in your home to secure your loan. These are generally adjustable rate notes that have an interest-only payment, at least in the first few years of the note. These have lower rates of interest than other consumer loans.

The benefit of these loans is that the interest may be tax-deductible, reducing the cost of borrowing. The problem is that these loans will often keep people from making the hard financial choices to curb their spending. Why worry about spending when you can get a home equity loan or HELOC to pay off your credit cards each year? These loans also sacrifice future financial flexibility and put your home at risk if you default.
**Student loans** have low, federally subsidized interest rates; these loans are often used to pay for higher education. Examples of federal student loans that are available to parents and students include federal-direct loans, plus-direct loans, Stafford loans, and Stafford-plus loans.

One benefit of federal student loans is that some have specific advantages, such as subsidized interest payments and lower interest rates. Also, you can defer payment of federal-direct loans and Stafford loans until six months after you graduate or discontinue full-time enrollment. The disadvantages of these loans are that there is a limit to how much you can borrow, and, like all debts, you must pay these loans back.

**Automobile loans** are secured by the automobile the loan is paying for. This type of loan usually has a term of two to six years.

The advantage of an automobile loan is that it usually charges a lower interest rate than an unsecured loan. The disadvantage is that you must make interest payments, and since vehicles depreciate quickly, you are often left with a vehicle that is worth less than what you owe on the loan.

**Payday loans** are short-term loans of one or two weeks and are secured with a postdated check. The postdated check is held by the payday lender and cashed on the day specified. These loans charge very high interest rates—some payday loans charge more than 500 percent on an annual percentage rate basis (APR). I recommend you avoid using these loans completely.

The APR is equal to the simple interest paid over the life of the loan. The APR takes into account all costs for a year, including the interest rate, the cost of pulling credit reports, and all other fees; the total cost may be significant. To calculate the APR for any loan, multiply the amount of money paid in fees and interest by the number of periods in a year to get the annual cost of the loan; then divide the annual cost by the amount borrowed.

For example, suppose you paid $20 to borrow $100 for two weeks by writing a postdated check for $120. There are 26 two-week periods in a year. Thus the equation for finding your annual payment for this loan would be $20 * 26 = $520. In other words, you would pay $520 dollars in interest for a $100 loan: Consider that $520/$100 results in 520 percent interest. That is very expensive cash! Do not use payday loans!

**Explain the Characteristics and Costs of Mortgage Loans**

Mortgage loans are used to finance the purchase of a home or investment property. There are a number of different things you should consider when deciding how to finance a home. Your choice of loans should be based on four key concepts:

1. Your time horizon: How long do you expect to have the mortgage, and how certain are you of that time horizon?
2. Your preference (if any) for low required payments: How important are lower payments in the initial years of the loan?
3. Your tolerance for interest-rate risk: Are you willing to assume the interest-rate risk of the loan?
4. Your work status: Are you or have you been a member of the armed forces? If so, you may qualify for special mortgage programs.

Types of Mortgage Loans

There is basic terminology you must understand before we discuss mortgages.

Conventional loans are neither insured nor guaranteed. They are loans with amounts below the maximum amount set by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddy Mac) for a single family loan (see Table 2). Fannie Mae and Freddy Mac are the major purchasers of mortgages from the loan brokers or originators, so they set the standard as to the type of loans they will purchase. This maximum amount changes over time. Conventional loans require Private Mortgage Insurance (PMI) if the down payment is less than 20 percent. PMI guarantees payment to the lender should you fail to make payments. Borrowers can eliminate PMI by having equity greater than 20 percent.

<table>
<thead>
<tr>
<th>Year</th>
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<tr>
<td>2010</td>
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</tr>
<tr>
<td>2011</td>
<td>$417,000</td>
</tr>
<tr>
<td>2012</td>
<td>$417,000</td>
</tr>
<tr>
<td>2013</td>
<td>$417,000</td>
</tr>
</tbody>
</table>

Loan limits are 50 percent higher in Alaska, Guam, Hawaii, and the U.S. Virgin Islands.

Jumbo loans are loans in excess of the maximum eligible for purchase by the two Federal Agencies. Some lenders also use the term to refer to programs for even larger loans, such as loans in excess of $500,000.

Piggyback loans are two separate loans, one for 80 percent of the value of the home and one for 20 percent. The second loan has a higher interest rate due to its higher risk; it is used to eliminate the need for Private Mortgage Insurance, the cost of which can be substantial.

There are eight main types of mortgage loans available in the United States: fixed-rate mortgages (FRMs), variable- or adjustable-rate mortgages (ARMs), variable or fixed interest-only mortgages (IO), option adjustable-rate mortgages (Option ARMs), negative-amortization (NegAm), balloon mortgages, reverse mortgages, and special loans.

Fixed-rate mortgages (FRMs) have a fixed rate of interest for the life of the loan. These are the least risky types of mortgage from the borrower’s point of view because the lender assumes the major interest-rate risk. For many years, this was the most common type of mortgage.

The benefits of fixed-rate mortgages include higher initial monthly payments (a greater percentage of each payment goes to pay down principal), no risk of negative amortization, and
interest-rate risks that are transferred to the lender. The risks include higher interest rates (lenders must be compensated for increased interest-rate risk) and higher monthly payments that are more difficult to pay, particularly for those not on a regular salary.

**Variable- or adjustable-rate mortgages (ARMs)** have a rate of interest that is pegged to a specific interest-rate index that changes periodically. Generally, the initial interest rate is lower than that of a fixed-rate loan because the borrower assumes more of the interest-rate risk. However, due to the risk of rising future interest rates, ARMs may result in significantly higher interest rates in the future. ARMs may have a fixed rate for a certain period of time; after this period ends, the interest rate begins to adjust on a periodic basis.

The benefits of variable-rate loans include lower initial interest rates that vary with national interest rates, lower monthly payments (because of the lower interest rates), and no risk of negative amortization. The risks include a possible “payment shock” if interest rates rise, perhaps beyond what borrowers are able to pay, and somewhat higher monthly payments that may be difficult for those not on a regular salary.

**Fixed or variable interest-only loans** are FRMs or ARMs with an option that allows the borrower to make interest-only payments for a certain number of years; payments are then reset to amortize the entire loan over the remaining duration of the loan. Some borrowers will take out an interest-only loan to free up principal to pay down other, more expensive debt. However, once the interest-only period has passed, the payment amount resets, and the increase in payment can be substantial.

The benefits of fixed or variable interest-only loans include lower initial monthly payments and greater flexibility; these benefits may be helpful if the borrower could better use his or her money elsewhere. Because borrowers only pay interest costs (and not principal), they can afford higher loan amounts to buy more house, with the expectation that they may move before the payments increase. The risks of these kinds of loans include a substantial increase in monthly payments when the interest-only period ends and the fact that there is no amortization of principal during the initial interest-only period. For example, if a borrower takes out a fixed-rate interest-only mortgage with a 10-year interest-only option, the borrower pays interest for the first 10 years. In year 11, however, the borrower must pay substantially higher payments as the loan now must amortize over 20 years instead of the normal 30 years. The borrower must assume appreciation of the house to make money. The main risk of interest-only loans is that many borrowers do not have the discipline to invest savings from principal, so they spend it. In addition, there is the risk of borrowing too much money because of the lower initial payments.

**Option adjustable-rate mortgages (option ARMs)** have interest rates that adjust monthly and payments that adjust annually. There are “options” on the payment amount, one of which is a minimum payment option, which may be smaller than the interest-only payment. The minimum payment option often results in a growing loan balance (termed negative amortization). The lender specifies a specific maximum balance for the loan, i.e., 110 percent or 125 percent of its original value. Once this maximum is reached, payments are automatically increased. The loan becomes fully amortized after 5 or 10 years, regardless of the increase in the amount of principal.
The benefits of option ARMs include lower initial monthly payments and greater flexibility; these benefits are especially appealing if borrowers have better use for their money elsewhere. Borrowers can afford more house, and they may move before the payments increase. The risks of option ARMs include major “payment shock” when the negative amortization or option period ends and the payment is reset. There is the risk that the borrower will borrow too much money. There is also the risk that the minimum monthly payments will be insufficient to cover principal and interest costs, and the difference, called negative amortization, will be added to the loan principal. This type of loan should be avoided as it is highly risky for borrowers.

**Negative-amortization mortgages (NegAms)** are loans in which scheduled monthly payments are insufficient to amortize, or pay off, the loan. Interest expenses that have been incurred, but not paid, are added to the principal amount; this process increases the amount of the debt. Some NegAm loans have a maximum negative amortization that is allowed. Once that limit is reached, payments increase automatically to ensure that interest is sufficient to not exceed the limit.

A benefit of NegAm mortgages is that borrowers do not have to make full payments on the loans, and hence they conserve cash. The risk is that borrowers may find themselves at the negative-amortization limit, where payments are automatically reset to a level higher than the borrowers can afford.

**Balloon mortgages** have scheduled interest and principal payments that will not result in the loan being paid in full at the end of the term. The final payment, or balloon, to pay off the loan can be very large. These loans are often used when the debtor expects to refinance the loan when it approaches maturity.

The benefit of balloon mortgages is that borrowers do not have to make full payments on the loans, and hence they conserve cash. The risk is that borrowers may get to the end of the payment period and not be able to come up with the required balloon payment.

**Reverse mortgages** have proceeds that are made available against the homeowner’s equity. In essence, a financial institution purchases the seller’s home and allows the seller to stay in the home until he or she dies. Reverse mortgages are typically used by cash-poor but home-rich homeowners who need to access the equity in their homes to supplement their monthly income at retirement.

The benefit of these mortgages is that the homeowners have an increased income stream to use for retirement, and they can stay in their homes until they die. The disadvantage is that if death occurs soon after the loan is closed, the lender has purchased the house for a very low cost.

**Special loans** are insured or guaranteed. Insured loans are issued by others but insured by a United States federal agency. The Federal Housing Administration (FHA) does not originate any loans but insures the loans issued by others based on income and other qualifications. With an FHA loan, there is lower PMI (1.5 percent of the loan), but it is required for the entire life of the loan.
loan. While the required down payment is very low, the maximum amount that can be borrowed is also low.

Guaranteed loans are issued by others but guaranteed by a federal agency. The Veterans Administration (VA) guarantees loans issued by others. These loans are only for ex-servicemen and women as well as those on active duty. These loans may be for 100 percent of the home value.

Understand How to Select the Least Expensive Sources for Consumer Loans and How to Reduce the Costs of Borrowing

Consumer Loans Categorized by Total Cost

The least expensive types of consumer loans are obtained from parents or family, home equity lenders, and secured-loan lenders (including mortgage lenders).

More expensive consumer loans are obtained from credit unions, savings and loan institutions, and commercial banks.

The most expensive types of consumer loans are obtained from credit card companies, retail stores, finance companies, and payday lenders.

The key is to only purchase those things you really need and to pay as little for the privilege of borrowing as you can. Ideally, you should save your money first and then purchase what you need with cash.

Reducing Your Borrowing Costs

Listed below are four ways to reduce your borrowing costs:

1. Understand the key relationships in borrowing. The total interest cost of your loan is directly related to the interest rate and the maturity length. Keep the interest rate low and the maturity short. The amount of your periodic payment is inversely related to both the maturity and interest rate of your loan. Keep both low. Finally, some sources of lending are cheaper than others. Generally, parents are cheaper lenders than banks.

2. Understand the key clauses for consumer and mortgage loans. Remember, all clauses are in the lender’s favor, and very few, if any, are in the borrower’s favor. You are putting your future in someone else’s hands when you borrow—you are committing future earnings to today’s consumption. Use wisdom in your decisions and know what you are doing before you do it. Read documents very carefully and understand them before you sign them.

3. Know the steps to reducing consumer costs. First, if possible, don’t get into debt in the first place. Remember what religious leaders have said about managing debt and staying out of debt. In emphasizing how burdensome debt can be, J. Reuben Clark Jr. said the following:
Once in debt, interest is your companion every minute of the day and night; you cannot shun it or slip away from it; you cannot dismiss it; it yields neither to entreaties, demands, or orders; and whenever you get in its way or cross its course or fail to meet its demands, it crushes you.  

Second, remember your goals and budget. Remember that ignorance, carelessness, compulsiveness, pride, and necessity can be offset by wisdom, exactness, discipline, humility, and self-reliance. If you really need something, plan and save for it; don’t borrow for it.

Third, compare the after-tax cost of borrowing with the after-tax cost of using savings and losing your return. It makes little sense to borrow at a high interest rate when you have savings earning a lower rate. Use the following formula:

\[
\text{After-tax lost return} = \text{nominal interest rate} \times (1 - \text{tax rate})
\]

\[
\text{Tax rate} = \text{federal, state, and local marginal tax rates}
\]

For example, assume you are looking to purchase a new television set. You have $500 in savings earning 4.0 percent or you can borrow $500 from the television store at an APR of 14.5 percent for two years. If you are in the 25-percent federal marginal tax rate and 7-percent state marginal tax rate, your after-tax lost return is 2.7 percent or .04*(1- (.25 + .07)). Clearly it would be better to take your savings and purchase the television set than to pay 14.5 percent interest.

Finally, maintain a strong credit rating. The more you do to increase your credit score, the more attractive you will be to potential lenders and the lower the interest rate you will have to pay on your loan.

4. Reduce the lender’s risk. If you can reduce the risk of the loan to your lender, your lender may be able to offer you a lower interest rate. You can reduce the lender’s risk in a number of ways:

Use a variable-rate loan. If you choose to use a variable-rate loan, the lender is not penalized if market interest rates increase. Be aware that by choosing a variable-rate loan, you reduce the risk to the lender but increase the risk for yourself. While I prefer fixed-rate mortgages, reducing the lender’s risk may result in a lower rate (at least initially).

Keep the loan term as short as possible. The shorter the term, the less time the lender is at risk.

Provide collateral for the loan. If a lender has collateral for a loan, there is less risk for the lender because the collateral can be sold if you cannot pay back the loan as promised.

Put a large down payment on the item to be financed. Lenders realize that the greater the amount of money you have already paid for an item, the less likely you are to walk away from your loan. Lending you money becomes less risky for lenders if you are willing to make a large down payment.
Summary

Inspired religious leaders have urged their congregations to get out of debt and live within their means. We need to heed that counsel. In this chapter, we discussed the dangers of consumer loans and how these loans can keep you from achieving your goals. We also identified characteristics of specific types of consumer loans and learned how to calculate the costs of borrowing. Finally, we outlined the types of consumer loans according to their cost and discussed ways you can reduce the costs of borrowing.

**Consumer loans** pay for items that are fairly expensive; you usually don’t need these items (at least not urgently). Such items include electronics, automobiles, furniture, and recreational vehicles.

Consumer loans are very expensive and should rarely be used. They encourage you to buy now rather than to save for the future, a practice that may keep you from achieving more important long-term personal goals. Consumer loans also require you to pay interest with money you might otherwise invest for your goals.

It is important for you to understand that different consumer loans have different characteristics. Know what you are getting into before committing to a loan.

**Mortgage loans** are used to finance the purchase of a home or investment property. Your choice of mortgage loans should be based on three key factors: (1) Your time horizon: How long do you expect to have the mortgage, and how certain are you of that time horizon? (2) Your preference (if any) for low required payments: How important are lower payments in the initial years of the loan? And (3) Your tolerance for interest-rate risk: Are you willing to assume the interest-rate risk of the loan?

There are four main ways to reduce your borrowing costs:

1. Understand the key relationships in borrowing
2. Understand the key clauses for consumer loans and mortgage loans
3. Know the steps to reduce borrowing costs
4. Reduce the lender’s risk

Assignments

**Financial Plan Assignments**

Think through the purpose of any consumer loans you have. Are they necessary? Could you have gotten by without them? If you have consumer loans outstanding, write down the costs of those loans in terms of interest rates, fees, grace period, balance calculation method, and any other fees or expenses. What can you do to pay off these loans quickly and get back on the path to debt
elimination? Resolve now not to get into debt except for a home or education.

Learning Tools

The following Learning Tools may be helpful as you prepare your Personal Financial Plan:

9. Debt Amortization and Prepayment Spreadsheet

This Excel spreadsheet gives a debt amortization and prepayment schedule to help you as you reduce and eliminate your debt.

18. Credit Card Repayment Spreadsheet

This Excel spreadsheet helps you determine how long it will take you to pay off a specific credit card or loan based on the balance owed, annual percentage rate, compounding periods, and payments per month.

20. Debt Elimination Spreadsheet with Accelerator

This spreadsheet allows you to input your different debts and interest rates. It then prioritizes your debt based on interest rate and creates a repayment plan based on the minimum payments each month. This spreadsheet also allows you to include an accelerator amount (an amount in addition to your normal monthly payments) to show you how long it will take you to pay off your debt.

Review Materials

Review Questions

1. What are seven different types of consumer loans?
2. What is the most critical document of the loan process? Why?
3. What are the three concepts that should be considered before obtaining a home mortgage?
4. What are the benefits of getting a fixed-rate mortgage? A variable-rate mortgage?

Case Studies

Case Study 1

Data

Matt is offered a $1,000 single-payment loan for one year at an interest rate of 12 percent. He determines there is a mandatory $20 loan-processing fee, $20 credit check fee, and $60 insurance fee. The calculation for determining your APR is (annual interest + fees) / average amount borrowed.
Calculations

A. What is Matt’s APR for the one-year loan, assuming principal and interest are paid at maturity?

B. What is Matt’s APR if this was a two-year loan with principal and interest paid only at maturity?

Case Study 1 Answers

Matt’s interest cost is calculated as principal * interest rate * time.

A. The APR for the one-year loan is:
   Interest = $1,000 * 0.12 * 1 year = $120
   Fees are $20 + $20 + $60 = $100
   His APR is (120 + 100) / 1,000 = 22.0%

B. The APR for the two-year loan is:
   Interest = $1,000 * 0.12 * 2 years = $240
   Fees are $20 + $20 + $60 = $100
   His APR is
   
   \[
   \frac{(240 + 100)}{2} \div 1,000 = 17.0%.
   \]

Since this is a single-payment loan, the average amount borrowed is the same over both years. Note that Matt’s APR is significantly higher than his stated interest rate because of the fees charged. He should be very careful of taking out this loan.

Case Study 2

Data

Matt has another option with the same $1,000 loan at 12 percent for two years. But now he wants to pay it back over 24 months and he has no other fees.

Calculations

Using the simple interest and monthly payments, calculate:

A. The monthly payments
B. The total interest paid
C. The APR of this loan

Note: The simple-interest method for installment loans is simply using your calculator’s loan amortization function.

Case Study 2 Answers

A. To solve for simple interest monthly payments, set your calculator to monthly payments, end mode:
Chapter 6. Consumer and Mortgage Loans

PV = -1,000, I = 12%, P/Y = 12, N = 24, PMT=?

PMT = $47.074

B. Total interest paid = 47.074 x 24 – 1,000 = ?

$129.76

To calculate the APR, it is [(interest + fees) / 2] / average amount borrowed (which changes each year as you pay it down in an amortized or installment loan). The average amount borrowed of $540.68, which is the average of the monthly principle outstanding (see Table 3). The APR is calculated as ($129.76 / 2 years) / $540.68 = 12%.

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Table 3. APR Calculation

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</table>

| Total Int.=      | 129.76  | Actual APR = | 12.0%     |

Case Study 3

Data

You are looking to finance a used car for $9,000 for three years at 12 percent interest.
Calculations

A. What are your monthly payments?
B. How much will you pay in interest over the life of the loan?
C. What percent of the value of the car did you pay in interest?

Case Study 3 Answers

A. To solve for your monthly payments, set PV equal to -9,000, I equal to 12, N equal to 36, and solve for PMT.
   
   Your payment is $298.93 per month.
B. To get your total interest paid, multiply your payment by 36 months. $298.92 * 36 = $10,761.44 – 9,000 = ?
   $1,761.44

C. To determine what percent of the car you paid in interest, divide interest by the car’s cost of $9,000 = $1,761.44 / 9,000 = 19.56%
   
   You paid nearly 1/5 the value of the car in interest. Why not save next time and buy a nicer car (or save some of that money)?

Case Study 4

Data

Bill is short on cash for a date this weekend. He found he can give a postdated check to a payday lender who will give him $100 now for a $125 check that the lender can cash in two weeks. The APR equals the total fees divided by the annual amount borrowed. The effective annual rate = [(1 + APR / periods)^periods] - 1.

Calculations

A. What is the APR?
B. What is the effective annual interest rate?

Application

C. Should he take out the loan?

Case Study 4 Answers

A. The APR is the amount paid on an annual basis divided by the average amount you borrow.
   APR = ($25 * 26 two-week periods) / $100 = $650 / $100 = 650%

B. To solve for your effective annual interest rate, put it into the equation for determining the impact of compounding.
   The effective annual interest rate is
   (1 + [6.5 / 26 periods])^26 periods – 1 = 32,987%
Chapter 6. Consumer and Mortgage Loans

This is a very expensive loan.

C. No. It is just too expensive.

**Case Study 5**

Data
Wayne is concerned about his variable-rate mortgage. Assuming a period of rapidly rising interest rates, how much could his rate increase over the next four years if he had a 6-percent variable-rate mortgage with a 2-percent annual cap (that he hits each year) and a 6-percent lifetime cap?

Application
How would this affect his monthly payments?

**Case Study 5 Answers**

Assuming rates increased by the maximum 2 percent each year, at the end of the four years it could have reached its cap of 6 percent, giving a 12 percent rate. Nearly doubling the interest rate would significantly increase Wayne’s monthly payment.

**Case Study 6**

Data
Anne is looking at the mortgage cost of a traditional 6.0 percent 30-year amortizing loan versus a 7.0 percent 30-year/10-year interest-only home mortgage of $300,000.

Calculations
A. What are Anne’s monthly payments for each loan for the first 10 years?
B. What is the new monthly payment beginning in year 11 after the interest-only period ends?

Application
C. How much did Anne’s monthly payment rise in year 11 in percentage terms?

**Case Study 6 Answers**

A. Anne’s monthly payments are
   Traditional: The amortizing loan payment is:
   \[
   PV = -300,000, \ I = 6.0\%, \ P/Y = 12, \ N = 360, \ PMT = ?
   \]
   \[
   PMT = $1,798.65
   \]
   Interest-only: The payment would be $300,000 * 7.0% / 12 = $1,750.00

Page 102
Chapter 6. Consumer and Mortgage Loans

B. After the 10-year interest-only period, her new payment would be (she would have to amortize the 30-year loan over 20 years):

\[ PV = -300,000, \ I = 7.0\%, \ P/Y = 12, \ N = 240, \ PMT = ? \]

\[ PMT = \$2,325.89 \]

C. The new payment is a 33\% increase over the interest-only period in year 10.

Case Study 7

Data

Jon took out a $300,000 30-year Option ARM mortgage for purchasing his home, which had a 7 percent mortgage. Each month he could make a minimum payment of $1,317 (which did not even cover the interest payment), an interest-only payment of $1,750, a payment of $1,996 that included both principal and interest, or an additional amount. The loan had a negative-amortization maximum of 125 percent of the value of the loan. Jon was not very financially savvy, and for the first 10 years made the minimum payment only. As a result, at the end of year 10, he was notified that he had hit the negative-amortization maximum and that his loan had reset.

Calculations

A. What is Jon’s new monthly payment beginning in year 11 after he hit the negative amortization limit?
B. How much did Jon’s monthly payment rise over the minimum payment he was paying previously?

Case Study 7 Answers

A. After the negative-amortization limit is hit, he must now amortize the loan over 20 years instead of 30. His new loan amount is not $300,000, but $375,000 (300,000 * 125 percent) due to the fact he did not pay enough to even cover interest payments:

\[ PV = -375,000, \ I = 7.0\%, \ P/Y = 12, \ N = 240, \ PMT = ? \]

\[ PMT = \$2,907.37 \]

B. His minimum payment was $1,317, and his new payment is $2,907. It is a 121-percent increase over the minimum payment period.

Notes

Other good sources of information on mortgages are available at:

www.mtgprofessor.com
www.bankrate.com

1 Ensign, Nov. 1998, 52–54

Page 103
7. Debt and Debt Reduction

Introduction

Attitudes toward debt have fluctuated dramatically over the last 50 years. Many who lived through the 1930s vowed never to go into debt again. Yet gradually people grew to see debt as a tool to obtain what they wanted. In the late nineties in particular, the stock market’s upward trend encouraged consumers to acquire significant debt. Then, when the economy faltered, people realized once again we live in a time of great economic uncertainty. The decline in the stock market and the slowing economy during those years led to a major increase in bankruptcies throughout the United States.

Advertising has been instrumental in promoting the view of debt as a tool: “Get what you want,” the advertisements say. “Get it now, and pay only $80 a month!” “Buy a car with zero down and make no payments for the next 12 months!” Get what you want now and pay it off over the next 15 years.

Objectives

Once you have completed this chapter, you should be able to do the following:

1. Understand what leaders have said regarding debt
2. Understand the debt cycle and why people go into debt
3. Understand how to develop and use personal debt-reduction strategies
4. Know where to get help if you are too far in debt

Understand What Leaders Have Said Regarding Debt

Debt can be a form of bondage, limiting both temporal and spiritual freedom. To help people avoid this bondage, Joseph F. Smith advised: “Get out of debt and keep out of debt, and then you will be financially as well as spiritually free.”

While some might argue that their financial situation has nothing to do with their spirituality, Marion G. Romney pointed out that self-reliance is essential for spiritual growth to continue:

Independence and self-reliance are critical keys to our spiritual growth. Whenever we get into a situation which threatens our self-reliance, we will find our freedom threatened as well. If we increase our dependence, we will find an immediate decrease in our freedom to act.

When we are in debt, our freedom to act and our ability to grow spiritually are reduced. Staying out of debt is not just a temporal commandment, as some suppose; it is also a spiritual commandment.
Is There Reasonable Debt?

Debt is necessary at times when people may need to borrow for some goals that might otherwise be impossible to achieve. Such goals may include gaining an education and purchasing a modest home; purchasing a second car or a new wardrobe on credit, however, may not be appropriate. Gordon B. Hinckley counseled: “Reasonable debt for the purchase of an affordable home and perhaps for a few other necessary things is acceptable. But from where I sit, I see in a very vivid way the terrible tragedies of many who have unwisely borrowed for things they really do not need.”

When going into debt for a home or an education, you should use prayer and wisdom to make good decisions about the amount of money you borrow and the type of loans you take out. If you do go into debt, you should pay your debt off as soon as you can.

Another type of debt that may be necessary is business debt. While we will not cover this in detail, we include some cautions from N. Eldon Tanner regarding business debt:

Investment debt should be fully secured so as to not encumber a family’s security. Don’t invest in speculative ventures. The spirit of speculation can become intoxicating. Many fortunes have been wiped out by the uncontrolled appetite to accumulate more and more. Let us learn from the sorrow of the past and avoid enslaving our time, energy, and general health to a gluttonous appetite to acquire increased material goods.

It is acceptable to incur debt to undertake a business endeavor if (1) the debt does not jeopardize the personal or family finances of the business owners or managers and (2) the debt is used for a valid business purpose or investment opportunity. Speculative ventures and consumption under the guise of investment should be avoided. Using debt to finance a speculative venture magnifies the risk of the investment and is simply leverage. Finally, business debt must be incurred with full commitment to repay the money. Failure to repay any debt—including business debt—is a form of dishonesty. Keeping these principles in mind will help us determine when debt may or may not be appropriate for a business investment.

Understand the Debt Cycle and the Reasons People Go into Debt

To understand the nature of debt, it is important to understand the debt cycle. The debt cycle starts when you begin to spend more than you earn. You know it’s wrong, but you do it anyway, telling yourself, “It’s just this once,” and “I’ll pay it back next month.”

When you are not living within your means, you must borrow to maintain your standard of living. At first, this may mean adding a little more debt to your credit card because it is easily accessible. Although you intend to pay this debt off soon, you may find yourself continuing to spend more than you earn in order to support your lifestyle. Soon you may find that you have borrowed to the available limit on your credit card, so you get a second credit card, and your spending continues. You dig yourself deeper and deeper into debt each month.
The situation keeps growing worse. You obtain more credit cards, and soon you may find that you have as many as five—all of them used to their maximum limit. You may be able to get another card, but the interest rate is now over 20 percent. Interest costs on your current cards are high too, and you are paying only the minimum balances on everything. In fact, most of your payments are for interest costs. With so much of your income going toward interest costs, you find yourself limited financially and unable to maintain your current standard of living.

This debt cycle can continue for only so long. Eventually you can’t get any more credit, and the interest alone becomes more than you can pay each month. You have lost your money, your sense of self-worth, and your good credit history.

Some people are already so deep in debt that it will take a long time for them to get back out; others are just beginning the cycle. When I have talked with people who have been in debt, some have described the debt cycle and its results as “chains of hell.” The debt cycle starts ever so slowly, but over time the chains become as unbreakable as steel and may cause you to do things you never would have thought possible.

While there are many reasons why people accumulate debt, there are five key trends:

**Ignorance:** Some people don’t understand interest and its costs. They may even, consciously or subconsciously, avoid learning about these things because they know they would have to change their spending habits, and change is difficult.

**Carelessness:** Some people understand interest but get a little careless in their spending. They think, “If I spend a little more this one time, it’s OK—it won’t hurt this once.” But it does hurt—even this once.

**Compulsiveness:** Others lack the self-control and discipline to control their spending. That is why spending, to some professionals, is considered an addiction, just like alcohol, drugs, or pornography.

**Pride:** Some people worry more about how they look to their neighbors than about how they look to God. Ezra Taft Benson counseled: “Pride . . . is manifest in so many ways, such as faultfinding, gossiping, backbiting, murmuring, [and] living beyond our means.” Some people are more interested in “keeping up with the Joneses” than in living within their means. They may overspend on brand-name clothes and other goods in order to impress others with their lifestyle, all while maxing out their credit cards and getting deeper and deeper into debt.

**Necessity:** Finally, some people go into debt in order to feed their families and provide for other basic needs. These people need help, and help is available. However, instead of going into debt to deal with a difficult situation, they should counsel with their church leaders to seek other solutions. Necessity should rarely be the reason people go into debt.

It is necessary to combat these trends and habits both in order to avoid debt and as part of the road to getting out of debt. As we learn, grow, and develop our financial skills, we become more
self-reliant. As you humbly receive help from those who are able to give it, and as you gain knowledge, exactness, discipline, and humility, the Lord will be able to turn your weaknesses into strengths. He has promised:

And if men come unto me I will show unto them their weakness. I give unto men weakness that they may be humble; and my grace is sufficient for all men that humble themselves before me; for if they humble themselves before me, and have faith in me, then will I make weak things become strong unto them.7

When you are in need, God can help you understand what you should do, show you what changes you need to make, and direct you to the knowledge you need to make those changes. As you follow His guidance, you are changed from the inside out. In the process, you become both spiritually and financially self-reliant. The Lord takes you from where you are to where you need to be. Rather than having burdensome debt, you can train yourself to replace the following vices with virtues:

*Ignorance can be replaced by wisdom.* Wisdom is a necessary tool for combating ignorance and may be gained as you learn about the dangers of debt, the costs of interest, and how improper debt management prevents you from achieving your goals. You must learn to understand debt, understand why we go into debt, and understand how to properly manage it. You will have to change your spending habits and possibly even your very lifestyle in order to spend money responsibly and get out of the debt you have accumulated.

*Carelessness can be replaced by exactness.* Exactness in your finances is essential for combating careless spending. As you learn about the dangers of the debt cycle, you will realize that once you enter the debt cycle, it is difficult to get out of it. If you are not in debt, you can set a goal now to never enter this cycle and to be exact and circumspect in financial matters in order to avoid the debt cycle. If you are already caught in the debt cycle, you can prepare a detailed plan to get out of debt and stay out.

*Compulsiveness can be replaced by diligence.* You can develop the self-control you need to be diligent in your financial matters. You can plan a budget and spend only on the things that are important. You can set personal financial goals and work toward them, budgeting and spending responsibly so that you can eventually reach those goals.

*Pride can be replaced by humility.* You can humble yourself as you recognize that your wealth isn’t yours. When you see yourself as a steward of your wealth, you realize that it doesn’t matter what others think about you—it only matters what God thinks of you and what you think about yourself. As you strive to do what God would have you do, pride gives way to humility.

*Necessity can be replaced by self-reliance.* When you are in need, God can help you understand what you should do, show you what changes you need to make, and direct you to the knowledge you need to make those changes. As you follow His guidance, you are changed from the inside out, and in the process, you become both spiritually and financially self-reliant.
Understand How to Develop and Use Personal Debt-Reduction Strategies

What if you are already in debt? Is there a process that can help you get out? The good news is that there is. The following process is essential for debt-reduction:

1. Recognize and accept that you have a debt problem.
2. Stop incurring debt. Don’t buy anything else on credit. Be especially careful about using home equity to pay down debts until you have your spending under control. Will Rogers commented, “If you find yourself in a hole, stop digging.”
3. Make a list of all your bills.
4. Look for many different ways of reducing debt, not just one. Examples might include consolidating balances to a lower interest rate credit card, having a yard sale to earn money to pay down debt, or using savings to reduce debt.
5. Organize a repayment or debt-reduction strategy and follow it.

There are three basic types of debt-reduction strategies:

**Personal strategies:** These are strategies you can use on your own; they include the use of spreadsheets and financial management software, such as Quicken, Mint.com, or Mvelopes, or other programs to help you organize your financial situation so you can make payments to get out of debt.

**Counseling strategies:** These strategies require outside help and include debt consolidation and debt negotiation strategies from credit counseling agencies.

**Legal strategies:** These strategies require professional legal help and may consist of declaring bankruptcy.

**Personal Strategies**

In this chapter, we will focus on personal strategies to help those in debt organize a plan to get out of debt. Even if you are not in debt, it is still helpful to learn these debt-reduction strategies because you will probably know someone who would benefit from these suggestions.

1. **Debt-elimination calendar: Most expensive debt first.** In his article “One for the Money,” Marvin J. Ashton discusses his debt-elimination strategy. His logic is that you should organize your debts and pay off your most expensive ones first.

He recommends that you set up a spreadsheet or ledger with a row for every month you will be making payments on your debts and a column for each creditor (see Table 1). You start by paying off the debt with the highest interest rate; this way you are paying off your most expensive debt first, which will save you the most money. Once your most expensive debt is paid off, continue applying the same total amount of money to other lines of credit until all of your debts are paid off. This is the critical point. After you have paid off one debt, you must keep...
paying the same amount of money but use that additional money to pay off the next most important debt. Then, once you have paid off your all your debts, you can continue paying yourself consistent with your personal and family goals.

Counseling Strategies

Regarding counseling strategies, you may be able to get help from either nonprofit credit counseling agencies (CCAs), which can help you reduce your monthly interest charges, or for-profit agencies, which can help you consolidate and negotiate your debt. Regardless of your choice, check out the company you select with the Better Business Bureau before you spend any money.

Nonprofit credit counseling agencies are set up specifically to help people reduce their credit card debt. These nonprofit agencies have arrangements with many credit card companies, and by working with those credit card companies, you can have your interest payments reduced or even eliminated with specific creditors. The creditors give these nonprofit agencies a rebate that comes from what the creditors are able to collect from you. Creditors are generally willing to work with credit counseling agencies because they would rather get some money back than none at all.

Using these services will cost you about $15 to $20 for setup and about $12 per month after that. If you work with a credit counseling agency, realize that it will likely show up on your credit reports. However, your goal is to reduce your debt—not to increase it through paying high fees. If you successfully complete the program, your success may be noted on your credit reports as well.

Nonprofit credit counseling agencies can be found by calling the National Foundation for Credit Counseling (1-800-388-2227). The following are a few questions you should ask nonprofit credit counseling agencies before you sign up to work with them:

- Is the agency licensed? (To verify their answer, ask for their tax ID.)
- Is the agency a member of the National Foundation of Consumer Credit (NFCC)?
- Is the agency accredited through the Council on Accreditation?
- Are the agency’s counselors certified by the NFCC?
- What is the agency’s monthly management fee? Is it tax-deductible?
- How long would I be in the program? (It should rarely be longer than five years.)
- How much would I be paying on my debts each month? (Payments are usually taken directly from a checking or savings account.)
- Will I talk with the same person every time or with many different people?

For-profit credit counseling agencies make money by helping people get out of debt. There are two main methods through which they work: debt consolidation and debt negotiation.

Debt consolidation: The goal of this strategy is to consolidate debt into a single loan with a lower interest rate. For-profit agencies make money on loan-origination charges and other loan
fees as they help homeowners take out an interest-only home loan and use the excess cash that would have gone to pay down principal to pay off debt. Borrowers should realize, however, that interest-only mortgages have an interest-only option for a specific period, i.e., one to seven years. After the interest-only period, the loan becomes fully amortizing and the loan principal must be repaid in a shorter amount of time, increasing monthly payments.

**Debt negotiation:** Debt negotiators work with creditors to reduce the interest rate and principal on certain types of loans, especially credit card loans. Initially, the consumer makes monthly payments to the debt management company, which may hold those payments until the consumer’s accounts are long overdue. At this point, the debt management company attempts to negotiate with the creditors to reduce the consumer’s interest rate and principal. They are sometimes able to significantly reduce the amount owed; however, help from these companies is not cheap. They typically charge a two-month retainer fee up front to work with your creditors. In addition, should this strategy backfire, you may have many months of nonpayment history on your credit report even though you made monthly payments as required to the for-profit credit counseling agency.

Before you begin working with a for-profit credit counseling agency, be sure you understand how the agency makes money. If it doesn’t make sense to you, go with another company. The following are a few questions you should ask for-profit credit counseling agencies before you sign up to work with them:

- What types of loans will the agency help consolidate or negotiate?
- How much will the agency’s services cost?
- How does the agency get paid? Who pays the agency?
- When does the agency get paid?
- What is the monthly fee? Is it tax deductible?
- How long would I be in their program? (It should never be longer than five years.)
- How much would I be paying on my debts each month? (Payments are usually taken directly from a checking or savings account.)
- Will I talk with the same person every time or with many different people?

There are benefits to using these types of programs. First, these companies may be able to significantly reduce the interest charges and even the principal of some types of debt. Second, they may be able to help you out of extreme debt if you follow through with them.

There are also drawbacks to working with these organizations. Most importantly, they are very expensive, and there is no guarantee they will be able to help. In addition, these organizations are established mainly to make money, which means you will pay much more for their help than you will pay for the help of nonprofit credit counseling agencies. Remember, these companies stop making payments before they begin to negotiate, so working with them may have a significant negative impact on your credit reports. Watch for the following warning signs, and go elsewhere for help if you notice any of them:
Chapter 7. Debt and Debt Reduction

- High, up-front or “voluntary” fees
- Vague contracts that do not explain fees
- Promises that sound too good to be true (for example, a promise that creditors will cut the principal owed by 50 percent)
- Fees for just distributing payments to creditors
- Pressure to sign up for debt-repayment services immediately before fees are disclosed
- Fees for phone consultations

Remember, you are working with your money. Use it wisely, and find a program that can help you resolve your debt issues in a consistent, logical way and within a reasonable time frame.

2. **Debt-elimination calendar: Smallest debt first.** Others, such as Dave Ramsey, have recommended that those in debt pay off their smallest debt first. In this manner, borrowers see debts being eliminated, which shows success and gives motivation for further debt repayment. While the “most expensive debt first” framework is better from a “total cost” point of view, both methods have the same objective and both can be helpful in eliminating debt. **Learning Tool 20:** Debt Elimination Spreadsheet with Accelerator on their website is a useful tool for determining which method will repay debts the quickest. With this tool, you have the option to pay down either the highest interest rate or smallest principal first. Most times, the difference is not significant and either method will accomplish the same objective. The key is to act now.

3. **Home equity loans.** You have probably heard radio and TV advertisements for debt consolidation loans. Debt consolidation loans are home equity loans, or loans against the equity in your home. Home equity loans have some benefits: because they are secured loans (credit cards are unsecured loans), they have lower interest rates, which reduces the monthly payment on your debt. In addition, the interest on home equity loans may be tax deductible.

However, there are two drawbacks to this type of loan. First, by taking out a home equity loan, you may not be addressing your real problem: the bad habit of spending money you do not have and living beyond your means. If your spending habits have not changed, your spending will continue even after you take out the home equity loan.

Second, if you take out a home equity loan and do not pay it off, you run the risk of losing not only your credit score but your home as well. Home equity loans put your home at risk because your home is used as collateral for the loan. Experience has shown that over 80 percent of those who take out a home equity loan to pay credit card debt have the same amount of debt they had at the time they took out the loan within three years. No spending changes have occurred, and they people soon find themselves back in debt. As their spending continues, they may now suffer both reductions in their credit ratings and the loss of their homes.

Should you take out a home equity loan to consolidate and pay off your debts? The answer is not straightforward. It’s likely that you will get into the same problem again in the near future if you have not changed your spending habits. If you have already addressed the spending problem that got you into debt in the first place, a home equity loan may be a useful option.
If you find yourself too far in debt for personal strategies to work successfully, you have a few choices:

**Legal Help—Bankruptcy**

Legal help should be your last resort; however, if there is no possible way that you can repay your debts, you may want to consider this option. There are two major types of bankruptcy: Chapter 7 and Chapter 13. If you declare *Chapter 7 bankruptcy*, your assets will be liquidated and used to pay creditors according to procedures outlined in the Bankruptcy Code. This is the quickest, simplest, and most frequently selected type of bankruptcy. Under Chapter 7 bankruptcy, certain debts cannot be waived, including child support, student loans, and drunk driving fines.

### Table 1: Debt-Elimination Calendar

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<th>Interest Rate</th>
<th>Credit Card Amount Owed</th>
<th>Consumer Loan Min. Payment</th>
<th>Dentist Amount Owed</th>
<th>Piano Loan Min. Payment</th>
<th>Auto Loan Amount Owed</th>
<th>Auto Loan Min. Payment</th>
<th>Student Loan Amount Owed</th>
<th>Total Payments</th>
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<td>110</td>
<td>13%</td>
<td>$533.66</td>
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<th>Month</th>
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<th>Interest Rate</th>
<th>Amount Owed</th>
<th>Credit Card Amount Owed</th>
<th>Consumer Loan Min. Payment</th>
<th>Dentist Amount Owed</th>
<th>Piano Loan Min. Payment</th>
<th>Auto Loan Amount Owed</th>
<th>Auto Loan Min. Payment</th>
<th>Student Loan Amount Owed</th>
<th>Total Payments</th>
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<td>110</td>
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</tbody>
</table>

Page 113
If you declare Chapter 13 bankruptcy, a repayment plan is set up in which the court binds both you and your creditors to set terms of repayment. You retain your property and make regular payments with future income to a trustee, who pays creditors slowly over the life of the bankruptcy plan.

Research on bankruptcy has shown some interesting trends. The majority of all bankruptcies are caused by three events: divorce, death, or separation; unpaid medical expenses; and loss of the primary source of employment. You can substantially reduce your risk of these events by obtaining life and health insurance and continuing your education.

Unfortunately, some have come to see bankruptcy as a way of getting out of paying the obligations they can honestly pay on their own. If you are considering bankruptcy, ask yourself the following questions:

- Is it honest, or is it just a way to get out of debt legally? Remember, things that are legal may not necessarily be honest.
- Is your integrity worth more than money?
- Is it really necessary to declare bankruptcy?

A bankruptcy filing will remain on your credit reports for up to 10 years after you make your last payment. This will hurt your chances of getting the credit necessary to purchase a home or a business. Filing bankruptcy should not be taken lightly; it should be your last resort.

**Summary**

You have studied what the scriptures and other leaders have said concerning debt. Avoiding debt is important for both our temporal and spiritual well-being.

You have learned about the debt cycle and the reasons why people go into debt: ignorance, carelessness, compulsiveness, pride, and necessity. You have learned that once you begin the debt cycle, it is very difficult to stop. However, you have also learned the characteristics that will help stop the debt cycle: knowledge, exactness, discipline, humility, and self-reliance. Once you do overcome the debt cycle, you can help others obtain the same financial self-reliance.
We discussed different personal strategies for debt-reduction as well as counseling and legal strategies for debt-reduction. Personal strategies include using debt-reduction spreadsheets and payoff accelerators. We talked about counseling strategies in terms of both nonprofit and for-profit credit counseling agencies. Finally, we talked about the legal strategy of bankruptcy, and why it should be filed only as a last resort.

**Assignments**

**Financial Plan Assignments**

If you are in debt, or know others in debt, think through the reasons for that debt. Are there things that could have been done differently or things you could have done without that would have reduced the need for debt?

Review any debt you may have, including consumer debt, mortgage debt, and student loans. Write out your debt situation for each debt, including the following: creditor, phone number, reason for the loan, principal owed, interest rate, minimum payment, additional costs, fees, and the date by which you expect to have the loan paid off. Once you have written down all your debts, plan how to reduce your debt.

Finally, write down your views on how you will use debt in the future. Will you use it? What type of debt is acceptable? What are your thoughts and what are the reasons you feel the way you do toward both acceptable and unacceptable debt?

**Learning Tools**

The following Learning Tools may also be helpful as you prepare your Personal Financial Plan:

20. Debt-Elimination Spreadsheet with Accelerator
   This Excel spreadsheet gives a framework for paying off debt; it encourages you to pay off your debts in order of expense until you have paid off all your debts.

9. Debt Amortization and Prepayment Spreadsheet
   This Excel spreadsheet gives a debt amortization and prepayment schedule to help you as you reduce and eliminate your debt.

18. Credit Card Repayment Spreadsheet
   This Excel spreadsheet gives information on how long it will take to pay off credit cards and other debt.
Review Materials

Review Questions

1. What are two debts that, according to leaders, are okay to incur?
2. What are five reasons people go into debt? How may these reasons be combated in order to get back out of debt?
3. What is the first signal that you are entering the debt cycle?

Case Studies

Case Study 1

Data
A family friend has asked you to help one of his children, who is having some financial problems. The son gave you the following information: They have four children, ages three months to 18 years. Their bills include a mortgage of $150,000 at 6 percent, a second mortgage of $20,000 at 7.5 percent (because they were too far in credit card debt), debts to various financial institutions of $10,000 at between 12 percent and 28 percent (she lost her job due to the latest pregnancy), a lease on a new truck of $18,000, a loan on her car for $5,000, and miscellaneous Christmas bills totaling $3,000. After some work using Learning Tool 20: Debt-Elimination Spreadsheet with Accelerator, you determine that debt payments represent 83 percent of their income for living expenses.

Application
What suggestions do you have to help them get out of debt?

Case Study 1 Answers
The above was a real case that occurred a few years ago. I have included below my suggested process to help (there are likely other ways to help as well).

1. Help them determine what is important to them—their personal goals.
   • I helped them think through the process of setting effective goals, and then they wrote down their goals so they would be working for the right things.
   • I didn’t spend a lot of time together on this area, but I did emphasize its importance and had them do it on their own.

3. Help them realize where they are financially.
   • I helped them develop a balance sheet for the family.
   • We worked together to determine what assets were available and how much was owed. We developed an income statement.
   • We worked at finding out where the money was going so we could put it to the best use.
Chapter 7. Debt and Debt Reduction

- We put them on a very strict budget.

4. Help them understand why they went into debt in the first place.
   - I shared with them the reasons people go into debt so they could understand why they got into this problem in the first place.
   - I talked about the spiritual reasons behind not going into debt. I told them they needed to get their spiritual house in order so that God would help them get their temporal house in order.

5. Determine individual ways of reducing debt, the more the better.
   - I had them fill out their income taxes quickly so they could receive their income tax return.
   - They borrowed money against their cash-value insurance policy to reduce their debt.
   - I had them sell assets that they could do without (i.e., truck, old vehicles, etc.).

6. Help them determine a course of action and commit them to that course.
   - We worked together to make a plan, and then we all worked together to follow that plan.
   - I held them accountable for their plan.
   - I enlisted other people as part of a team approach to help them with talking to creditors and paying off their debts.

Now, four years later, they are still in debt, but their debts have become much more manageable and they are working to pay them off. Has it been easy? No. Is it worthwhile? Yes. The wife commented recently, “I just didn’t realize that it would be so hard for so long. You run into debt, but you crawl out of it.”

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1 Conference Report, Oct. 1903, 5
3 “I Believe,” Ensign, Aug. 1992, 6
4 “Constancy Amid Change,” Ensign, Nov. 1979, 80
5 Alma 5:7
7 Ether 12:27
8. Time Value of Money 1: Present and Future Value

Introduction

The language of finance has unique terms and concepts that are based on mathematics. It is critical that you understand this language, because it can help you develop, analyze, and monitor your personal financial goals and objectives so you can get your personal financial house in order.

Objectives

When you have completed this chapter, you should be able to do the following:

1. Understand the term investment
2. Understand the importance of compound interest and time
3. Grasp basic financial terminology (the language of finance)
4. Solve problems related to present value (PV) and future value (FV)

I strongly recommend that you borrow or purchase a financial calculator to help you complete this chapter. Although you can do many of the calculations discussed in this chapter on a standard calculator, the calculations are much easier to do on a financial calculator. Calculators like the Texas Instruments (TI) Business Analyst II, TI 35 Solar, or Hewlett-Packard 10BII can be purchased for under $35. The functions you will need for calculations are also available in many spreadsheet programs, such as Microsoft Excel. If you have a computer with Excel, you can use Learning Tool 12: Excel Financial Calculator, which is a spreadsheet-based financial calculator available on the website.

Understand the Term Investment

An investment is a current commitment of money or other resources with the expectation of reaping future benefits.

For the most part, we will be working with financial investments in this course—stocks (or equities), bonds, mutual funds, cash, treasury bills and notes, options, futures, and so on. However, we will make reference to other important investments such as education and relationships. It is important that we have a broader view of what an investment is so that we recognize those investments that are of most worth—those that bring true joy in this life and in the life to come. You should have priorities when it comes to investments, and the most important investments you will make involve your family, your religion, and your relationship...
with God. The Book of Mormon prophet Jacob wisely counseled: “Wherefore, do not spend money for that which is of no worth, nor your labor for that which cannot satisfy.”

Understand the Importance of Compound Interest and Time

Time is the only tool that everyone has an equal amount of each day. However, you must have the discipline and foresight to use time to your advantage by investing early and not stopping for “diversions” in your spending and your goals.

Interest is similar to rent. Just as tenants pay rent to landlords in exchange for the use of an apartment or house, people will pay you interest in exchange for the use of your money. You can either invest your money yourself or you can lend it to others who will then invest your money and pay you an agreed upon rate.

The key investing principle states that a dollar in hand is worth more than a dollar received in the future. This principle is true because you can invest that dollar today and begin earning interest on it. The sooner your money can earn interest, the faster your interest can earn interest, and the more money you will have.

Grasp Basic Financial Terminology (i.e., the Language of Finance)

For you to understand the language of finance, you must understand thirteen key terms:

- **Amortized loan**: A loan paid off in equal installments composed of both principal and interest. It may also be called an installment loan.

- **Annuity**: A series of equal payments; these payments are made at the end of a specific time period for a specified number of time periods (generally months or years).

- **Compound annuity**: An investment that involves depositing the same amount of money at the end of each year for a certain number of years.

- **Compounding (annually, quarterly, daily, etc.)**: The number of periods during the year where interest is calculated. Compound interest is where interest is paid on previously earned interest as well as on the principal. The shorter the compounding period, the higher the effective annual rate of interest.

- **Effective interest rate**: The actual rate (as opposed to the stated or nominal rate) that is received after the effects of compounding are taken into account.

- **Future value (FV)**: The value of an investment at some point in the future.

- **Interest or discount rate**: The stated rate you will receive for investing at a specified compounding period for a specified period of time.
Nominal return: The return on your investment before the impact of inflation and taxes is taken into account.

Present value (PV): The current value (today’s value) of a future sum of money.

Principal: The money you have available to invest or save, or the stated amount on a bond or deposit instrument.

Real return: The rate of return on an investment after the impact of inflation is accounted for. The formula for approximating the real return is the nominal return minus inflation. The exact formula for the real return is: 

\[ \text{Real return} = \left(1 + \frac{\text{nominal return}}{1 + \text{inflation}}\right) - 1 \]

Tax-adjusted return: The return on your investment after the impact of federal and state taxes has been taken into account.

Compounding

How will different compounding periods impact your investment and investment returns?

Compounding periods refer to the frequency with which interest is applied to your investment. Interest may be compounded daily, weekly, monthly, semiannually, or annually. A key relationship exists between time and interest rate. The shorter the compounding period, the higher the effective annual interest rate (the actual rate you are earning on your investment after taking the effect of compounding into account). For example, if interest is compounded daily, the investment will grow faster than if the interest is compounded monthly or annually.

The formula for calculating the effective interest rate (EIR) is as follows:

\[ \text{EIR} = \left(1 + \frac{\text{nominal return or APR}}{\text{periods}}\right)^{\text{periods}} - 1 \]

Problem 1: Impact of Compounding

Let’s illustrate the effect of compounding and the effective interest rate. The following are examples of four investments with four different nominal returns. Which of these investments would you rather own?

Investment A earns 12.0 percent annually
Investment B earns 11.9 percent semiannually
Investment C earns 11.8 percent quarterly
Investment D earns 11.7 percent daily

To figure out which investment is best for you, you must determine the effective interest rate of each investment.

For Investment A, the effective rate would be \((1 + .12 / 1)^1 - 1\), or 12.00 percent.
For Investment B, the effective rate would be \((1 + .119 / 2)^2 - 1\), or 12.25 percent.
For Investment C, the effective rate would be \((1 + .118 / 4)^4 - 1\), or 12.33 percent. For Investment D, the effective rate would be \((1 + .117 / 365)^{365} - 1\), or 12.41 percent.

Even though Investment D has the lowest nominal return, because of compounding, it has the highest effective interest rate. Investment D would be the best vehicle, assuming you were lending money at this rate. Compounding makes an important difference!

Solve Problems Related to Present Value (PV) and Future Value (FV)

Present Value (PV)

Let’s suppose you want to determine the current value of the ultimate earnings on an investment. This question could be restated in the following manner: What is the present value of my investment that will mature in \(N\) years at \(I\) percent interest (or discount rate)?

To solve this problem, you will need to know the future value of your investment, how many years are required for the investment to reach maturity, and what interest or discount rate your investment has. The result of the equation will be a dollar amount that is smaller than the future amount of principal and interest you will have earned; it is the amount the investment is worth at the present time.

The present value (PV) equation is as follows:

\[
PV = \frac{FV}{(1 + I)^N}
\]

The key inputs in the PV equation are as follows:

- \(FV\) = the future value of the investment at the end of \(N\) years
- \(N\) = the number of years in the future
- \(I\) = the interest rate, or the annual interest rate or discount rate
- \(PV\) = the present value, in today’s dollars, of a sum of money you have invested or plan to invest

After you find these inputs, you can solve for the present value (PV).

Problem 2: Determining Present Value

Let’s suppose your rich uncle promises to give you $500,000 in 40 years. Assuming a six percent interest rate, what is the present value of the amount your uncle is promising to give you in 40 years?

To solve this problem, use the equation given above, which would appear as follows: \(PV = 500,000 / (1 + .06)^{40}\), or $48,611. You can also use a financial calculator. Set your calculator to end mode, meaning payments are at the end of each period, and clear the memory registers to make sure you have no old data in the calculator memories. Set $500,000 as your future value.
Chapter 8. Time Value of Money 1: Present and Future Value

(FV), 40 as your number of years (N), and 6 as your interest rate (I); then solve for the present value (PV). You should get the same result as you did when you used the PV equation.

**Future Value (FV)**

Let’s suppose you want to determine what an investment will be worth at some point in the future, i.e., what will the value of my investment be in N years if my interest rate is I percent? You will need to know how many years it will be until you have the investment, the interest rate, and the amount of the investment (the present value of the investment).

The result of the equation will be a dollar amount that is larger than the original investment, since your money will earn interest and will then earn interest on that interest. For an approximation, remember the rule of 72, which states that an investment will double approximately each time you multiply the number of years of investment by the interest rate (in percentage terms) and get a number that is greater than 72. For example, if your investment is earning 8 percent interest, it will take nine years for it to double (72 divided by 8 = 9).

The future value (FV) equation is as follows:

\[ FV_N = PV \times (1 + I)^N \]

The key inputs in the FV equation are as follows:

- FV = future value of the investment at the end of N periods (years)
- N = number of years in the future
- I = interest rate, or the annual interest (or discount) rate
- PV = present value, in today’s dollars, of a sum of money you have already invested or plan to invest

**Problem 3: Determining Future Value**

Let’s look at two similar problems:

A. Calculate the future value (in 15 years) of $5,000 that is earning 10 percent; assume an annual compounding period.

B. Calculate the future value (in 15 years) of $5,000 that is earning 10 percent; assume simple interest (the interest earned does not earn interest).

C. How much did interest on interest earn in the first problem?

A. To solve this problem, we must consider compound interest. On your calculator, clear your registers and your memory. Set –$5,000 as the present value (PV), 10 percent as the interest rate (I), and 15 as the number of years in the future (N); then solve for the future value (FV), which is $20,886. With a standard calculator, the result is 5,000 \times (1 + .10)^{15}, or the same sum of $20,886.
B. To solve for simple interest, which does not accrue interest on interest, it is easiest to use a standard calculator. First, calculate your annual interest, which is $5,000 times 10 percent (5,000 * .10), or $500. Multiply $500 by 15 years; the result should be $7,500. Then add the amount of the original investment of $5,000 to get $12,500.

C. The difference between $20,886 and $12,500 is $8,386, which is the amount of interest that your interest has earned. This concept is the key to financial success—earn interest on your interest.

**Summary**

In this chapter, we have become familiar with the language of finance. The language of finance comprises many different concepts and terms, and understanding these concepts and terms is can help you to develop, analyze, and monitor your personal and financial goals successfully.

An *investment* is the current commitment of money or other resources with the expectation of reaping future benefits. We make investments in many areas of our lives; key investments can involve education and skills, knowledge and friendships, food storage and emergency funds, and finances.

*Compounding* is an important principle to understand. Compounding periods are the frequency with which interest is applied to your investment. Interest may be compounded daily, weekly, monthly, semiannually, or annually. The sooner your money can earn interest, the faster your interest can earn interest, and the more money you will have.

*Present value* (PV) is another key term. The present value of an investment refers to the current value of a future sum of money. You must remember, however, that money you will earn in the future is less valuable to you than money you have right now; you cannot use future money to earn interest today. You can only earn interest on money you have in hand.

*Future value* (FV) is the value an investment will have at some point in the future. The result of a future value equation will be a dollar amount that is larger than the original investment (assuming a positive rate of interest or return) because your money will earn interest and earn interest on that interest.

**Assignments**

**Financial Plan Assignments**

As you read through this chapter, think about the purpose of each financial concept. Use either a calculator or the Excel financial calculator from the Learning Tools chapter to make sure you understand how to solve problems of present value and future value.
Learning Tools

The following Learning Tools may also be helpful as you prepare your Personal Financial Plan:

3. Financial Calculator Tutorial

This document is a financial calculator tutorial about most of the major financial calculators. It also includes the financial formulas if you would prefer to program your own calculator.

12. Excel Financial Calculator

This Excel spreadsheet is a simple financial calculator for those who prefer to use spreadsheets. This tool can perform most of the functions of a financial calculator, including present value, future value, payments, interest rates, and number of periods.

Review Materials

Review Questions

1. What is compound interest?

2. What are the four variables of the present value equation?
3. What are the 13 financial terms mentioned in the chapter? What do they mean?
4. What is the relationship between the compounding period and the effective interest rate?

Case Studies

Case Study 1

Data

Brian has a goal to have $500,000 saved by the time he turns 65, which is 40 years from now.

Calculation

Assuming he can make 6 percent on his money, what is the value of that money now (this indicates present value)? The math formula is as follows:

\[ PV = \frac{FV}{(1 + I)^N} \]

Case Study 1 Answer

The formula is \( PV = \frac{FV}{(1 + I)^N} \), or \( PV = 500,000 \div (1.06)^{40} \), or $48,611.10. This formula shows you how this equation would be calculated on a standard calculator.
Using a financial calculator, you would clear the memories and then enter the following information:

- $500,000 = FV
- 6% = I, which is the interest rate (the annual interest, or discount, rate)
- 40 = N, or the number of years

You would then solve for PV:

\[ PV = \text{the present value, in today’s dollars, of a sum of money you have invested or plan to invest. If you use a financial calculator for this equation, the present value should come out as $48,611.10.} \]

**Case Study 2**

**Data**

Ron has $2,500 saved.

**Calculation**

If his investment earns 8 percent per year for 20 years, how much will his investment be worth in 20 years (the investment’s future value)? The formula is as follows:

\[ FV = PV (1 + I)^N \]

**Case Study 2 Answer**

The equation would be \[ FV = 2,500 \times (1 + 0.08)^{20} \] or $11,652.39

If you were using a financial calculator, you would clear the memories and then enter the following:

- $2,500 = PV
- 8% = I, which is the interest rate (the annual interest, or discount, rate)
- 40 = N, or the number of years

You would then solve for FV:

\[ FV = 11,652.3 \]

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1. 2 Nephi 9:51
9. Time Value of Money 2: Inflation, Real Returns, Annuities, and Amortized Loans

Introduction

This chapter continues the discussion on the time value of money. In this chapter, you will learn how inflation impacts your investments; you will also learn how to calculate real returns after inflation as well as annuities and payments on amortized loans.

Objectives

Once you have completed this chapter, you should be able to do the following:

1. Explain how inflation impacts your investments
2. Understand how to calculate real returns (returns after inflation)
3. Solve problems related to annuities
4. Solve problems related to amortized loans

Explain How Inflation Impacts Your Investments

Inflation is an increase in the volume of available money in relation to the volume of available goods and services; inflation results in a continual rise in the price of various goods and services. In other words, because of increased inflation, your money can buy fewer goods and services today than it could have bought in the past.

Inflation negatively impacts your investments. Although the amount of money you are saving now will be the same amount in the future, you will not be able to buy as much with that money in the future (the purchasing power of your money erodes). Inflation makes it necessary to save more because your currency will be worth less in the future.

Problem 1: Inflation

Forty years ago, gum cost five cents a pack. Today it costs 99 cents a pack. Assume that the increase in the price of gum is completely related to inflation and not to other factors. At what rate has inflation increased over the last 40 years?

Before solving this problem, clear your calculator’s memory, and set your calculator to one annual payment. Then input the following information to solve this problem:

\[
\begin{align*}
PV &= –$0.05 \text{ (the price of gum forty years ago)} \\
FV &= $0.99 \text{ (the price of gum today)} \\
N &= 40 \text{ (The cost has increased every year for forty years.)} \\
I &= ?
\end{align*}
\]
On average, the inflation rate has been 7.75 percent each year for the last 40 years. So, the average price of gum has increased by 7.75 percent each year for the last 40 years.

**Problem 2: Inflation—The Future Value of a Wedding**

I have six daughters and one son. It is estimated that an average wedding cost $23,000 in 2007. Assuming four-percent inflation, what would it cost me to pay for all six of my daughters’ weddings in 15 years? (Hopefully not all six weddings will take place in the same year.)

Before you begin, clear your calculator’s memory and set your calculator to one annual payment. Input the following information to solve for the cost of a single wedding in 15 years:

- **PV** = $23,000 (Assume that on average a wedding still costs $23,000.)
- **N** = 15 (The cost will increase every year for 15 years.)
- **I** = 4 (The inflation rate is four percent.)
- **FV** = ?

In 15 years, the value of a single wedding will be $41,422. This means six weddings will cost $248,530. Inflation will raise my costs by 80 percent \((($41,422 / 23,000) – 1)\) over the next 15 years, so I need to plan now.

**Understand How to Calculate Real Returns**

A real return is the rate of return you receive after the impact of inflation. As discussed earlier, inflation has a negative impact on your investments because your money will buy less in the future. For example, 40 years ago a gallon of gas cost 25 cents per gallon; currently, gas costs $4.00 per gallon. While the gas itself hasn’t changed (much), the price has increased. To keep your real return constant (in other words, to maintain your buying power), you must actually earn more money in nominal (not inflation adjusted) terms.

Traditionally, investors have calculated the real return \((r_r)\) as simply the nominal return \((r_n)\), or the return you receive, minus the inflation rate \((\pi)\). This method is incorrect. It is preferable to use the following formula:

\[
(1 + \text{nominal return } (r_n)) = (1 + \text{real return } (r_r)) \cdot (1 + \text{inflation } (\pi))
\]

To solve for the real return, divide both sides of the equation by \((1 + \text{inflation } (\pi))\). Once you’ve divided, the equation looks like this:

\[
(1 + \text{nominal return } (r_n)) / (1 + \text{inflation } (\pi)) = (1 + \text{real return } (r_r))
\]

Then, subtract one from both sides and reverse the equation to get the following:

\[
\text{Real return } (r_r) = [(1 + \text{nominal return } (r_n)) / (1 + \text{inflation } (\pi))] – 1
\]
Problem 3: Real Return (i.e., the Return after Inflation)

Paul just graduated from college and landed a job that pays $23,000 per year. Assume that inflation averages 1.96 percent per year.

A. What nominal rate will Paul need to earn in the future to maintain a 2-percent real return rate?

B. In nominal terms, what will Paul’s salary be in 10 years? Assume that his salary keeps up with inflation and that inflation averages the same 1.96 percent per year.

a. To determine the nominal rate of return, remember the formula for real return: 
\[ r_r = \frac{(1 + r_n)}{(1 + \pi)} - 1 \]
Now plug in the values you know: 
\[ 0.02 = \frac{(1 + x)}{(1 + 0.0196)} - 1 \]
Solving for \( x \) results in a nominal return of 3.99 percent. Thus, Paul’s nominal return must be 3.99 percent in the future to maintain a real return of 2 percent.

b. To maintain his current purchasing power 10 years from now, Paul will have to make $28,036.87 in real terms.

This problem is very similar to those we have already discussed. Use the following values to solve this problem:

\[
\begin{align*}
PV &= -23,000 \text{ (This is Paul’s current salary.)} \\
I &= 2 \text{ (Interest is replaced by inflation.)} \\
N &= 10 \text{ (This is the number of years in the future.)} \\
FV &= ? \\
\end{align*}
\]

Understand How to Solve Problems Related to Annuities

An annuity is a series of equal payments that a financial institution makes to an investor; these payments are made at the end of each period (usually a month or a year) for a specific number of years. To set up an annuity, an investor and a financial institution (for example, an insurance company) sign a contract in which the investor agrees to transfer a specific amount of money to the financial institution, and the financial institution, in turn, agrees to pay the investor a set amount of money at the end of each period for a specific number of years.

To determine the set amount of each equal payment for a certain investment, you must know the amount of the investment (PV), the interest rate (I), and the number of years the annuity will last (N).

Problem 4: Annuities

When you retire at age 60, you have $750,000 in your retirement fund. The financial institution you have invested your money with will pay you an interest rate of 7 percent. Assuming you live
to age 90, you will need to receive payments for 30 years after you retire. How much can you expect to receive each year for your $750,000 investment with a 7 percent interest rate?

To solve this problem, input the following information into your financial calculator:

Set –$750,000 as your present value (PV). Your present value is negative because it is considered an outflow. You pay this amount to the financial institution, and the financial institution pays you back with annual payments.

Set 30 as the number of years (N).

Set 7 percent as your interest rate (I). Remember that you may need to convert this percentage to the decimal 0.07 in some calculators.

Now solve for the payment (PMT). The present value of this annuity is $60,439.80. This means you should receive 30 annual payments of $60,439.80 each.

Without a financial calculator, solving this problem is a bit trickier. The formula is as follows:

\[
PMT = \frac{PV_{N,I}}{[1 - (1 / (1 + I)^N)] / I}
\]

\[
PMT = \frac{750,000}{[1 - (1 / (1.07)^{30})]} / 0.07 = 60,440
\]

The key is to start saving for retirement as soon as you can. Starting to save early will make a big difference in what you are able to retire with.

**Problem 5: Compound Annuities**

With a compound annuity, you deposit a set sum of money into an investment vehicle at the end of each year; you deposit this amount for a specific number of years and allow that money to grow.

Suppose you are looking to buy a new four-wheeler to remove snow from your driveway. Instead of borrowing the $7,000 you would need to pay for the four-wheeler, you want to save for the purchase. You need to ask yourself two questions:

A. How much will I need to save each month if I want to buy the four-wheeler in 50 months if I can earn 7 percent interest on my investment?

B. How much will I have to save each month if I want to buy the four-wheeler in 24 months if I can earn 7 percent interest on my investment?

**Note:** The method you use to calculate the monthly payments will depend on the type of financial calculator you have. Some calculators require you to set the number of payments to 12 (for monthly payments) and also divide the interest rate by 12 months. Other calculators only
require you to set the number of payments to 12. Determine what your calculator requires before solving problems requiring monthly data.

Before solving for the monthly payment, follow these steps: (1) clear your calculator’s memory, (2) set your number of payments to 12 so that your calculator will calculate monthly payments instead of annual payments, and (3) make sure your calculator is operating in “end mode,” since the payments are received at the end of each period.

To solve the first question, input the following information:

\[
\begin{align*}
FV & = -7,000 \\
N & = 50 \\
I & = 7 \\
PMT & = ?
\end{align*}
\]

If you earn 7 percent interest on your investment, you will need to save $120.98 each month to save $7,000 in 50 months. If you do not have a financial calculator, use the following to solve this problem:

\[
PMT = FV_N \left( \frac{1 - (1 + I/12)^{-N}}{I/12} \right)
\]

\[
PMT = 7,000 \times \left[ \frac{1 - (1 + 0.07/12)^{-50}}{0.07/12} \right] = $120.98
\]

To solve the second question, input the following information:

\[
\begin{align*}
FV & = -7,000 \\
N & = 24 \\
I & = 7 \\
PMT & = ?
\end{align*}
\]

After solving for the payment, you will discover that you need to save $272.57 each month to save $7,000 in 24 months. If you do not have a financial calculator, use the following to solve this problem:

\[
PMT = 7,000 \times \left[ \frac{1 - (1 + 0.07/12)^{-24}}{0.07/12} \right] = $272.57
\]

As a general rule, it is better to save for a purchase than to borrow money for it because when you borrow you will have to pay interest instead of earning interest.

**Problem 6: Present Value of Annuities**

Let’s try another sample problem using annuities; this time, we will be calculating the present value instead of the set payment amount.

There are two people who each want to buy your house. The first person offers you $200,000 today, while the second person offers you 25 annual payments of $15,000. Assume a 5 percent
interest or discount rate. What is the present value of each offer? If you could take either offer, which person would you sell your house to?

First offer: The present value of this offer is $200,000 because the buyer can pay you all of the money today.
Second offer: This offer is a little different because you will not receive all of the money today; therefore, you must calculate the present value.

To calculate the present value of the first offer using a financial calculator, clear your calculator’s memory, set the number of payments to one annual payment, and make sure your calculator is set to “end mode.” Then, input the following information:

\[
PMT = -$15,000 \\
N = 25 \\
I = 5 \\
PV = ?
\]

The present value of the second offer is $211,409. If you do not have a financial calculator, use the following formula to solve for the present value:

\[
PV_{N,I} = PMT \times \left[1 - \frac{1}{(1 + I)^N}\right] / I
\]

\[
PV_{25,0.05} = $15,000 \times \left[1 - \frac{1}{(1.05)^{25}}\right] / 0.05 = $211,409
\]

Which is the better offer? The second offer has a higher present value: if we can assume that you don’t need the money right away and that you are willing to wait for payments and confident the buyer will pay you on schedule, you should accept the second offer. As you can see from this example, it is very important that you know how to evaluate different cash flows.

**Problem 7: Future Value of Annuities**

Just as it is possible to calculate the present value of an annuity, it is also possible to calculate the future value of an annuity.

Josephine, age 22, started working full time and plans to deposit $3,000 annually into an IRA that earns 6 percent interest. How much will be in her IRA in 20 years? 30 years? 40 years?

To solve this problem, clear your calculator’s memory and set the number of payments to one (for an annual payment). Set I equal to six and the PMT equal to $3,000.

For 20 years: Set N equal to 20 and solve for FV. \( FV = $110,357 \)
For 30 years: Set N equal to 30 and solve for FV. \( FV = $237,175 \)
For 40 years: Set N equal to 40 and solve for FV. \( FV = $464,286 \)
If Josephine increased her return rate to 10 percent, how much money would she have after each of the three time periods? How does this interest rate compare to the 6 percent interest rate over time?

Do the previous problems at 10-percent interest. Begin by clearing the calculator’s memory. Set I equal to 10 and the PMT equal to $3,000.

For 20 years: Set N equal to 20 and solve for FV. FV = $171,825 ($61,468 more than she would earn at the 6 percent interest rate)

For 30 years: Set N equal to 30 and solve for FV. FV = $493,482.07 ($256,307.51 more than at the 6 percent rate)

For 40 years: Set N equal to 40 and solve for FV. FV = $1,327,777.67 ($863,491.77 more than at the 6 percent rate)

Your rate of return and the length of time you invest make a big difference when you retire.

Solve Problems Related to Amortized Loans

An amortized loan is paid off in equal installments (payments) made up of both principal and interest. With an amortized loan, the interest payments decrease as your outstanding principal decreases; therefore, with each payment a greater amount of money goes toward the principal of the loan. Examples of amortized loans include car loans and home mortgages.

To determine the amount of a payment, you must know the amount borrowed (PV), the number of periods during the life of the loan (N), and the interest rate on the loan (I).

Problem 8: Buying a Car

You take out a loan for $36,000 to purchase a new car. If the interest rate on this loan is 15 percent, and you want to repay the loan in four annual payments, how much will each annual payment be? How much interest will you have paid for the car loan at the end of four years?

Before solving this problem, clear your calculator’s memory and set your calculator to one annual payment. Input the following information into your financial calculator:

\[
\begin{align*}
PV &= -$36,000 \\
N &= 4 \\
I &= 15 \\
PMT &= ?
\end{align*}
\]

Solve for your PMT to get $12,609.55.

The amount of interest you will have paid after four years is equal to the total amount of the payments ($12,609.55 * 4 = $50,438.20) minus the cost of your automobile ($36,000); the total
comes to $14,438.21. That is one expensive loan! In fact, the interest alone is more than the cost of another less-expensive car. If you want to buy this car, go ahead, but don’t buy it on credit—save for it!

**Problem 9: Buying a House**

What are the *monthly* payments on each of the following mortgage loans? Which loan is the best option for a homeowner who can afford payments of $875 per month? What is the total amount that will be paid for each loan? Assume each mortgage is $100,000.

- **Loan A.** To determine the monthly payment for a 30-year loan with an 8.5-percent fixed interest rate, clear your calculator’s memory, then set your calculator to 12 monthly payments and “end mode.” Input the following to solve this equation:

  \[
  \begin{align*}
  PV &= \text{–}100,000 \\
  N &= 360 \text{ (Calculate the number of monthly periods by multiplying the length of the loan by the number of months in a year: } 30 \times 12 = 360.)\\
  I &= 8.5 \\
  PMT &= ?
  \end{align*}
  \]

  Your monthly payment for this loan would be $768.91, and the total amount of all payments would be $768.91 \times 360$, or $276,807.60.

- **Loan B.** For a 15-year loan at 7.75 percent interest, follow the same steps explained above. This time, input the information listed below:

  \[
  \begin{align*}
  PV &= \text{–}100,000 \\
  N &= 15 \times 12 = 180 \\
  I &= 7.75 \\
  PMT &= ?
  \end{align*}
  \]

  The monthly payment for this loan would be $941.28, and the total amount of all payments would be $941.28 \times 180$, or $169,430.40.

- **Loan C.** For a 20-year loan at 8.125 percent interest, the calculations are still the same. Input the following in your financial calculator:

  \[
  \begin{align*}
  PV &= \text{–}100,000 \\
  N &= 20 \times 12 = 240 \\
  I &= 8.125
  \end{align*}
  \]
PMT = ?

The monthly payment for this loan would be $844.24, and the total amount of all payments would be $844.24 * 240, or $202,617.60.

Considering the mortgage payment the homeowner can afford, the best financial option is Loan C—the 20-year fixed-rate mortgage at 8.125 percent interest. This loan would allow the homeowner to pay off the home in 10 fewer years than if he or she had the 30-year loan and to pay $74,190 less.

**Problem 10: Becoming a Millionaire**

Your friend thinks becoming millionaire is totally beyond her earning abilities. You, financial wizard that you are, plan to show her otherwise. Assuming your friend is 25 years old and will retire at age 65, and assuming a 6 percent interest rate, how much will she have to save each month to reach her goal of becoming a millionaire when she retires? How much each month if she earns 9 percent on her investments?

Clear your memory and set payments to monthly. $FV = 1,000,000, N = (40 * 12), I = 6\%$, Solve for Payment (PMT)

$$PMT = \$502.14.$$ She will need to save $502 per month.

At 9 percent interest:

Clear your memory and set payments to monthly. $FV = 1,000,000, N = (40 * 12), I = 9\%$, Solve for Payment (PMT)

$$PMT = \$213.62.$$ She will need to save only $214 per month.

It’s not that hard to become a millionaire if you invest a specific amount every month and can earn a modest interest rate.

**Summary**

The major goal of this chapter was to help you better understand the time value of money. This chapter also helped you understand how inflation impacts your investments.

Real return is the rate of return you receive after the impact of inflation. As discussed earlier, inflation has a negative impact on your investments because you will not be able to buy as much with your money in the future. Traditionally, investors have calculated real returns with the approximation method by simply using the nominal return minus the inflation rate. Although the approximation method is fairly accurate, it can give incorrect answers when it is used for precise financial calculations. Because of the possibility of error, it is preferable to use the exact formula: $(1 + \text{nominal return} (r_n)) = (1 + \text{real return} (r_t)) * (1 + \text{inflation} (\pi)) = (1 + \text{nominal return} (r_n)) / (1 + \text{inflation} (\pi)) - 1.$

Page 134
Inflation is an increase in the volume of available money in relation to the volume of available goods and services; inflation results in a continual rise in the price of various goods and services. Because of inflation, you can buy fewer goods and services with your money today than you could have bought in the past.

An amortized loan is paid off in equal installments (payments) that are made up of both principal and interest. With an amortized loan, the interest payments decrease as your outstanding principal decreases; therefore, with each payment, you pay a larger amount on the principal of the loan. Examples of amortized loans include car loans and home mortgages.

An annuity is a series of equal payments that a financial institution makes to an investor at the end of each period (usually a month or a year) for a specific number of years. A compound annuity is a type of investment in which a set sum of money is deposited into an investment vehicle at the end of each year for a specific number of years and allowed to grow. Annuities are important because they can help you prepare for retirement and allow you to receive a specific payment every period for a number of years.

Assignments

Financial Plan Assignments

As you read through this chapter, think about the purpose of each new financial idea: annuities, present value of an annuity, and future value of an annuity. Also review the uses of amortized loans and the calculations that concern them. Using either your financial calculator or the Excel financial calculator from the Learning Tools section, make sure you understand how to solve problems of amortized loans and annuities, including the present and the future value of an annuity. It is also critical that you understand the impact of inflation on returns. Make sure you understand the correct method for calculating real returns (the return after the impact of inflation).

Learning Tools

The following Learning Tools may also be helpful as you prepare your Personal Financial Plan:

3. Financial Calculator Tutorial

   This document is a tutorial for how to use most of the major financial calculators. It also includes the financial formulas for those who prefer to program their own calculators.

12. Excel Financial Calculator

   This Excel spreadsheet is a simple financial calculator for those who prefer to use spreadsheets rather than financial calculators. It can perform most of the functions
of a financial calculator, including the functions of present value, future value, payments, interest rates, and number of periods.

Review Materials

Review Questions

1. What is an annuity?
2. How do you set up an annuity?
3. What is a compound annuity?
4. What is the relationship between interest rate and present value?
5. What is inflation? How does it impact investments?

Case Studies

Case Study 1

Data
Lee is 35 years old and makes a $4,000 payment every year into a Roth Individual Retirement Account (IRA) (this is an annuity) for 30 years.

Calculations
Assuming the discount, or interest, rate Lee will earn is 6 percent, what will be the value of his Roth IRA investment when he retires in 30 years (this is future value)?

Note: The formula is a bit tricky. It is
\[
FV_{N,I} = \text{Payment} \times \frac{[(1 + I)^N - 1]}{I} \quad \text{(This is the future value of an annuity factor for N, I)}
\]

Case Study 1 Answer
There are two ways for Lee to solve the problem. Using the formula, the problem is solved this way:

\[
FV_{N,I} = \text{Payment} \times \frac{[(1 + I)^N - 1]}{I} = FV = \$4,000 \times \frac{[(1.06)^{30} - 1]}{.06} = \$316,232.75
\]

If you are using a financial calculator, clear the calculator’s memory and solve:
1 = P/Y (payments per year)
4,000 = PMT (payment)
6 = I (interest rate)
30 = N (number of years)
Solve for FV = $316,232.75

Case Study 2

Data
Janice will make a yearly $2,000 payment for 40 years into a traditional IRA account.
Calculations

Given that the discount, or interest, rate is 6 percent, what is the current value of Janice’s investment in today’s dollars? The formula is

\[ PV_{N,I} = \text{Payment} \times \left[ 1 - \left( \frac{1}{1 + I} \right)^N \right] / I \] (the present value of an annuity factor \( N,I \))

Case Study 2 Answer

Using the formula, the calculation is

\[ PV_{N,I} = \text{Payment} \times \left[ 1 - \left( \frac{1}{1 + I} \right)^N \right] / I = \text{PV} = 2,000 \times \left[ 1 - \left( \frac{1}{1.06} \right)^{40} \right] / .06 = 30,092.59 \]

Using the financial calculator, the calculation is

Clear memories and use the following:

1 = P/Y
2,000 = PMT
6 = I
40 = N
Solve for PV = $30,092.59

Case Study 3

Data

Brady wants to borrow $20,000 dollars for a new car at 13 percent interest.

Calculations

He wants to repay the loan in five annual payments. How much will he have to pay each year (this indicates present value)? The formula is the same formula that was used in the previous problem:

\[ PV_N = \text{Payment} \times (PVIFA_{I,N}) \]

Case Study 3 Answer

Using the formula, put Brady’s borrowed amount into the equation and solve for your payment. \( PV_{N,I} = \text{Payment} \times \left[ 1 - \left( \frac{1}{1 + I} \right)^N \right] / I = \text{PV} = 20,000 = \text{Payment} \times \left[ 1 - \left( \frac{1}{1.13} \right)^5 \right] / .13 = 5,686.29 \) per year.

Using a financial calculator, clear the calculator’s memory and use the following:

1 = P/Y
20000 = PV
13 = I
5 = N
Solve for PMT = $5,686.29

Case Study 4

Data

Page 137
Kaili has reviewed the impact of inflation in the late 1970s. She reviewed one of her parent’s investments during that time period and discovered that inflation was 20 percent and that her parent’s investment made a 30 percent return.

Calculations

What was her parent’s real return on this investment during that period?

Case Study 4 Answers

The traditional (and incorrect) method for calculating real returns is

Nominal return – inflation = real return. This formula would give you a real return of 10%: 30% – 20% = 10%.

The correct method is \( \left( \frac{1 + \text{nominal return}}{1 + \text{inflation}} \right) - 1 = \text{real return} \)

\( \frac{1.30}{1.20} - 1 = 8.33\% \).

In this example, the traditional method overstates return by 20 percent \( \left( \frac{10\%}{8.33\%} - 1 \right) \). Be very careful of inflation, especially high inflation!
10. Beginning Investing 1: Principles

Introduction

The previous chapters have been successful if they have helped you put personal financial management into perspective. These chapters have taught you to live on a budget, keep track of where your resources are going, manage your cash and cash equivalents wisely, protect yourself from loss by owning insurance, and make big-ticket purchases wisely. Now we begin a discussion on long-term investing.

Please be aware that this class approaches the subject of investments differently than other textbooks approach this subject. Most books take an asset-based approach: in other words, they talk about stocks, bonds, mutual funds, and other assets. These assets will change over time as new assets are developed and sold. I take a principles-based approach to discussing investments because the principles will not change over time.

Objectives

When you have completed this chapter, you should understand the key principles of investing including:

1. Investment basics
2. What to do before you invest (the top of the “investment hourglass”)
3. Investing factors you control
4. The ten principles of successful investing
5. Understand what you invest in (asset classes)

Properly prepare yourself to invest and understand what you will be investing in before you begin your investment program; these are important keys to success.

Investment Basics

It is important that we understand the key principles of investing. Richard G. Scott commented:

Joseph Smith’s inspired statement, “I teach them correct principles, and they govern themselves,” still applies. The Lord uses that pattern with us. . . Your consistent adherence to principle overcomes the alluring yet false life-styles that surround you. Your faithful compliance to correct principles will generate criticism and ridicule from others, yet the results are so eternally worthwhile that they warrant your every sacrifice.¹

What are the correct principles when it comes to investing? Let me share a few ideas.
Chapter 10. Beginning Investing 1: Principles

Principle: Everyone invests

Perhaps to start, we should define investing. Most would agree it is the giving up of something important to us now in order to get something better in the future. Now think about sacrifice. How would you define that term? Again, most would agree that it is the giving up of something important to us now in order to get something better in the future. Notice that these terms are nearly identical. We all invest, in terms of giving up our time, our talents, and our resources for things better in the future. Let's not be too narrow in our view of investing.

Principle: There is a purpose to investing

Spencer W. Kimball said:

Many people spend most of their time working in the service of a self-image that includes sufficient money, stocks, bonds, investment portfolios, property, credit cards, furnishings, automobiles, and the like to guarantee carnal security throughout, it is hoped, a long and happy life. Forgotten is the fact that our assignment is to use these many resources in our families and quorums to build up the kingdom of God."

I believe that God wants us to learn to invest, and we should want to learn as well. From the Lord’s view, the purpose of investing are:

- To bring us to Christ
- To help us achieve our divine missions
- To help us return with our families back to His presence, and
- To teach us to be “wise stewards.”

From our view, the purpose of investing is:

- To show by our choices what we really believe
- To accomplish our short- and long-term personal and family goals, and
- To steward our resources to be able to serve and bless our families and others.

Principle: There is a priority of investments

There is a priority of investments. Below are mine (see Picture 1). Do not be too narrow in your view of investing and investments.

Principle: Investing is not gambling

Some have wondered the difference between investing and gambling. They think that investing in the stock or bond markets are simply gambling. Perhaps we can share some thoughts on the difference between investing and gambling. They are:

Investing: The odds are in your favor
Chapter 10. Beginning Investing 1: Principles

- There is a favorable risk-return tradeoff
- It is part of a long-term plan
- You have done your homework
- It involves the creation of wealth

Picture 1. My Most Important Investments

Gambling: The odds are in another’s favor

- There is no favorable risk-return tradeoff
- There is no long-term plan
- There is no homework, only chance
- It is a zero-sum game—no wealth is created

So the difference is in the risk-return tradeoff, the planning, the work, and the creation of wealth.
Chapter 10.  Beginning Investing 1: Principles

What to Do Before You Invest

Following are some other important questions to ask yourself before you start investing:

- Are there certain products or services you feel you should never do without? Should you have health and life insurance before you begin investing?
- Is there a better use for your money than investing? Are there bills or debts you should pay before beginning your investment program? What should you do about your high-interest debts such as credit cards and consumer loans? Does it really make sense to earn 8 percent annually on an investment when you are paying 24 percent annually for credit cards and other forms of debt?
- How does investing fit in with your personal goals and budget? Do you have a plan for investing?

As I have worked with families and students, I have developed a helpful framework for teaching investing. I call this framework “the investment hourglass.” This tool helps relate priorities and risks to the goals you want to accomplish.

The investment hourglass is divided into two parts: the top of the hourglass, which represents questions you should consider before you invest, and the bottom of the hourglass, which represents how you should invest.

The hourglass is designed to help you prioritize your goals and objectives. Since investing is a means to an end—and not an end in itself—you should base your investment decisions on your priorities and personal goals. If you can answer each of the questions listed in the top of the hourglass affirmatively (see Chart 1), you are ready to invest. If you cannot agree with any of these statements, you have important steps to take before you begin investing.

The top of the hourglass teaches about priorities. What are your most important priorities, and how do we make sure we put first things first? First and foremost, your most important priority is being “square” with the Lord, who I believe is your most important creditor. Before you invest, ask yourself if you have paid your tithes or other contributions to your local church or religious organization consistent with your belief in God.

Your second priority is your family. If something were to go wrong with your health, or if you were to die, who would take care of your family? Make sure you have adequate life insurance and health insurance in place before you begin investing. Disability or death is not a valid excuse to stop providing for the needs of your family.

Your third priority is yourself. Personal responsibility has two parts: the first involves getting out of credit card and consumer debt. When there is no guarantee that you will make a return on your investments in the stock market, it does not make sense to pay 24 percent interest on credit cards. The second part of personal responsibility involves living by your budget, knowing your personal and family goals, and having an Investment Plan. Figuratively speaking, before you drive to a new location, you must understand where you are, where you want to be, and how to
get there. Your budget represents where you are, your goals represent where you want to be, and your Investment Plan represents how to get there.

**Chart 1. Top of the Investment Hourglass—Before You Invest**

1. Are your priorities in order and are you “square” with the Lord?
2. Do you have adequate health and life insurance?
3. Are you out of high-interest credit card and consumer debt?
4. Have you written down your personal goals, do you live on a budget, and do you have a well-written investment plan?

If you can answer “yes” to each of the questions from the top of the investment hourglass, you are ready to invest. This hourglass can help you keep your priorities in order: God first, family second, and personal responsibility third.

**Factors Controlling Investment Returns**

Reinhold Niebuhr in the Serenity Prayer wrote, “God grant me the serenity to accept the things I cannot change; courage to change the things I can; and wisdom to know the difference” (see Picture 3).

There are six factors that control investment returns. Five of those factors are within your personal control, while only one is outside of your control. The five factors you control are

- How much you save,
- How long your investments grow,
- Your mix of investments, i.e., your asset allocation,
- How much you pay in expenses, and
- How much you pay in taxes.

The only factor you do not control is
• Your investment returns.

Picture 2. Serenity Prayer

God grant me
The serenity
to accept the things
I cannot change.
The courage to change
the things I can.
And
The wisdom to know the
difference.

If you want to do well on your investing, spend your time and efforts on the things you can control! Focus on:

• Saving money each week or month by reducing your spending and sticking to your budget
• Keeping your investments in the market at your risk level,
• Your asset allocation mix, compounding, and diversification, and
• Reducing fees, expenses, transactions costs, and taxes.

Successful investors spend their time on the areas that are within their personal control while spending a minimal amount of time on areas outside their personal control. In the area of investment returns, some investors use passive management/indexing as an investment strategy to minimize risk and give them some control over their investment returns. On the other hand, most novice investors spend their time on areas they cannot control and fail to be concerned with areas they can control.
This chapter will give a brief review of the process for selecting investment vehicles. It will then briefly discuss the major asset classes and their risk and return history.

**Recognize the 10 Principles of Successful Investing**

If you understand the “correct principles” that relate to successful investing, you will be able to “govern,” or manage, your investment portfolio better. Dallin H. Oaks said:

> We live in a complex society, where even the simplest principle can be exquisitely difficult to apply. I admire investors who are determined not to obtain income or investment profits from transactions that add to the sum total of sin and misery in the world. But they will have difficulty finding investments that meet this high standard. Such complexities make it difficult to prescribe firm rules. We must rely on teaching correct principles, which each member should personally apply to govern his or her own circumstances.  

Once you are ready to invest, you must recognize that there is not just one right way to invest. There are multiple methods of investing, depending on your budget, personal goals, and Investment Plan. The key to successful investing is to know yourself and what you are trying to accomplish.

An important question to ask about investing is “how have most investors done?” By answering this question, it can help us to see if the current methods used by most investors have been successful in helping them attain returns in excess of their benchmarks—what they could accomplish with an indexing strategy.

To understand how most equity investors have done in investing, you must compare their returns to their benchmarks or indexes. One of the longest surveys of how investors have done is provided by Dalbar (Dalbar.com). Each year DALBAR puts out an annual survey called *Quantitative Analysis of Investor Behavior* (QAIB), which discusses how the average investor in equities, fixed income and asset allocation funds have done compared to his or her benchmarks over the past 20 years. It covers returns over the past 20 years and it is updated every year.

Interestingly, with all the information available at our fingertips via the internet and with our abilities to buy and sell stocks instantaneously, most investors have not had very high returns in comparison to their benchmarks (see Table 1). For example, over the 20 year period from 1993 to 2012, the average equity investor’s returns were 4.3% versus the equity benchmark returns of 8.2%, resulting in a shortfall or difference of 4.1%. While the good news is the difference is declining, the bad news is that it is still significant.

Have bond investors done any better in comparison to their bond benchmarks? Sadly, the returns were even less and the difference between the average bond investor’s return and the bond benchmarks was even greater (see Table 2).
What about those who participate in an asset allocation strategy (actively moving between equity
markets and bond markets based on which seems most attractive)—how have they done? Again, the
results are not overly encouraging (see Table 3).

Table 1. Historical Analysis of Equity Investor’s Return

<table>
<thead>
<tr>
<th>Year</th>
<th>Investor Period</th>
<th>Investor* Returns</th>
<th>Benchmark Returns</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>1987–2006</td>
<td>4.3%</td>
<td>11.8%</td>
<td>-7.5%</td>
</tr>
<tr>
<td>2008</td>
<td>1988–2007</td>
<td>4.5%</td>
<td>11.8%</td>
<td>-7.3%</td>
</tr>
<tr>
<td>2009</td>
<td>1989–2008</td>
<td>1.9%</td>
<td>8.4%</td>
<td>-6.5%</td>
</tr>
<tr>
<td>2010</td>
<td>1990–2009</td>
<td>3.2%</td>
<td>8.2%</td>
<td>-5.0%</td>
</tr>
<tr>
<td>2011</td>
<td>1991–2010</td>
<td>3.8%</td>
<td>9.1%</td>
<td>-5.3%</td>
</tr>
<tr>
<td>2012</td>
<td>1992–2011</td>
<td>3.5%</td>
<td>7.8%</td>
<td>-4.3%</td>
</tr>
<tr>
<td>2013</td>
<td>1993–2012</td>
<td>4.3%</td>
<td>8.2%</td>
<td>-4.1%</td>
</tr>
</tbody>
</table>

* DALBAR 2007–2013

Table 2. Historical Analysis of Fixed Income Investor’s Return

<table>
<thead>
<tr>
<th>Year</th>
<th>Investor Period</th>
<th>Investor* Returns</th>
<th>Benchmark Returns</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>1987–2006</td>
<td>1.7%</td>
<td>8.6%</td>
<td>-6.9%</td>
</tr>
<tr>
<td>2008</td>
<td>1988–2007</td>
<td>1.6%</td>
<td>8.0%**</td>
<td>-6.4%</td>
</tr>
<tr>
<td>2009</td>
<td>1989–2008</td>
<td>0.8%</td>
<td>7.4%</td>
<td>-6.6%</td>
</tr>
<tr>
<td>2010</td>
<td>1990–2009</td>
<td>1.0%</td>
<td>7.0%</td>
<td>-6.0%</td>
</tr>
<tr>
<td>2011</td>
<td>1991–2010</td>
<td>1.0%</td>
<td>6.9%</td>
<td>-5.9%</td>
</tr>
<tr>
<td>2012</td>
<td>1992–2011</td>
<td>0.9%</td>
<td>6.5%</td>
<td>-5.6%</td>
</tr>
<tr>
<td>2013</td>
<td>1993–2012</td>
<td>1.0%</td>
<td>6.3%</td>
<td>-5.3%</td>
</tr>
</tbody>
</table>

* DALBAR 2006–2012, ** Estimate, not given in report

Table 3. Historical Analysis of Asset Allocation Investor’s Return

<table>
<thead>
<tr>
<th>Year</th>
<th>Investor Period</th>
<th>Investor Returns*</th>
<th>Benchmark Returns**</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>1986–2005</td>
<td>3.3%</td>
<td>11.0%</td>
<td>-7.7%</td>
</tr>
<tr>
<td>2007</td>
<td>1987–2006</td>
<td>3.7%</td>
<td>10.5%</td>
<td>-6.8%</td>
</tr>
<tr>
<td>2008</td>
<td>1988–2007</td>
<td>3.5%</td>
<td>10.1%</td>
<td>-6.7%</td>
</tr>
<tr>
<td>2009</td>
<td>1989–2008</td>
<td>1.7%</td>
<td>8.0%</td>
<td>-6.3%</td>
</tr>
<tr>
<td>2010</td>
<td>1990–2009</td>
<td>2.3%</td>
<td>7.7%</td>
<td>-5.4%</td>
</tr>
<tr>
<td>2011</td>
<td>1991–2010</td>
<td>2.6%</td>
<td>8.2%</td>
<td>-5.7%</td>
</tr>
<tr>
<td>2012</td>
<td>1992–2011</td>
<td>2.3%</td>
<td>7.5%</td>
<td>-5.92</td>
</tr>
</tbody>
</table>

* DALBAR 2006–2013 ** Estimate of 60% equity and 40% fixed income benchmarks

As the saying goes, “If you do what everyone else does, you will get what everyone else gets.” Based
on the DALBAR studies, it seems that whatever people are doing regarding investing is not working
very well for equity or fixed income investors. Perhaps there are better ways to invest than what
others have done in the past.

How have most actively managed mutual funds performed compared to their benchmarks? If they
have performed better, we could conclude that the active managers are adding value over and above
the return that an investor could receive by investing in a low-cost, tax-efficient index fund or ETF.
In general, actively managed mutual funds have not beaten their benchmarks over the long term. While in some years actively managed funds outperform their index fund counterparts, the support for actively managed funds for longer periods of time is low.

Another paper that examined mutual fund performance on both a total return and after-tax basis reported:

In general, we find that index funds outperform actively managed funds for most equity and all bond fund categories on both a total return and after-tax total return basis, with the exception of actively managed small company equity and international funds. These results should be viewed with caution, however, as there is evidence that actively managed funds outperform the index funds during periods when the economy is either going into or out of a recession.\(^5\)

**Chart 2. Percentage of Actively Managed Funds That Failed to Beat Their Benchmarks\(^6\)**

Recent experience is not much different. In the last 10 years, the percentage of actively managed funds that failed to beat their benchmarks was in excess of 55-65%, depending on asset class (see Chart 1).

Whatever you decide to invest in, and whatever phase of investment you are in, it is critical that you adhere to correct principles. Following are 10 principles that I believe, if followed, will help you to minimize that difference between investor returns and benchmarks and will likely help you to have a successful portfolio.
Principle 1: Know Yourself

Investing is not an end in itself; rather, it is a means of reaching your personal and family goals. Consequently, you need to know yourself as an investor. You should have well-written and well-thought-out goals; goals are critical because they help you determine what you want to accomplish with your investment program. For help on writing your goals, see Chapter 2, Creating Your Personal Financial Plan and Setting Personal Goals.

You also need to know your budget. A critical part of successful investing is having a well-planned budget; a percentage of your income should be earmarked for savings and investment. You cannot invest without funds, and you should not invest with borrowed money. For help on budgeting, see Chapter 3, Budgeting and Measuring Your Financial Health.

You also need to understand your ability to tolerate risk. You want to develop a “sleep-well portfolio”—a portfolio that is planned so that even when investments go wrong, as they often do, you can still sleep well at night.

Beware of overconfidence in your portfolio. One sign of overconfidence is frequent trading. A study found that men trade 45 percent more often than women trade and that men’s annual returns were, on average, 2.7 percent lower than women’s annual returns. The study also found that single men trade 60 percent more often than single women trade and that single men’s annual returns were 1.4 percent lower than single women’s annual returns.

You must be especially wary of overconfidence when trading online. The same study showed that the same group of investors beat the market by 1.9 percent before online trading. However, when the same group of investors switched to online trading, the group underperformed by 3.6 percent. While online trading may appear to give you more control, it can result in lower overall returns if it leads to more frequent trading.

Principle 2: Understand Risk

Risk is inherent in all investment activities. Some risks include inflation risk, business risk, interest-rate risk, financial risk, market risk, political and regulatory risk, exchange-rate risk, call risk, and liquidity risk. The key to managing risk is to understand the different types of risk and to invest at a risk level that is comfortable for you. Often, taking a risk tolerance test will help you discover the level of risk that is right for you. One such risk tolerance test is included in the Learning Tools section of this website in Learning Tool 16: Risk Tolerance Test.

Principle 3: Stay Diversified

Diversification is your best defense against risk. Diversification does not mean simply investing in 10 different banks; rather, to be properly diversified, you should invest in different companies, industries, and perhaps even countries that won’t be subject to the same economic factors or risks. Make sure you understand the risks of each of your investments.
Many people review the portfolio returns from various asset classes over the last 10, 20, or 50 years to get an idea of an asset class’s performance history. However, these people often invest in only one or two single assets instead of in a portfolio of 500 or more stocks and are often disappointed when they do not get the returns they expected. Remember, the returns from asset classes are from portfolios of hundreds of assets—not from individual assets. To see the effects of diversification, see Learning Tool 23: Return Simulation for Asset Classes in the Learning Tools directory of this website.

**Principle 4: Make Low-Cost and Tax-Efficient Investments**

Watch your investment costs carefully, including costs for transaction fees, management fees, and taxes. Remember that when investing, a dollar saved is worth more than a dollar earned.—you have to pay taxes on every new dollar you earn, but every dollar you save is already taxed and can earn interest on income. Be aware that frequent trading incurs significant transaction and tax costs; avoiding this will help you keep your costs low.

Defer or eliminate taxes as much as possible. Mutual funds are required by law to distribute 90 percent of all capital gains, dividends, and interest to their shareholders each year. That means you must pay taxes on the distributions from your mutual funds each tax season, even though you may not have sold a single share. Mutual funds are pass-through accounts for tax purposes, which means that the tax consequences of the mutual fund are paid by the investor, not the mutual fund. The portfolio manager’s decisions can have a significant impact on your tax bill.

Make tax-efficient investments to avoid paying more taxes than necessary. Remember, it is not the amount of money you make but the amount of money you keep after taxes and inflation that makes you wealthy.

**Principle 5: Invest for the Long Run**

Invest for the long run; this is how you will achieve your goals. There are no “get-rich-quick” schemes that work.

Avoid short-term trading. Short-term trading is expensive and incurs transaction costs and taxes. Be sure to keep at least part of your funds in the market for the long run—taking money out of the market may not only slow your progress but could stop it altogether. A recent study found that those who traded more often, using the turnover ratio as a proxy for trading, had lower returns than those who traded less often and used a buy-and-hold strategy (see Chart 2).

**Principle 6: Use Caution If You Are Investing in Individual Assets (which I do not recommend)**

If you want to invest in individual assets (which is not necessary for a successful portfolio), do your homework and know what you are investing in and who you are investing with. Learn about the company, its financial statements, its management, its short- and long-term strategies, its domestic and global industry, and its competition. It takes many hours of diligent, careful
research to investigate a company thoroughly. Do not take others’ word for it: do the research yourself. Of course, finding a great company is not enough—the stock must also be priced right. A great company whose stock is overpriced can still be a lousy investment.

**Chart 2. Trade More, Make Less**

![Chart: Trade More, Make Less](image)

If you do not have time to research individual companies, invest in mutual or index funds that contain many individual assets. If your mutual fund has 10 stocks, you need to know those 10 stocks well. However, if your mutual fund has 500 or more stocks, you do not need to know those 500 stocks as well because each stock has such a small impact on your total portfolio.

**Principle 7: Monitor Portfolio Performance against Benchmarks**

Thomas S. Monson stated, “Where performance is measured, performance improves. Where performance is measured and reported, the rate of improvement accelerates.”

How can you know how your investments are doing if you do not monitor their performance? To understand the performance of your investments, you will need to learn how to use benchmarks. Benchmarks are passively managed portfolios of financial assets that indicate how well your financial assets are performing. Set your own portfolio benchmarks and then monitor your portfolio performance on a monthly, quarterly, and annual basis.
If you choose to invest in actively managed mutual funds, compare the assets’ after tax performance against the benchmarks you have set. If the return on these assets is consistently lower than the benchmarks, consider investing in no-load (no sales charge), low-fee index funds, which are discussed later in this course. The returns on index funds are generally more consistent in matching the performance of selected benchmarks than actively managed funds.

**Principle 8: Do Not Waste Too Much Time and Energy Trying to Beat the Market**

It is difficult, expensive, and time-consuming to try to beat the market, or gain returns in excess of the returns on the major asset classes. While it may be possible on a short-term basis, it is difficult to consistently beat the market on a long-term basis. You are competing against hundreds of thousands of professional money managers with much more time, money, and access to information than you have.

If you want to try to beat the market, try for a short period of time and compare your returns after taxes to your benchmarks. Do not waste too much time and energy trying to beat the market because you will be able to match the market return with little or no effort through no-load, low-fee index mutual funds or exchange traded funds (ETFs).

If you feel you must trade actively, try to trade efficiently in terms of taxes. Trade in tax-deferred or tax-eliminated retirement accounts such as a 401(k), Roth IRA, or traditional IRA accounts so your taxes are eliminated or deferred until you take the money out at retirement.

**Principle 9: Invest Only with High-Quality, Licensed, Reputable People and Institutions**

When you need help, do not be afraid to ask for it. However, be sure to get help from good people whose actions and beliefs are consistent with the principles discussed in this chapter. Good help from qualified, licensed, and experienced financial planners, financial advisors, and brokers may help you with your Investment Plan.

Make sure you invest with mutual fund companies that have a tradition of meeting the needs of their investors. Work with good companies that offer good products. Be careful with your money and invest it wisely.

Use the best resources available to help you invest, but be aware of how much you pay to use those resources. In addition, make sure your advisors are licensed to counsel you on the broad range of investment assets you are (or should be) considering. Work only with licensed and registered advisors. In some circumstances, fee-only financial planners or advisors may be a better choice than financial planners or advisors that are paid on commission.

**Principle 10: Develop a Good Investment Plan and Follow It Closely**

Develop a good Investment Plan that is consistent with your goals, your budget, and the principles discussed in this chapter. Follow this plan closely. An Investment Plan is a detailed road map of your investment risk and return, constraints, investment strategy, and reporting and
Your Investment Plan should outline the amount of return you are seeking and the risk level you are comfortable with for investments. This plan documents constraints—such as taxes, liquidity, and time horizon—that affect your portfolio. It details which asset classes you will or will not invest in and includes your view on active versus passive management. It lays out your plan for the percentage of gross income you will invest each month, the amount you will invest in each of your chosen asset classes, the maximum percentage of your assets that you will invest in any single new investment, and the ways your strategy will change as you get older. Finally, your Investment Plan details how often you will rebalance your portfolio and how often you will report the portfolio performance to others.

Think of your Investment Plan as a road map to successful investing. Your plan should be consistent with the principles discussed in this course. If you plan wisely and invest accordingly, you will save yourself from heartache and problems in the future, and you will likely achieve your personal and family goals.

Understand What You Invest In

Investing entails risk, which means different things to different investors. Risk could mean the possibility of losing all your money. It could also mean the possibility of losing principal. Risk could also entail the possibility of not achieving a specific holding-period return.

Risk is measured in many different ways. In the past, the main risk of investing was considered “default risk,” or the risk that a company would not be able to pay back an investment due to default or bankruptcy. Government securities were considered risk-free investments because investors knew the government could always print money.

In more recent years, analysts began to use variance, or standard deviation, to better measure risk; using this measurement, they found that even government securities are risky. This measure of risk is not concerned with the possibility of default but with the volatility of the investments—the risk that the investment’s return may be lower than expected. Currently, investors also use a metric known as “beta,” which measures the way a specific stock moves in relation to a specific market or benchmark.

Generally, most investors prefer to use variance or beta to measure risk. Both are measures of how volatile a stock is—how much it moves both up and down. In the case of beta, risk is also measured by how much the stock moves in comparison to a specific benchmark. A lower variance indicates that the price does not move very much. A higher variance indicates that the price moves a lot in comparison to the benchmark. A beta higher than one indicates that the stock is more volatile than the market; a beta less than one indicates that the stock is less volatile than the market; a beta of exactly one indicates that a stock moves with the market. When you look at a stock’s returns, you should always look at the variance of the stock as well. Generally, higher returns carry higher risks because investors must be compensated for taking on additional risk.
There are a few important concepts you should understand related to risk:

- *Investment risk* is the probability of not achieving some specific return objective.
- The *risk-free rate* is the rate of return that will definitely be obtained.
- The risk premium is the difference between the expected return and the risk-free rate.
- *Risk aversion* is the reluctance of an investor to accept risk.

**The Importance of Asset Classes**

Understanding asset classes is critical if you are to invest. You should invest at a level of risk that you are comfortable with and that will help you to achieve your personal and financial goals. The way you manage risk is by managing the amount of your portfolio in the respective asset classes (or baskets of investments).

Asset classes are broad categories of investments with specific and similar risk and return characteristics. They are distinguished by characteristics specific to particular groups of securities, such as type of financial instrument, market capitalization, maturity, geographic location, etc. The major asset classes are cash and cash equivalents, fixed income, and equities. We will discuss each asset class simply to help you understand the benefits and risks of the specific asset class.

**Cash and Cash Equivalents.** The major goal of this asset class is liquidity and to preserve capital. This asset class includes Certificates of Deposits (CDs), money market funds, T-bills, and commercial paper, etc. For an individual investor, it would also include your savings, checking account, money market deposit accounts. It offers a fixed rate of return.

Cash includes money market funds which seek to preserve the value of your investment and still offer a somewhat competitive return. Short-term interest-bearing investments includes Treasury bills and Savings Bonds, loans to the U.S. Government, and commercial paper, loans to corporations.

The advantages of cash and cash equivalents is liquidity and stability of principal. You can turn these securities into cash quickly and easily. They are generally low risk. There is little risk of losing principal since the borrowers have good credit and loans are for short periods of time. These are good investment assets for money you plan to use in less than 3-5 years and don’t want to take risks with losing principle.

The disadvantages is that they are less attractive as medium-to-long-term investments (> 5 years) as returns on cash and cash equivalents are unlikely to keep up with inflation.

Four final thoughts on cash:

1. Cash is great for liquidity—even especially for your Emergency Fund.
2. Returns on cash are unlikely to keep up with taxes and inflation.
3. Cash assets are generally fully taxable—make sure you take taxes into consideration.
4. Use cash for liquidity and some diversification, but realize that this asset class will add little to performance over time.

**Fixed Income (or Bonds).** The major goal of fixed income is to provide income and to hopefully earn returns in excess of inflation. There are many different types of fixed income assets including taxable bonds include U.S. Treasuries, corporate bonds and agency issues (bonds issued by U.S. government agencies, like Ginnie Mae); tax-free bonds include revenue or general obligation bonds issued by local or state governments and agencies. Such bonds are generally free from federal and state taxes on income.

Short-term bonds (or short term bond mutual funds) include bonds that mature in less than five years. Short-term bonds are less vulnerable to interest rate risk than long-term bonds as there is a shorter time period before the bonds mature. Short-term bonds are generally considered good investments for anyone needing a dependable stream of income (dividends) in an environment where interest rates are not likely to rise.

Intermediate-term bonds/bond funds are bonds with a maturity of 3–10 years. Because of their longer maturity, they are more susceptible to interest rate risk, the risk that interest rates rise during the period you own the bonds.

Long-term bonds (or junk bonds or bond mutual funds) are bonds with a maturity of 10 or more years. These bonds generally have the highest yields, but are the most vulnerable to interest rate volatility.

Inflation protected securities are securities whose yield is linked to the rate of inflation as measured by a specific inflation index. These bonds have the benefit that when interest rates rise, the yield on the bond rises as well.

The U.S. Government also sells savings bonds to investors whose earnings fall within specific income limits. I Bonds (or inflation linked bonds) have their interest rate linked to inflation that changes every six months. EE Bonds pay a fixed interest rate over a specific period of time.

Bond mutual funds are different from buying individual bonds. Mutual funds buy and sell bonds before they mature. Investing in a bond mutual fund means you are buying a share in thousands of different bonds in a changing portfolio, and so you are more diversified than in buying an individual bond. The income from a fixed-income mutual fund fluctuates as mutual funds buy and sell bonds. The market value of the mutual fund changes depending on whether the fund is selling bonds at a loss or gain. The longer the maturity of the bonds (see the average maturity) the more dramatically your principal will gain or lose value as interest rates change.

The advantages of fixed income investments is that they offer greater potential return than cash, but at greater risk. They are a good diversification tool when holding a diversified portfolio of assets, as bonds generally move differently than stocks.
The disadvantages are that returns have been historically lower than stocks. They are very susceptible to interest rate and other risks. Generally, fixed income assets alone are not good long-term investments because they don’t provide enough growth to beat inflation over long periods of time. The should be part of an overall diversified portfolio.

Equities (or Stocks). The major goal of this asset class is to provide growth and earn returns in excess of inflation. Over long periods of time, the stock market historically has been the only major asset class to consistently outpace inflation.

An equity share is ownership in a businesses’ earnings and assets. You get a proportionate share of the profits by receiving dividends, and also benefit from increases in the company’s share price as well. Mature companies are a likelier source of dividends (rapidly growing companies often prefer to reinvest profits).

Equity asset classes are generally delineated by market capitalization (which is shares outstanding multiplied by the stock's current market price), type of company (growth versus value), or geographic area. The benchmarks for each asset class tend to change over time, but equity asset classes can be generally defined as follows:

Market capitalization is one measure of the size of a company. It is calculated by multiplying the market price of the stock by the number of shares (i.e. ownership pieces) outstanding. The greater the capitalization, the larger the company. It is used to weight companies in various benchmarks by the size of the company, i.e. large-capitalization (or large cap), mid-capitalization (or mid-cap), or small-capitalization (or small-cap) firms.

Large caps are stocks with a market capitalization greater than $10 billion in the US, and smaller capitalizations for international companies. These are the generally the largest, most well established companies in the US, with a history of sales and earnings as well as notable market share which has allowed them to grow and expand. Traditionally, large cap was synonymous with "dividend-paying company," but this is no longer a standard for classification. These are generally mature corporations with a long track record of steady growth and dividends.

Mid-cap or mid-capitalization stocks are stocks with market capitalization between roughly $2 billion and $10 billion. These stocks tend to grow faster than big cap companies, and are generally less volatile than small cap companies. Mid-caps generally perform somewhere between small-cap and the large-cap asset classes. For asset-allocation purposes, mid-caps are generally not considered a major asset class.

Small-cap or small capitalization stocks are companies with a market capitalization less than $2 billion. These are smaller, sometimes newer, US and global companies that are still developing and may have a smaller market share than their large-cap counterparts. Small-cap stocks are subject to greater volatility and may fail more frequently than companies in other asset categories, but are generally expected to grow faster than bigger companies.

Within the equity stock categories are three separate types of stocks: growth, value and blend.
Growth stocks are companies whose earnings are expected to grow very rapidly. Frequently these are companies developing new technologies or new ways of doing things.

Value stocks are companies which are inexpensive in terms of the market (in terms of low PE and low P/BV ratios). These are companies that have potential for good long-term return through both appreciation and dividends.

Blend stocks are stocks that include part of both value and growth components.

International/Global/Emerging Market stocks are stocks of companies based entirely outside the U.S. or throughout the world. These can be of any size (small-cap, large-cap), any type (value, growth) and from any part of the world. Funds that contain a mixture of U.S. and foreign holdings are called global funds.

International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets.

Stock mutual funds are funds that own stock in specific groups or types of companies. When you buy a mutual fund, you are buying a share in multiple companies which change over time depending on the fund manager’s decisions. You are responsible for paying taxes on all distributions by the mutual fund, which are taxed at your level—not the fund level.

Mutual funds are delineated by investment objective, which can be any of the equity asset classes discussed above.

The advantages of equities is that when purchased as part of a diversified portfolio they offer highest return of the major asset classes. Growth and value stocks tend to perform in alternating cycles—it makes sense to own both types. Stock generally are a good investment for long-term investing—they have consistently beat inflation over the long-term.

The disadvantages of equities are they offer less stability of principal than other asset classes, and subject to short-term price fluctuations. Equities are risky for short-term investments. If you’re investing for less than 3-5 years, only a small portion (if any) of your investments should be in stocks due to their volatility.

**History of Asset Class Returns**

It is important to understand how the various asset classes have performed historically. Remember that an asset class is a group of financial assets with similar risk and return characteristics. From a historical analysis, we can learn much about a particular asset class (see Chart 3).
I believe it is important to study history, including the history of investments and investment returns. Some have questioned the importance of learning an asset class’s performance history because they reason that the future will not be like the past. Gordon B. Hinckley stated the following regarding this notion: “All of us need to be reminded of the past. It is from history that we gain knowledge which can save us from repeating mistakes and on which we can build for the future.”

What have been the characteristics of risk and return historically? Chart 4 and Table 4 show that from 1927 to 2012, large-capitalization stocks (as represented by the S&P 500) have yielded a return of about 9.5 percent per year and have a standard deviation of 19.2 percent. Small-capitalization stocks have yielded a return of about 12.0 percent per year and have a standard deviation of 29.1 percent. T-bonds have yielded a return of 5.6 percent per year and have a standard deviation of 8.4 percent. T-bills have yielded a return of about 3.6 percent per year and have a standard deviation of about 0.9 percent. Note that while different asset classes have different risk and return relationships, there is generally a positive relationship between risk and return (see Chart 3). Moreover, these numbers will change every year.

Chart 5, which shows the S&P 500 annual return since 1925, shows that the annual return appears to be very volatile—there are many years of high returns and many years of negative returns. However, looking at the return in terms of 5-year periods instead of 1-year periods shows that there are only a few major periods of time on the chart that show a negative return (see Chart 6). If you follow the return trend over a 10-year period, you will likewise see that there have been very few times when the 10-year return was not positive (see Chart 7).

We will now look at risk, or standard deviation. Table 4 shows the geometric return and the standard deviation for each of the major asset classes. As you look at the large-cap (the Standard
and Poor’s 500 Index) return and risk, note that over 5, 10, 25, 50, 75, and 85 years, the return was volatile, yet over longer periods has been around 7 to 10 percent. The standard deviation has ranged from approximately 15 percent to 20 percent.

**Chart 4. Annual Risk versus Return**

![Annual Risk versus Return from 1927-2012](chart)

**Chart 5. S&P 500 Annual Returns**

![S&P 500 1 Year Annual Returns from 1926 - 2012](chart)

If you look at small-cap returns over the same periods of time, you will see that same volatility, particularly in recent years. Though over longer periods the return has been between 10 to 14 percent, notice that the risk levels of small-cap returns (the standard deviation) are between 20 percent and 30 percent.
If you look at fixed-income investments (T-bonds), you will see that they have, on average over longer periods, yielded a return ranging from 5 percent to 9 percent; the variance for T-bonds during this time period was between 8 percent and 12 percent.

If you look at T-bills on the chart, you will see that they have yielded a range of approximately 0.1 to 5 percent interest over the various periods of time; T-bills have had a standard deviation of between 0.1 and 0.9 percent.
Inflation (as measured by the CPI) has been between 1.5 and 4.1 percent with a standard deviation of between 0.5 and 1.9 percent.

In order to invest successfully, you must understand the risks and benefits of each of the major asset classes. This chapter has attempted to share some risk and return history over the past 85 years.

Table 4. Geometric Return and Risk over Specific Time Periods (Ending 2012)

<table>
<thead>
<tr>
<th>Year</th>
<th>S&amp;P500</th>
<th>SmallCap</th>
<th>T-bond</th>
<th>T-bill</th>
<th>EAFE (International)</th>
<th>Emerging Markets</th>
<th>REITs</th>
<th>CPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Year</td>
<td>5 Years</td>
<td>10 Years</td>
<td>25 Years</td>
<td>50 Years</td>
<td>75 Years</td>
<td>85 Years</td>
<td>Compound Return</td>
<td>Standard Deviation</td>
</tr>
<tr>
<td>16.0%</td>
<td>1.7%</td>
<td>7.1%</td>
<td>9.7%</td>
<td>9.8%</td>
<td>10.9%</td>
<td>9.5%</td>
<td>16.7%</td>
<td>3.7%</td>
</tr>
<tr>
<td>10.1%</td>
<td>18.9%</td>
<td>14.9%</td>
<td>14.8%</td>
<td>15.0%</td>
<td>15.6%</td>
<td>19.2%</td>
<td>12.5%</td>
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</tr>
<tr>
<td>1.8%</td>
<td>9.0%</td>
<td>7.3%</td>
<td>9.2%</td>
<td>7.5%</td>
<td>5.8%</td>
<td>5.6%</td>
<td>9.0%</td>
<td>13.8%</td>
</tr>
<tr>
<td>1.0%</td>
<td>0.6%</td>
<td>1.7%</td>
<td>3.7%</td>
<td>5.2%</td>
<td>3.9%</td>
<td>3.6%</td>
<td>0.1%</td>
<td>0.2%</td>
</tr>
<tr>
<td>11.5%</td>
<td>-4.3%</td>
<td>3.8%</td>
<td>8.5%</td>
<td>21.9%</td>
<td>25.8%</td>
<td>18.4%</td>
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<tr>
<td>13.9%</td>
<td>4.9%</td>
<td>13.0%</td>
<td>23.0%</td>
<td>39.4%</td>
<td>27.6%</td>
<td>1.6%</td>
<td>1.9%</td>
<td>2.4%</td>
</tr>
</tbody>
</table>
| 1.0% | 1.6% | 1.5% | 1.1% | 1.2% | 1.6% | 1.8% | Source: Ibbotson Associates 2012 for large cap, small cap, T bond, T bill and Inflation, and Morgan Stanley Capital International for the remainder.

Summary

I approach the topic of investments differently than other textbooks. Most books take an asset-based approach. I take a principles-based approach because the principles of good investing will not change over time. There are important investing principles that, if followed, will result in a quality
investment plan and lead to a successful investment portfolio. We must understand investment basics, the purpose of investing, the priority of our investments, and investing versus gambling.

We must understand what we should do before we invest, which is to:

1. Be square with the Lord,
2. Have adequate health and life insurance to care for the needs of your family in the event that something were to happen to you,
3. Be out of high-interest credit card and consumer debt, and
4. Write down your goals, be living on a budget, and have a well-written and well-thought-out investment plan.

These steps help you prepare a “priorities-based” investment plan. There is no better way to start investing than to have your priorities in order.

We discussed the six factors that control investment returns. Five of these factors are within our control, and only one is outside of our control. We should work on the factors that we can control: how much you save, how long your investments grow, your mix of investments, i.e., your asset allocation, how much you pay in expenses, and how much you pay in taxes. We should not be as concerned with the factor we cannot control which is investment returns.

We shared the 10 principles of successful investing. These are critical if you are to achieve your goals. We shared how most investors have done with their investments, which isn’t positive. That is why the principles are so important. They are:

1. Know yourself.
2. Understand risk.
4. Invest low-cost and tax-efficiently.
5. Invest for the long run.
6. Use caution if you must invest in individual assets.
7. Monitor portfolio performance against benchmarks.
8. Don’t waste too much time and energy trying to beat the market.
9. Invest only with people and institutions that are high-quality, licensed, and reputable.
10. Develop a good investment plan and follow it closely.

Follow these principles and you will have a much better chance of having a successful portfolio.

We continued with discussions of asset classes. We used history to help us understand the risk and return characteristics of the various asset classes.
Chapter 10. Beginning Investing 1: Principles

Assignments

Financial Plan Assignments

Understanding yourself is a critical part of investing. It is important that you understand not only your personal view of investing, but also your family view of investing.

Review the top of the investment hourglass. Where are you on the top of the hourglass? Are your priorities in order? Do you have adequate health and life insurance? Are you out of high-interest consumer and credit card debt? Have you written down your goals, are you living on a budget, and are you ready to begin writing your investment plan? Determine where you are and the steps you must take before you begin investing.

Review the principles of successful investing. Why do you think these principles are important? What can principles help us do to be better investors?

Review the risk and return history of the major asset classes. What asset classes would you include in your personal asset allocation?

Optional Reading Assignments

To help you understand what steps you must take before you invest, please read the following articles in the Readings directory of this website:


Learning Tools

The following Learning Tools may be helpful to you as you prepare your personal financial plan:

16. A Risk-Tolerance Test

This document is a simple risk-tolerance test to help you determine a suitable level of risk for your investments. It has eight questions, and it explains how each question can help you understand your tolerance for risk. It also gives a few recommendations for asset-allocation targets, based on your answers to the eight questions.

21. Key Questions on Money in the Family

This document asks questions regarding how your views on money were shaped. It asks nine simple questions related to money; the answers to these questions can help you gain important insight about the events that shaped your views on money.
Review Materials

Review Questions

1. What are the ten principles of successful investing?

2. What questions should you ask before you begin investing?

3. Why is it important to ask these questions first?

4. Why is it important to understand the key principles of investing first before you begin investing?

2 Kimball, Spencer W. Ensign, June 1976, p. 4
7 Carla Fried, “The Problem with Your Investment Approach,” Business 2.0, Nov. 2003, 146
9 “Reach with a Rescuing Hand,” New Era, Jul. 1997, 4
11. Beginning Investing 2: Application

Introduction

You have an understanding of key investment principles, why you invest, factors you control, how most investors have done with their investments (performance has not been good compared to benchmarks), and asset classes. You understand what you should do before you invest, and you have reviewed the principles of successful investing. You understand asset classes and you have reviewed the risk and return characteristics of the various asset class. These principles we discussed are critical to understanding, developing, and implementing a successful investment portfolio. In addition, you have reviewed the investment hourglass, a learning tool to help you understand that investing is a means to an end, not an end in itself. Investing is a way to achieve your personal and family financial goals.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand how to apply the key principles to your personal investing including:
   1. Building an investment portfolio
   2. Selecting investment vehicles carefully
   4. Investing at your risk level, i.e., determining your asset allocation
   5. Wisely selecting assets, and
   6. Final cautions for investing

Building an Investment Portfolio

Strategies for developing investment portfolios differ among individual portfolio managers and institutions. The strategy each investor prefers depends on the way he or she views the market; an investor’s strategy also depends on his or her goals, budget, and experience in investing. It is impossible to discuss the strategies that every portfolio manager uses to build each portfolio; however, as I have reviewed successful portfolios, I have found that several critical phases of investment remain the same.

The top half of the investment hourglass detailed the steps you should take before you begin investing. Like the way we live our lives and decide on our goals, the way we invest should be based on our priorities.

The bottom of the investment hourglass contains a pattern of successful portfolios that I have seen in my experience as I have worked with students, families, and institutions (see Chart 3).
Chart 3: The Investment Hourglass Bottom

The bottom of the investment hourglass is divided into four levels, representing four phases of investment. The first level, or base, of the hourglass represents the phase in which you develop your emergency fund and food storage. I strongly recommend that you start this phase first. Generally, it is recommended that you have the larger of three to six months of income or expenses in very liquid cash or cash equivalents (i.e., savings accounts, internet savings accounts, money market mutual funds, short-term CDs, checking accounts, etc.) for your emergency fund. For information on cash management vehicles, see the chapter on **Cash and Liquid Asset Management**.

The second level represents the phase in which you develop your portfolio’s core, or broad exposure. This level generally gives you exposure to the least risky of all the equity asset classes, mainly large-capitalization mutual funds. When you first begin investing, I strongly recommend that instead of purchasing individual stocks and bonds you follow the principles of investing discussed earlier and instead invest in low-cost, no-load index mutual funds. Doing so will give you broad diversification (I prefer a minimum of 500 securities per fund), market returns, and tax-efficient investments. For information on mutual funds, see chapter on **Investments 6: Mutual Fund Basics**.

The third level represents the phase in which you further diversify your portfolio by broadening and deepening your asset classes. If your core allocation is large-capitalization stocks, to deepen your portfolio you might include mutual funds which invest in small-capitalization or mid-capitalization stocks. If you were to broaden your asset classes, you might look to add no-load, low-cost, tax-efficient mutual funds which gave you exposure to new asset classes such as international (companies listed on stock exchanges located outside the United States), emerging markets (companies listed on stock exchanges located in the developing countries), or Real Estate Investment Trusts (portfolios of real estate investments that are developed and trade similar to mutual funds). There are many more other asset classes as well.
Finally, the fourth level represents the phase in which you develop your opportunistic assets, such as individual stocks and sector funds. Truthfully, you do not ever need to purchase individual stock or bond assets or sector funds.

Levels two, three, and four are also divided in terms of taxable assets and retirement assets. *Taxable assets* are assets on whose generated earnings you will need to pay taxes each year. *Retirement assets* are assets that you will not need until after you retire and on whose generated earnings you do not pay taxes ever or until you take the money out at retirement. The breakdown of your assets between your taxable and retirement accounts will depend on your personal goals and your available retirement vehicles.

The bottom of the investment hourglass illustrates three important principles.

First, it illustrates the importance of keeping risk in perspective. The base of the hourglass encompasses the least risky investments. As you move up the hourglass, you take on higher risk and, hopefully, higher returns.

Second, the hourglass teaches you the “how to” of investing. You should invest in lower-risk assets first and then expand your portfolio to increase its potential for greater risk and more return as the size of your assets increases.

Third, the investment hourglass separates taxable assets and retirement assets. The impact that taxes have on these two types of accounts is not the same, so retirement and taxable assets should be managed differently.

**Select Investment Vehicles Carefully**

Before you can build a successful investment portfolio, you must understand the difference between investment vehicles and investment (or financial) assets. *Investment vehicles* are special types of investment accounts that provide a tax-advantaged framework that allows you to invest in various financial assets. Tax advantages include the deferral of current taxes or the elimination of future taxes on earnings. These accounts are useful because they provide specific tax advantages that are not available when financial assets are purchased individually. *Investment vehicles* are like shopping carts in the grocery store.

*Investment, or financial, assets* are specific classes of financial securities in which you may invest, including stocks, bonds, mutual funds, real estate, money-market mutual funds, CDs, and so on. As you have learned, these financial assets are grouped into asset classes and are associated with different levels of risk. *Investment assets* are like the groceries you put in your shopping cart.

There are many types of investment vehicles. Many investment vehicles are geared towards helping you build a retirement account and most are named after a specific line in the Internal Revenue Code. For example, a 401(k) plan is a retirement plan offered to employees of private companies, a 403(b) plan is a retirement plan offered to employees of public companies, a
Chapter 11. Beginning Investing 2: Application

Simplified Employee Plan (SEP-IRA) is a retirement plan designed for employees of small businesses, and an Individual Retirement Account (IRA) is a retirement plan designed for individuals. Table 1 shows characteristics of select investment vehicles for 2012.

Table 1. Select Investment Vehicles for 2013 (Before Catch-Up)

<table>
<thead>
<tr>
<th>Plan</th>
<th>Tax-Deferred</th>
<th>Tax-Eliminated</th>
<th>Maximum Amount</th>
<th>For Employees of:</th>
</tr>
</thead>
<tbody>
<tr>
<td>401-k</td>
<td>Yes</td>
<td></td>
<td>$17,500</td>
<td>Businesses w/ Plans</td>
</tr>
<tr>
<td>Roth 401-K</td>
<td>Yes</td>
<td></td>
<td>$17,500</td>
<td>Businesses w/ Plans</td>
</tr>
<tr>
<td>403(b)</td>
<td>Yes</td>
<td></td>
<td>$17,500</td>
<td>Non-profit, tax-exempt</td>
</tr>
<tr>
<td>Roth 403(b)</td>
<td>Yes</td>
<td></td>
<td>$17,500</td>
<td>Non-profit, tax-exempt</td>
</tr>
<tr>
<td>457</td>
<td>Yes</td>
<td></td>
<td>$17,500</td>
<td>State/Municipalities</td>
</tr>
<tr>
<td>SEP IRA</td>
<td>Yes</td>
<td></td>
<td>$51,000</td>
<td>Small Businesses</td>
</tr>
<tr>
<td>SIMPLE IRA</td>
<td>Yes</td>
<td></td>
<td>$12,000</td>
<td>Small Businesses</td>
</tr>
<tr>
<td>IRA</td>
<td>Yes</td>
<td></td>
<td>$5,500</td>
<td>Individuals</td>
</tr>
<tr>
<td>Roth IRA</td>
<td>Yes</td>
<td></td>
<td>$5,500</td>
<td>Individuals</td>
</tr>
<tr>
<td>Education IRA</td>
<td>Yes</td>
<td></td>
<td>$2,000</td>
<td>Individual Education</td>
</tr>
<tr>
<td>529 Plans</td>
<td>Yes</td>
<td></td>
<td>$390,000 per child</td>
<td>Individual Education</td>
</tr>
</tbody>
</table>

Understanding the process can help you identify the tax benefits and other benefits that different investment vehicles offer. The process is divided into three sections: free money; tax-advantaged money; and tax-efficient and wise investments. Understanding the process can help you determine which investment vehicles you should use first in working toward your financial goals.

**Priority 1: Free Money**

The first priority is free money: free money is the money provided by your company when you participate in a company-sponsored retirement plan or a reduction in taxes for investing in specific education vehicles for your children and family. Free money is often provided through a matching plan, in which your company offers to match a percentage of the money you invest in your retirement plan. A matching plan is used as an incentive to encourage employees to remain with the company and to invest in a retirement plan. Some states allow a tax deduction for your contribution to that state’s 529 Plan for education, which is also a form of free money.

Free money is your first priority because it is free and the percentage matched by the company is usually higher than any rate of return you could earn in the market. The risk of investing in a company-sponsored plan is that you are usually required to stay with the company for a certain number of years to become fully vested, or in other words, take full ownership of the free money.

**Priority 2: Tax-Advantaged Money**

There are two different types of tax-advantaged vehicles or accounts: tax-eliminated accounts and tax-deferred accounts. Your choice of which account is better mainly depends on your
current tax rates and your estimation of your future tax rates. If you expect your tax rates to be higher in the future than they are now, you will save a greater amount for retirement if you choose a Roth retirement account versus a traditional. However, if you expect your tax rates to be lower in the future than they are now, you will save a greater amount for retirement if you choose a traditional retirement account. To help you decide which type of IRA is more beneficial for you, see Learning Tool 28: Roth versus Traditional: Which Is Better for You in the Learning Tools directory of this website. It allows you to set an annual contribution, an estimate for a rate of return on earnings, and your current and future tax rates. By changing your future tax rates, you can determine if your balance in the future would be higher or lower, all other areas being held constant.

Tax-eliminated accounts: Tax-eliminated accounts require you to pay taxes on principal before you invest it; however, you do not have to pay any taxes on the capital gains or earnings in the future. There are several different tax-eliminated investment vehicles and assets that can help you save for retirement (i.e., Roth IRAs or Roth 401(k)) or for education (i.e., 529 funds, Education IRAs and Series EE or I bonds). When tax-eliminated accounts are used for qualified purposes, withdrawals can be made without penalty and without taxes.

With a Roth IRA or a Roth 401(k), you pay taxes on the principal before you deposit the money into your retirement account. Once you reach age fifty-nine and a half, you can take both the principal and interest out of this retirement account without paying taxes on the money. By paying taxes beforehand, you eliminate taxes on all capital gains and earnings in this account. Roth IRAs have an additional advantage: if you need to use the funds in your account before retirement, you can withdraw the principal without penalty because you have already paid taxes on the principal. The disadvantage of a Roth IRA is that, like all retirement accounts, you cannot withdraw your earnings without penalty until you are at least fifty-nine and a half years old.

With many 529 funds and Series EE and I bonds, you are investing with after-tax dollars. If you use your earnings to cover qualified educational expenses for your children, you do not have to pay taxes on the earnings. However, if you do not use the earnings for qualified educational expenses, you must pay a 10-percent penalty on your earnings, as well as federal and state taxes on the amount withdrawal as it is considered ordinary income for tax purposes.

Tax-deferred accounts: Tax-deferred accounts allow you to invest without first paying taxes on the principal; then, when you withdraw money from the account at retirement, you pay taxes on both the principal and the earnings. This type of account is advantageous because it allows you to invest a larger amount of money using a smaller percent of your net income. Examples of tax-advantaged investment vehicles include Individual Retirement Accounts (IRAs); 401(k), 403(b), and 457 plans; and Simplified Employment Plan Individual Retirement Accounts (SEP-IRAs).

Suppose your gross income last year was $45,000, and you invested $3,000 in a traditional IRA. Your adjusted gross income (the income on which you pay taxes) would be $42,000 ($45,000 less the $3,000 contribution). Contributing to an IRA reduces the amount you must pay in taxes today (the amount of your tax savings would be equal to $3,000 multiplied by your tax rate). However, when you retire after age fifty-nine and a half and take this money out of your
retirement accounts, you are not only required pay taxes on your $3,000 investment, but you must also pay taxes on any earnings the IRA investment has produced as well. Note also that although your investments were long-term investments, both earnings and principle are taxed at ordinary tax rates.

The risk of using tax-deferred investment vehicles is that you must be at least age fifty-nine and a half to make withdrawals. If you withdraw funds before you reach this age, you must pay taxes on the funds at your ordinary income-tax rate, and you must also pay a 10-percent penalty fee. Thus, if you make early withdrawals, you may lose up to 50 percent of your investment in taxes (a 10-percent penalty charge plus 40 percent in taxes if you have the highest marginal tax rate possible). Tax-deferred earnings that have remained in your retirement account for more than twelve months are still taxed as ordinary income, which is taxed at a higher rate than capital gains.

**Priority 3: Tax-Efficient and Wise Investments**

The third priority is tax-efficient, wise investments. Wise investors know they will have to pay taxes and transaction fees on any investment they make, so they work to minimize these costs as much as possible. They also monitor their investments’ performances by comparing their returns after taxes and transaction fees to the appropriate benchmarks. The following are five important suggestions for investing tax-efficiently and wisely.

1. **Know the impact of taxes.** As an investor, you must be particularly concerned about the effects of taxes, because taxes are one of the largest expenses you will have to pay when you invest. Every dollar you pay in taxes is a dollar you will not be able to invest. To invest in a tax-efficient manner, you must understand how taxes influence your returns (capital gains, dividends, and interest). You can use the following formula to calculate your after-tax return:

   \[
   \text{Return} \text{ after tax} = \text{Return} \text{ before-tax} \times (1 - \text{marginal tax rate})
   \]

   Your after-tax return is equal to your before-tax return multiplied by the result of one minus your marginal tax rate. Your marginal tax rate is the tax rate you pay on your last dollar of earnings. Your marginal tax rate encompasses your federal, state, and local taxes. It is important for you to know your marginal tax rate. Remember that different types of earnings are taxed differently. Bond interest is taxed at your marginal tax rate, stock dividends are taxed at 15 percent or 5 percent, and unrealized capital gains (the capital gains on assets that have not been sold yet) are not taxed at all until the assets have been sold.

   To understand the impact of taxes, you must calculate the estimated after-tax return of each asset you are considering.

2. **Reduce taxes and defer earnings and taxes to the future.** Capital gains are taxed at a much lower rate than ordinary income (15 percent if your marginal tax rate is 25 percent or more, or 0 percent if your marginal tax rate is 15 percent or less. Earn as much of your income as possible in the form of long-term capital gains.
Invest in your qualified and individual retirement plans. This way you are getting a tax break now, and will not have to pay taxes until retirement. You could also invest in Roth retirement vehicles where you pay taxes now, but never pay taxes on the investments ever again.

You can replace ordinary income with capital gains by using a buy-and-hold strategy when you invest. This strategy means that you hold on to your assets for as long as possible and do not trade in your accounts. By holding on to assets for extended periods of time, you defer earnings to the future and avoid paying taxes now.

3. Minimize turnover and taxable distributions. Minimize turnover on all assets and minimize taxable distributions on your mutual funds. Every time you sell an asset, you set up a taxable event (a transaction that has tax consequences). By using a buy-and-hold strategy, you minimize the impact of taxes and reduce your transaction costs as well.

The law requires that mutual funds distribute 90 percent of all capital gains and interest to shareholders annually. You will have to pay taxes and fees on these distributions, even if you do not sell your mutual fund. As an investor in a mutual fund, you must sometimes pay taxes because of the actions of the mutual fund’s portfolio manager.

You can minimize turnover and taxable distributions by selecting your mutual funds wisely. Invest in funds that do not have a history of trading actively (i.e., funds that have low turnover or trading). These funds will reduce the amount you must pay in taxes each April.

4. Replace interest income with stock dividend income. Because of changes in the tax law in 2004, taxes on dividends from individual company stocks or stock mutual funds were reduced to 15 percent or 0 percent, depending on your marginal tax rate. However, interest earned on bonds or bond mutual funds is taxed at your ordinary income rate. If you put more emphasis on stock dividend income than interest income, you will potentially increase your portfolio’s return and pay less in taxes as well. These steps should only be taken if they are appropriate for your risk-tolerance level.

5. Invest tax-free. If you are in a high marginal tax bracket, you can invest in assets that do not require you to pay federal or state taxes. For example, municipal bonds are federal tax-free; they may also be state tax-free if you are a resident of the state that is issuing the bonds. Treasury bonds are state tax-free, and certain government savings bonds, such as Series EE and Series I bonds, are both federal and state tax-free if the proceeds are used solely for qualified educational expenses.

Using the Process

Some investment vehicles are preferred over others because they provide tax advantages and other advantages. Unfortunately, some of the investment vehicles that are high money priorities also have lower maximum contribution limits. For example, in 2013 the maximum amount you could contribute to a Roth IRA was $5,500, while there was no limit on how much you could invest in taxable individual financial assets.
Although some investment vehicles have limitations, it is still a good idea to adhere to the process discussed. You should first invest money in vehicles that are the highest priority on the list. When you have reached the maximum amount you can invest in these vehicles, or when you have invested as much money as your company is willing to match, then you should invest in the next highest priority. Continue to invest until you have utilized all of your available investment funds.

When selecting financial assets to include in your retirement account, remember that you will not have to pay taxes on the principal or earnings until you take the money out, or not at all. If you own financial assets that are actively traded or that generate a lot of income, these assets should be held in your retirement accounts; you will not have to pay taxes on the assets until you take them out at retirement, if at all. Assets that you may want to hold in your retirement account include actively traded accounts, taxable bonds, and high-turnover mutual funds.

Financial assets that you are managing with a buy-and-hold strategy should be kept in taxable investment accounts. Such assets include tax-free bonds, tax-efficient indexes and mutual funds, and other financial assets that you do not plan to sell for a long time. Although you may be required to pay taxes on these funds each year for dividends and other short-term distributions, it is usually tax efficient to hold these assets for extended periods of time. The taxes that you must pay on these funds will add little to your yearly tax bill.

**Invest at Your Risk Level (your asset allocation)**

One of the key challenges of investing is to invest at a risk level you are comfortable with. Different investors can accept different levels of risk as they work to achieve their personal and family goals. This view and understanding of risk is not an easy thing to determine.

If you choose to invest at lower risk levels, you will have a greater probability of not losing money, yet because of the lower risk, your returns are likely to be lower as well. There is a tradeoff between risk and return. If your risk level is too low, you will need to save more money for retirement and other goals as your returns will likely be less.

If you take too much risk in your investing, there are concerns as well. With higher risk, you have higher volatility and hopefully higher returns. However, if you invest at a higher risk level than you are comfortable with, you will be very concerned every time the market declines.

Interestingly, most investors are torn between “fear” and “greed.” When the financial markets decline, the “fear” kicks in. We think we should take our investments out of the market, and that we will know and be able to put them back in before the market goes up again (this is called market timing). I personally know of no investor that can consistently time the market.

Likewise, when the markets are going up, the “greed” kicks in. We think we should put all our assets into one or two “sure things”, which are anything but sure.
Our challenge then is to find a median point between fear and greed, so that we can build a portfolio that will give us the amount of risk that we are comfortable with and that will help us to achieve our goals. That is where risk tolerance comes in.

**Risk Tolerance.** Risk tolerance is an investor’s willingness to accept risk. It is related to the holdings of the investor’s investment portfolio or their expected holdings in their investment portfolio, particularly their asset allocation or asset mix. Generally, a higher risk tolerance indicates a willingness to take on more risk, while a lower risk tolerance indicates a willingness to take on less risk.

Your risk tolerance is determined in two main ways: 1. It can be derived from an investor’s age and their current portfolio holdings, i.e., an implied risk tolerance, or 2. It can be estimated by an investor answering specific questions regarding investor demographics including age, characteristics, spending habits, history, and investment experience.

When we define risk in the determination of risk tolerance, risk in this case is generally considered the volatility of investment returns. Investors with a lower risk tolerance will have more assets in less risky or less volatile asset classes such as bonds and cash. Investors with a higher risk tolerance will have more assets in more risky or more volatile asset classes such as equities or stocks including small caps, international, REITs, etc.

Some have wondered if risk tolerance is more an absolute number or a general category. For the purposes of this class and lecture, risk tolerance is considered more a general category. In this class, we divide risk tolerance into five general categories: very conservative, conservative, moderate, aggressive, and very aggressive.

The purpose of risk tolerance is to enable an investor to determine an appropriate asset allocation or investment mix based on the investor’s willingness to accept risk. This allocation is critical because it determines the amount of risk an investor is willing to accept. A lower risk tolerance should lead to a lower risk portfolio, with more invested in bonds and cash. A higher risk tolerance should lead to a higher risk portfolio with more equities.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Annual Return*</th>
<th>Standard Deviation*</th>
</tr>
</thead>
<tbody>
<tr>
<td>US Small Cap</td>
<td>12.0%</td>
<td>29.1%</td>
</tr>
<tr>
<td>US Large Cap</td>
<td>9.5%</td>
<td>19.2%</td>
</tr>
<tr>
<td>Treasury Bonds</td>
<td>5.6%</td>
<td>8.4%</td>
</tr>
<tr>
<td>Treasury Bills</td>
<td>3.6%</td>
<td>0.9%</td>
</tr>
<tr>
<td>Inflation</td>
<td>3.1%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>

Source: Calculated from Ibbotson Data, 2013. Note that each of these asset classes are portfolios of financial assets, not individual assets.

The challenge of risk tolerance is that it is not an exact science, and can mean different things to different people. Risk tolerance varies from one individual to another.
Please note that there are many different risk tolerance tests and categories that may lead to slightly different results. There are lots of different risk tolerance tests available online, many of which are more to sell investment products than to really help people understand how they should invest their assets. Luckily, we are not selling anything with this manual or this website.

**Asset allocation.** Asset allocation it is the process of determining how the assets of a portfolio are divided, mainly into which asset classes. A well-diversified portfolio should have broad diversification across many asset classes to reduce overall portfolio risk. A broadly diversified portfolio is an investor’s key defense against risk, a key to a “sleep-well portfolio,” one that is not torn between fear and greed.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Annual Return*</th>
<th>Standard Deviation*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other: US REIT</td>
<td>13.0%</td>
<td>27.6%</td>
</tr>
<tr>
<td>Equity: Emerging Markets</td>
<td>15.2%</td>
<td>24.3%</td>
</tr>
<tr>
<td>Equity: US Small Cap</td>
<td>10.3%</td>
<td>20.8%</td>
</tr>
<tr>
<td>Equity: International</td>
<td>3.8%</td>
<td>18.4%</td>
</tr>
<tr>
<td>Equity: US Large Cap</td>
<td>7.1%</td>
<td>14.9%</td>
</tr>
<tr>
<td>Government Treasury Bonds</td>
<td>7.3%</td>
<td>12.0%</td>
</tr>
<tr>
<td>Government Treasury Bills</td>
<td>1.7%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Inflation</td>
<td>2.4%</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

**Table 3. 10 Year Return and Volatility of Asset Classes from 2002 to 2012**

Source: Calculated from Ibbotson and MSCI 2013. These are portfolios of financial assets, not individual assets.

Asset allocation is important for two reasons:

1. Research has shown that most of the returns from financial assets are mainly a function of returns from the specific asset class decision, and not from the individual stock selection decision. Asset class choice influences returns.

2. In the process of selecting your asset allocation, you are selecting your risk level for your overall portfolio. Selecting asset classes is selecting the risk or risk level for your portfolio.

While we cannot know which asset classes will be the most risky over the upcoming years, we can use historical data to determine the most risky asset classes over the past 85 years ending December 2012 in terms of volatility (or standard deviation). The higher the standard deviation the more volatile the asset class (see Table 2).

As you know, time periods change. What were the most risky asset classes over the past 10 years ending December 2012 (see Table 3)?

Notice that generally the higher risk asset classes had the higher return, but it was not necessarily the case.
Chapter 11. Beginning Investing 2: Application

So if risk tolerance is important then the challenge becomes the process of determining your asset allocation. How do we do that?

Asset allocation is a three-step process:

**Step 1:** Set your initial bonds and cash allocation to equal your age as a percent of your overall portfolio allocation. For example, if you are 40 years old, you should have 40% of your portfolio in bonds and cash, and 60% in equities.

**Step 2:** Take this risk tolerance test. Based on your results, you will adjust that allocation to take into account your individual risk tolerance and come up with an risk-appropriate asset mix. If you are more conservative you will increase your bonds and cash allocation and decrease your equity allocation. If you are more aggressive, you will do the opposite.

**Step 3:** Determine your preferred asset classes based on risk within your major asset classes. If you are a conservative investor, you will likely have many different bond asset classes (short-term, long-term corporates, governments, municipals, etc.), but likely only large cap equities, and perhaps a small amount of other equity asset classes. If you are more aggressive, you will do the opposite, have more small cap, international, emerging markets, REITs, etc. and less allocation to bonds and cash.

To come up with your asset allocation, I recommend you take our risk tolerance test from the website. **Learning Tool 16: A Risk Tolerance Test** is a tool we developed to help students understand and determine their asset allocation and risk tolerance. The process is:

1. Read through the entire test to familiarize yourself with what you are doing (it is included below).
2. Review each of the 8 questions and answer each of the questions carefully based on your views, experience and opinions.
3. Then add up your points from each question. There are five potential responses to each question, worth 1 to 5 points.
4. Add up the point next to the correct response and sum your total points from each of the 8 questions.
5. From your total points, we will have recommended actions for your asset allocation.

**Question 1: Demographics. What is your age currently?**
   1. 65 and over
   2. 45 to 64
   3. 35 to 44
   4. 25 to 34
   5. 24 and under

**Question 2: Time Horizon. What is your investment time horizon for this money?**
   1. 1 year
   2. 2-5 years
3. 5-10 years  
4. 10-20 years  
5. 20 years or longer

Question 3: Investment Goals. What is your primary objective for this money?  
1. Preservation of Principal  
2. Current Income  
3. Growth and Income  
4. Conservative Growth  
5. Aggressive Growth

Question 4: Expected Personal Earnings: Regarding your current income, do you expect it to:  
1. Decrease dramatically in the future  
2. Decrease a slight amount in the future  
3. Stay about the same  
4. Increase with the pace of inflation  
5. Increase dramatically

Question 5: Emergency Funds: What amount of money do you have set aside for emergencies? (This does not include borrowings or credit lines, but does include money you can access quickly)  
1. None  
2. Enough to cover three months of expenses  
3. Enough to cover six months of expenses  
4. Enough to cover nine months of expenses  
5. Over twelve months of expenses

Question 6: Investment Experience: What is your personal investment experience?  
1. I have never invested any money in any financial market or instrument.  
2. I am relatively new investor,--only a few years.  
3. I have invested in IRAs and employer sponsored retirement plans (401 (k)) for some time, but now I am ready to develop additional investment strategies outside of that plan.  
4. I have invested for quite some time and am fairly confident in my investment decisions.  
5. I have invested money for years and have a definite knowledge of how financial markets work.

Question 7: Investment Risk: Regarding your view of risk, which investment would you be more comfortable making?  
1. I am comfortable investing in savings accounts, CDs, and other short-term financial instruments.
2. I invest in savings accounts/CDs, but I also own income-producing bonds and bond mutual funds.
3. I have invested in a broad array of stock and bond mutual funds, but only the highest quality.
4. I have invested primarily in growth stocks and growth stock mutual funds.
5. I like to pick out new and emerging growth companies and aggressive stock mutual funds.

Question 8: Investment Preference: Which investment would you be more likely to invest in?
The investment has:
1. A 20-year average return of 0-2%, with infrequent downturns and no years of negative returns.
2. A 20-year average return of 3-4% with mostly positive returns but less than a year of negative returns.
3. A 20-year average return of 5-6% with a few downturns and more than one-year of negative returns.
4. A 20-year average return of 7-8% with several periods of negative returns.
5. A 20-year average return of 9% or greater with several periods of substantially negative returns.

You should now have your total score. From your total score, it can help you understand what type of investor you are: Very conservative, Conservative, Moderate, Aggressive, and Very aggressive. Each score will have a recommended action regarding increasing or reducing risky assets (see Table 4).

The challenge is to get from your risk tolerance to your asset allocation. Table 4 below helps you do that. Match your beginning allocation, which is your age in bonds, with your recommended action. Once you perform the recommended action, you will have your asset allocation or asset mix consistent with your preferred level of risk.

Investors are free to shift between the cash and bond allocations without any change in effectiveness of the test. I personally prefer to always have, at minimum, a 1-5% allocation to cash.

So how does this scoring work? For example, if you scored 35 points, you would be considered a “aggressive” investor. This is your risk tolerance or type of investor you are.

To get to your asset allocation or asset mix, you need to start with your age in bonds. For example, assume you are age 40 so assume 40% in bonds.

Next, do what the Asset Allocation Recommendations suggest. For an “aggressive” investor, you would add 10% to equities and subtract 10% to your bond and cash allocations from the above charts. Your asset allocation at age 40 would be 30% bonds and cash, and 70% equities.
You are likely wondering if you can have two individuals with similar asset allocations yet with different risk levels? The answer is yes. This is due to their different ages. For example, three investors each have a 60% equity and 40% bond allocations. Investor A is age 50 and is Aggressive; Investor B is age 60 and is Moderate; and Investor C is age 40 and is Very aggressive. Their overall allocations of 60% equity and 40% bonds the same. However, their allocations within the equity and bond allocations will likely be very different. Aggressive investors will have more small cap, international, and other risk equity asset classes. Conservative investors will have more in savings accounts, bonds, government securities, and municipal bonds.

### Table 4. Asset Allocation Results from the Risk Tolerance Test

<table>
<thead>
<tr>
<th>Investor Type</th>
<th>Asset Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Asset Classes:</strong></td>
<td><strong>Recommendations:</strong></td>
</tr>
<tr>
<td>Very Conservative</td>
<td>8 to 12 points</td>
</tr>
<tr>
<td>Cash</td>
<td>+5%</td>
</tr>
<tr>
<td>Bonds</td>
<td>+15%</td>
</tr>
<tr>
<td>Stocks</td>
<td>-20%</td>
</tr>
<tr>
<td>Conservative</td>
<td>13 to 20 points</td>
</tr>
<tr>
<td>Cash</td>
<td>+0%</td>
</tr>
<tr>
<td>Bonds</td>
<td>+10%</td>
</tr>
<tr>
<td>Stocks</td>
<td>-10%</td>
</tr>
<tr>
<td>Moderate</td>
<td>21 to 28 points</td>
</tr>
<tr>
<td>Cash</td>
<td>0%</td>
</tr>
<tr>
<td>Bonds</td>
<td>0%</td>
</tr>
<tr>
<td>Stocks</td>
<td>0%</td>
</tr>
<tr>
<td>Aggressive</td>
<td>29 to 36 points</td>
</tr>
<tr>
<td>Cash</td>
<td>-5%</td>
</tr>
<tr>
<td>Bonds</td>
<td>-5%</td>
</tr>
<tr>
<td>Stocks</td>
<td>+10%</td>
</tr>
<tr>
<td>Very Aggressive</td>
<td>37 to 40 points</td>
</tr>
<tr>
<td>Cash</td>
<td>-5%</td>
</tr>
<tr>
<td>Bonds</td>
<td>-15%</td>
</tr>
<tr>
<td>Stocks</td>
<td>+20%</td>
</tr>
</tbody>
</table>

**Wisely Select Individual Assets**

Once you have the “whys” of investing, understand your principles of successful investing, are ready to invest (meaning your priorities are in order, you are out of credit card and consumer
debt, have adequate health and life insurance, and know your goals, budget, and have a well written investment plan), and know your target asset allocation, the next challenge is to choose your financial assets. What type of assets should you choose?

The answer to this question depends on the size of your investment portfolio. Many wonder when and if they should pick individual stocks?

I recommend most investors avoid picking individual stocks and bonds. For those who really want to do this, then I recommend waiting until your portfolio is sufficiently large (i.e., $500,000 or more) to make this feasible. You can have a successful portfolio without purchasing individual stocks and bonds. Why is this the case?

There are five major reasons why I do not recommend picking stocks when your portfolio is small, and these all relate to our principles of successful investing.

1. Principle 3: Stay Diversified. Picking single stocks violates the principle of diversification, especially when you are just beginning to build your portfolio. With a small portfolio, it is difficult to achieve acceptable diversification with limited numbers of stocks.

2. Principle 4: Invest Low Cost. Investing in stocks when you have a small portfolio is very expensive. Transactions costs for purchasing stocks are among the highest of any major asset class.

3. Principle 6: Know What You Invest In. Picking stocks when you have not developed the knowledge base necessary to evaluate stocks is very risky, bordering on speculation or gambling. Most have not as yet put in the time to learn to evaluate stocks nor have developed the tools to make good stock selection decisions. This caution also includes most of my Finance students unless they have taken my Finance 409 Equity Modeling and Valuation and 415 Asset Management classes which specifically address the selection process.

4. Principle 8: Don’t spend too much time trying to “Beat the Market.” Picking stocks is very difficult and challenging. There is so much more to be learned about valuation that can’t be taught in a single presentation or class on investing. I have given only the very basics in this chapter.

5. Stock selection is not required to have a successful investment portfolio. While it is intellectually challenging to select stocks, you can generally improve returns and reduce risk more by properly selecting asset classes and buying no-load mutual funds, index funds and exchange traded funds (ETFs). You may never need to buy an individual stock unless you really want to. I personally have no individual stocks in my portfolio except with what I do with the students in my classes.

I recommend students use no-load mutual funds, index funds and ETFs to get exposure to the asset classes they are considering.
Index funds and ETFs are mutual funds which hold specific shares in proportion to those held by an index. Their goal is to match the benchmark performance. They came about because investors were concerned that most actively managed mutual funds have not been able to beat their benchmarks after all fees, taxes, and costs on a consistent basis.

Index funds have become the standard against which other mutual funds are judged. If an active manager cannot beat the benchmark after all fees and costs, then investors should just invest in the index fund or ETF. They know they will get the return of the index without the additional costs active management entails.

The principle becomes simply. If an actively managed mutual fund cannot perform consistently better (after taxes and fees) than a low cost index fund from the same asset class, then investors should invest in index funds. Research has shown that investors who invest in low-cost funds can have significantly more resources in retirement than those who invest in high-cost investments.¹

Remember the Dalbar study discussed earlier.² Investor’s have significantly underperformed the performance of the benchmarks (see Dalbar 2007-2012).

Index funds and ETFs grown quickly over the past years, as they have outperformed most actively managed funds after fees, taxes, and expenses.

Remember that winners rotate. There is no correlation between last year’s winners and this year’s winners for actively managed funds. Actively managed funds reduce performance through excessive trading and high fees. Experience has shown it is very difficult to beat index funds on a consistent basis after all fees and taxes.

Jason Zweig, a senior writer for Money Magazine commented:

> With an index fund, you're on permanent auto-pilot: you will always get what the market is willing to give, no more and no less. By enabling me to say "I don't know, and I don't care," my index fund has liberated me from the feeling that I need to forecast what the market is about to do. That gives me more time and mental energy for the important things in life, like playing with my kids and working in my garden.³

Warren Buffet commented about index funds:

> By periodically investing in an index fund, the know-nothing investor can actually outperform most investment professionals. Paradoxically, when 'dumb' money acknowledges its limitations, it ceases to be dumb.⁴

While it is exciting to buy individual stocks and actively managed mutual funds, most actively managed funds will generally under-perform index funds in the long run after all taxes, costs, and fees.⁵ The competition in stock-market research is intense and will get more competitive going forward, making markets more efficient and indexing even more attractive. Buying an index
fund or “passive investing” is a free-ride on the competition. Passive investing takes very little time and has generally outperformed most actively managed funds over time.

Remember, since analyzing companies is not likely going to be many of your jobs, it will be in most of your best interests to develop a “sleep-well portfolio” plan and follow it. This is done by:

Living on a budget and saving monthly. It is not what you earn but what you save and invest that makes you wealth.

Investing regularly for your personal and family goals. “Let the solemnities of eternity rest on your mind.”

Staying diversified and investing low cost and tax efficiently through index funds consistent with your level of risk.

Writing and following your Investment Plan.

Enjoying your family and friends.

Doing well in your day job, church responsibilities and community

**Final Cautions on Investing**

Let me share a few final thoughts on Investing:

Do not go into debt to invest. This includes taking equity out of your home, buying on margin, or short-selling assets. Investing has enough risks of its own. Do not compound that with leverage.

Beware of financial advisors who recommend shifting assets from one vehicle to another. I hear of advisors who recommend to don’t shift assets from a 401k retirement account, having you pay penalties, and then putting you into another asset, usually an insurance product. Do not move your investments from one investment vehicle to another unless you fully understand all the costs and benefits.

Beware the agency problem. Some advisors sell products based on their commissions, not what is best for you. Watch your turnover in your portfolio. A high turnover usually indicates problems and leads to lower returns.

Listen to the spirit. If it seems too good to be true, it probably is. Beware of members of your local congregation, friends, and others who will try to use associations to have you buy their products. There are no guaranteed returns. If it sounds too good to be true, it likely is a scam.

Finally, remember the wise counsel of M. Russell Ballard who said:
There are no shortcuts to financial security. There are no get-rich-quick schemes that work. Do not trust your money to others without a thorough evaluation of any proposed investment. Our people have lost far too much money by trusting their assets to others. In my judgment, we never will have balance in our lives unless our finances are securely under control.

**Summary**

We discussed in the earlier chapter the important investing principles that, if followed, will result in a quality investment plan and lead to a successful investment portfolio. We also discussed the investment hourglass and how that helps you understand what you should do before you invest. If you follow these principles, there is a greater chance of a successful portfolio—one that can help you achieve your personal and financial goals.

We discussed how you build an investment portfolio using the bottom of the investment hourglass. As you begin to save and invest, review the bottom of the investment hourglass. Start with the basics: build your emergency fund and food storage, then work up the pyramid. As you go up the pyramid, you will be adding risk to your portfolio. When you build your portfolio, it is critical that you take risk into account.

Selecting investment vehicles was next, which is the process of determining which investment vehicles can help you achieve your goals the fastest. It is largely related to understanding the tax advantages of the various investment vehicles, and utilizing the vehicles that can help you get the highest after-tax returns.

We took a risk tolerance test which helped you to understand which type of an investor you are: very conservative, conservative, moderate, aggressive, and very aggressive. This test had two purposes: to help you understand what type of investor you are and to help you understand a recommendation for your asset allocation, how risk is brought into your portfolio. The riskier the assets in your portfolio, the riskier the portfolio.

We discussed how you select financial assets for your portfolio. We discussed why it is a poor idea to buy individual stocks and bonds initially, especially when your portfolio is less than a $500,000. Easier and wiser investments would be no-load, low-cost index and mutual funds which offer immediate diversification, low cost, low taxes, and generally good performance.

We finished with some final cautions. Don’t go into debt to invest. This includes borrowing against your home equity, buying on margin, or selling short. Don’t move assets from one vehicle to another, i.e., take money from your 401k to buy a cash value insurance policy. Be careful of people selling assets—make sure they are licensed and the products are registered. If it sounds too good to be true, it likely is.
Assignments

Financial Plan Assignments

Understanding yourself is a critical part of investing. It is important that you understand not only your personal view of investing, but also your family view of investing. Start by taking the simple risk-tolerance test, found in Learning Tool 16: Risk-Tolerance Test. The test gives simple recommendations for possible asset-allocation targets (asset-allocation targets will be discussed later). Know how much risk you are willing to take. When you have answered these questions, you are ready to start creating your Investment Plan.

First, copy the sample plan found in Learning Tool 5A: Investment Plan Example. Read through this Plan.

Second, complete the introduction to the Investment Plan and add the information on yourself and your spouse if you are married, including your names and ages.

Third, complete the introductions to each of the four sections. In the introduction to Section I, add the different accounts you will use. It is acceptable to include all the listed accounts as you may use many of them during your lifetime. In addition, you must determine two separate time stages for this Investment Plan. Generally, these time stages equate to your time before retirement as Stage 1 and time in retirement as Stage 2. Add this information.

Fourth, after the results of your risk-tolerance test (see Learning Tool 16: A Risk-Tolerance Test), fill out the type of investor you are in Section I.B.

Fifth, using your risk-tolerance test results, develop equity targets, bond targets, and other targets for Stages 1 and 2 in Section III.C.1. and III.C.2. Start first with the general rule of thumb of your age in bonds, then use the results of your risk-tolerance test to adjust those allocations. If you have questions, consult the notes for adjustments to the general rule of thumb at the end of Learning Tool 16: A Risk-Tolerance Test. Later, you will return to this section to determine your allocations within the stock and bond asset classes.

Optional Reading Assignments

To help you understand what steps you must take before you invest, please read the following articles in the Readings directory of this website:


Learning Tools

The following Learning Tools may be helpful to you as you become more financially self-reliant and as you prepare your personal financial plan:

28. Roth versus Traditional: Which Is better?

This spreadsheet gives a simple way of comparing which of the alternatives, a Roth or a Traditional IRA or 401(k) is better for you, based on your assumptions.

23. Return Simulation Spreadsheet

This spreadsheet helps you see the impact of various investment strategies and volatility for different types of asset classes. With selective asset classes, it can also help you to see the historical impact of different asset-allocation decisions.

27. Expected Return Simulation and Benchmarks

This spreadsheet gives a historical perspective on returns and standard deviation (risk) for the major asset classes over the last 1, 5, 10, 25, 50, 75, and 80 years. It also includes some recommended benchmarks for the major asset classes.

Review Materials

Review Questions

1. What is the process of selecting investment vehicles? Why should we learn it?

2. How much can an individual invest in a Roth IRA in 2013 (see Table 1)? In a 401(k)? Are these tax-eliminated or tax-deferred investment vehicles?

3. What are asset classes? What are the three major asset classes?

4. What is the main goal of cash and cash equivalent investments? Fixed income investments? Equities?

2 DALBAR QAIB 2007-2013.
6 D&C 43:34.
Chapter 12. Learning to Give

12. Learning to Give

Introduction

We have spent a significant amount of time together during this course working on goals and learning about budgets, credit, debt, insurance, investing, retirement, and other important subjects. These topics are critical to self-reliance and getting our financial houses in order. However, there are two more important areas we have not yet discussed. These topics are often left out of traditional personal finance courses, but they are critical to a complete study on personal finance. The last two chapters in this manual discuss learning to give and deciding to decide.

We all wrestle with learning to give. This chapter will discuss our covenantal obligations to share with others. It has been said, “We make a living by what we get, but we build a life by what we give.” Any discussion on giving takes us back to the first chapter of this course, where we discussed the key principles of personal finance. There are four pillars you need to understand in order to learn how to give:

1. **Ownership:** Since everything we have belongs to God, our material blessings should be seen as both privileges and responsibilities. The things we are given are not really ours; they are on loan.

2. **Stewardship:** God does not simply give us things; He makes us stewards. We must remember that we will someday have to give an account of our mortal stewardships, including our financial resources, to a loving Heavenly Father and His Son.

3. **Agency:** The Lord gave us our agency, our right to choose. This is one of the greatest gifts God has given us. We should use it well and choose wisely.

4. **Accountability:** We have been given the right to choose between different courses of action, and we will be held accountable for the choices we make, including our financial choices.

Once we understand these pillars, giving becomes easier. We also come to understand that giving is not a one-time event but a Christ-like attribute. Mark E. Petersen wrote the following:

> Instead of taking from our fellowmen, we must learn to give—to be good Samaritans in very deed; to share with our less fortunate neighbors, and in reality show love for our fellowmen. So He said: “Remember the poor, and consecrate of thy properties for their support . . . And inasmuch as ye impart of your substance unto the poor, ye will do it unto me.”

**Picture 1. Introduction to Candy Making**
An Illustration of Giving

A while ago I took the some young men from church to the Peppermint Place in Alpine, Utah. The owner of the store, Taz Murray, is a good friend and colleague of mine. Taz invited us to bring the young men aged 12–18 to his store so he could spend time talking with the young men about careers, potential jobs at the candy store, and other topics, including marketing, finance, production, and human resources (see Picture 1).

Taz gave the young men instructions to put on their hairnets and shoe mitts to protect the production floor and products and took them to the various parts of the factory: the candy heaters (see Picture 2), the cutting machines, the drying rack (see Picture 3), and the packing tables (see Picture 4).
The highlight of the trip came when Taz showed the young men the retail side of the candy store (see Pictures 5 and 6). Here he gave them instructions about what they should and should not do. He said the young men could eat any candy he made in his factory. Any candy or related products that he did not make in his factory were off-limits because he had to purchase them. Then he gave each of the young men a bag and said, “Fill them up.” He warned the youth that if they put things in their bags that were off-limits, they would be escorted outside until the other youth were done.

The youth had a great time. They were so excited. They filled their bags with gumdrops, chocolate-covered nuts and raisins, gumballs, gummy candies, and suckers (see Picture 7).

As I have thought about the subject of giving, I have decided that life is like Taz Murray’s candy store. We each fill our own bags—our lives—with the experiences we have while here on earth. We have been given instructions as to what is good and what is bad. If we choose wisely, we will be able to enjoy the good things in life. If we fail to choose wisely, we must reap the consequences of our actions. Interestingly enough, the more we share with others, the greater our joy will be later on.
Chapter 12. Learning to Give

Picture 3 The Drying Rack

Picture 4. The Packing Tables
Chapter 12. Learning to Give

Picture 5. The Candy Store

Picture 6. Youth Helping Themselves in the Candy Store
Objectives

When you have completed this chapter, you should be able to do the following:

1. Understand the five myths of giving
2. Know what the scriptures say about money and giving
3. Understand the principles of wise giving
4. Understand why we should give
5. Understand how to give effectively

Understand the Five Myths of Giving

There are five myths of giving that need to be recognized:

1. Giving Makes Us Poorer

While people who give to others may initially have less financially, giving really makes them richer in the long term. Givers are happier. Research has shown that happy people make more money, have better marriages, and contribute more to society. Givers are also healthier. Research has shown that when people are happier, they put less stress on their bodies and hence tend to live longer. Finally, leaders give. Research has shown that those who give are perceived to be leaders by those who observe.
2. People Are Naturally Selfish

Selfishness is a learned behavior. Arthur Brooks said: “People are selfish, it’s true, but they’re not naturally selfish; people are unnaturally selfish. When we are our best selves, when we are in equilibrium, when we are where we’re supposed to be cognitively, neurochemically, and spiritually, then we are giving people.”

3. Giving Is a Luxury

Giving is not a luxury. Brooks also said “[Giving is] a necessity—the first 10 percent, not the last 10 percent. And the reason is that if we want to be better, we have to give.”

As Christians, we have been commanded to give, yet we know it is something we need to learn. “Every man shall give as he is able, according to the blessing of the Lord thy God which he hath given thee.”

4. The Government Provides Assistance, So We Do Not Need to Give

The purpose of giving is not just to help those in need, it is also to help us. We need to give as much as others need to receive. Remember the words of Mosiah: “When ye are in the service of your fellow beings, ye only in the service of your God.”

Brooks said, “The day the government takes over for you in your private charity is the day we become poorer, unhappier, and unhealthier. We must demand to take our place as givers and support the communities and people who need the services we can provide.”

5. You Must Have Money to Give

Giving doesn’t depend on the checkbook but on the heart. What you do is more important than what you have. I believe that if you don’t learn to give when you are poor, it will be very difficult for you to give when you are rich.

Know What the Scriptures Say about Money and Giving

Much is written in the scriptures about money and giving. The following scriptures illustrate the principles Jesus taught about material wealth during his earthly ministry.

Luke 12:34 states, “For where your treasure is, there will your heart be also.” Mark 8:36–37 adds, “For what shall it profit a man, if he shall gain the whole world, and lose his own soul? Or what shall a man give in exchange for his soul?”

Matthew 6:31–33 gives us insights about the priority of our pursuits:

Therefore take no thought, saying, what shall we eat? or, What shall we drink? or, Wherewithal shall we be clothed? (For after all these things do the Gentiles seek:) for
Think about Christ and His parables. Many of these parables concern money or similar topics, such as property or wealth. As you review the scriptures, it becomes apparent that these topics were as important in Jesus’ day as they are today. By consulting the following list of money-related parables in the books of Matthew and Luke, we see that 8 of the 10 parables in Matthew and 9 of the 12 parables in Luke are related to money in some way (see Table 1).

It has been said, “Money doesn’t change us. It just reveals us to ourselves.” What does your use of money reveal about you?

### Table 1. Parables of Christ

<table>
<thead>
<tr>
<th>Parables in Matthew (8 of 10)</th>
<th>Parables in Luke (9 of 12)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Hidden Treasure</td>
<td>The Two Debtors</td>
</tr>
<tr>
<td>The Pearl of Great Price</td>
<td>The Good Samaritan</td>
</tr>
<tr>
<td>The Drawn Fishing Net</td>
<td>The Importuned Friend</td>
</tr>
<tr>
<td>The Unmerciful Servant</td>
<td>The Rich Fool</td>
</tr>
<tr>
<td>The Laborers in the Vineyard</td>
<td>The Lost Piece of Silver</td>
</tr>
<tr>
<td>The Two Sons</td>
<td>The Prodigal Son</td>
</tr>
<tr>
<td>The Ten Virgins</td>
<td>The Unjust Steward</td>
</tr>
<tr>
<td>The Talents</td>
<td>The Pharisee and the Publican</td>
</tr>
<tr>
<td></td>
<td>The Ten Pieces of Money</td>
</tr>
</tbody>
</table>

Vaughn J. Featherstone has counseled:

> Determine to serve one another. Listen to the spirit when your flesh is weak. For truly the Master said, “Inasmuch as ye have done it unto one of the least of these my brethren, ye have done it unto me” (Matt. 25:40). The blessings are tenfold when we do those good, kindly acts of Christian service when it is inopportune or not convenient.⁶

### Understand the Principles of Wise Giving

There is a different type of accounting done in heaven—not an accounting of dollars and cents, but an accounting of our capacity and willingness to give. Lynn G. Robbins said: “The truer measure of sacrifice is not so much what one gives to sacrifice as what one sacrifices to give.”⁷

The following are a few principles we should remember as we give:

1. **We Are to Give Out of Love**

We must give to those in need because we have a concern for their well-being and happiness. We should not give out of pride because we have abundance. We are to give out of gratitude for all
God has done for us. Paul said, “And though I give all my goods to feed the poor, and though I give my body to be burned, if I have not love, it profits me nothing.”

2. We Are to Give Sacrificially

Joseph Smith taught: “A religion that does not require the sacrifice of all things never has power sufficient to produce the faith necessary unto life and salvation.” Giving should be a sacrifice where our pocketbooks show where our hearts really are.

3. We Are to Give Wisely

We are to give wisely and within our capacity. King Benjamin gave the following counsel:

And again, I say unto the poor, ye who have not and yet have sufficient, that ye remain from day to day; I mean all you who deny the beggar, because ye have not; I would that ye say in your hearts that: I give not because I have not, but if I had I would give. And see that all these things are done in wisdom and order; for it is not requisite that a man should run faster than he has strength. And again, it is expedient that he should be diligent, that thereby he might win the prize; therefore, all things must be done in order.

4. We Are to Give of Our Abundance

As mentioned earlier, there is a different type of accounting done in heaven. Luke records:

And he [Christ] looked up, and saw the rich men casting their gifts into the treasury. And he also saw a certain poor widow casting in thither two mites. And he said, Of a truth I say unto you, that this poor widow hath cast in more than they all: For all these have of their abundance cast in unto the offerings of God: but she of her penury hath cast in all the living that she had.

Robert D. Hales stated, “You have received much in your life; go forth and freely give in the service of our Lord and Savior. Have faith; the Lord knows where you are needed. The need is so great, brothers and sisters, and the laborers are so few.”

5. We Are to Give Freely According to What We Have Been Given

We are to give of our own free will. Alma counseled:

The people of the church should impart of their substance, every one according to that which he had; if he have more abundantly he should impart more abundantly; and of him that had but little, but little should be required; and to him that had not should be given. And thus they should impart of their substance of their own free will and good desires towards God, and to those priests that stood in need, yea, and to every needy, naked soul.
6. We Are to Give in a Manner That Supports Our Goals

Our giving should support our personal goals and values. Gordon B. Hinckley said, “Generally speaking, the most miserable people I know are those who are obsessed with themselves; the happiest people I know are those who lose themselves in the service of others.”

Understand Why We Should Give

We should give for many different reasons. I think the following five reasons are important:

1. We Have Been Commanded to Give

Gordon B. Hinckley stated the following, “Without sacrifice there is no true worship of God . . . ‘The Father gave his Son, and the Son gave his life,’ and we do not worship unless we give—give of our substance . . . our time, strength, talents, faith, [and] testimonies.”

Moreover, King Benjamin gave the following counsel:

I would that ye should impart of your substance to the poor, every man according to that which he hath, such as feeding the hungry, clothing the naked, visiting the sick and administering to their relief, both spiritually and temporally, according to their wants.

Note that King Benjamin is not talking about unlimited giving but about every man giving according to his ability to give. We must use wisdom and order when we give to others.

2. Giving Shows Our Love for God

It is important to remember that we do not give because God needs the money. We give to show the world and ourselves that we love Him. Carol B. Thomas gave the following comment:

Sacrifice is an amazing principle. As we willingly give our time, talents, and all that we possess, it becomes one of our truest forms of worship. It can develop within us a profound love for each other and our Savior, Jesus Christ.

I like the idea that willingly giving is one of the truest forms of worship.

3. Giving Helps Others

The Lord has said, “Wherefore, be faithful; stand in the office which I have appointed unto you; succor the weak, lift up the hands which hang down, and strengthen the feeble knees.”

4. Giving Helps Us Become More Like Christ

Marion G. Romney taught, “The Lord doesn’t really need us to take care of the poor, but we need this experience; for it is only through our learning how to take care of each other that we
develop within us the Christ-like love and disposition necessary to qualify us to return to his presence.”

It is necessary for us to give if we are to become like Christ; we must become like Christ so we can return to His presence and live with Him and our families in heaven.

5. Giving Helps Us Repay an Inestimable Debt

We owe an inestimable debt to God that we can never truly repay. While we can never repay this debt, we can try. King Mosiah said:

I say unto you, my brethren, that if you should render all the thanks and praise which your whole soul has power to possess, to that God who has created you . . . I say unto you that if ye should serve him who has created you from the beginning, and is preserving you from day to day, by lending you breath . . . I say, if ye should serve him with all your whole souls yet ye would be unprofitable servants.

Understand How to Give Effectively

Understanding the principles of wise giving is important for making your donations as effective as possible. The following are some ways you can make the most of your charitable donations:

Set Principles to Help You Select Your Charities

The principles I follow when donating to a charity are as follows:

- I support charities that are in harmony with my personal goals and values.
- I support charities that help people worldwide and make the world a better place.
- I support charities that are effective in their use of “the widow’s mite.” These charities will make wise use of my funds and make sure most funds go to the recipients, not marketing and administrative expenses.

Outlining principles to follow when selecting a charity will help you ensure that you are making effective and wise donations.

Commit to Giving a Fixed Percentage

When we consider charitable giving as a percent of income, we see some surprising data. The following statistics from 1991 depict the average amount individuals gave to charity, according to salary brackets:

- Individuals earning $20,000 to 30,000 gave $1,207, or 4.8 percent.
- Individuals earning $30,000 to 40,000 gave $1,318, or 3.8 percent.
- Individuals earning $50,000 to 100,000 gave $1,837, or 2.5 percent.
Why did those who earned more money give half as much (in percentage terms) as those who made less? Why should our giving decrease as our blessings increase? Although the data is old, the trend has not changed much in the succeeding years.

The decision as to how much we should give should be made individually or as a family. C. S. Lewis made an interesting comment on this subject:

I am afraid the only safe rule is to give more than we can spare . . . If our charities do not at all pinch or hamper us . . . they are too small. There ought to be things we should like to do and cannot do because our charitable expenditure excludes them.21

One thought that has been helpful to my family has been the habit of giving in percentage terms rather than in dollar terms when trying to determine the amount we should give. For many people, paying tithing is easy but making other contributions is much harder. If you put your contributions in percentage terms, God will know that regardless of how great or how small your financial blessings, the amount you give will always be the same. Remember, do not let your giving decline as your income increases. The amount you are able to give should increase over time.

Gordon B. Hinckley commented:

You know, as I know, that when you pay your honest tithes and offerings, the windows of heaven are opened and blessings are showered down upon you. That which you give is never missed; it becomes not a sacrifice but an investment under the wondrous powers of the Almighty to bless you.22

**Things to Look For and Avoid When Giving to a Charity**

Before you decide to give a penny to any charity, there are some important steps you should take to ensure that your giving will be the most beneficial. The Better Business Bureau (BBB) recommends the following tips for in deciding to give to a charity:23

1. **Ask for the charity’s full name and address.** Ask for identification from the solicitor. Do not be fooled by names that look impressive or that closely resemble the names of well-known organizations. Make sure you want your money to go to this specific charity.

A good source of information on charities is the BBB’s Wise Giving Alliance, available at [www.give.org](http://www.give.org). The alliance rates over 400 different charities. Another good charity website is the Charity Navigator at [www.charitynavigator.org](http://www.charitynavigator.org). This institution works to advance a more efficient and responsive philanthropic marketplace by evaluating the financial health of America’s largest charities. Their website can give a good deal of information about various charities that file a Form 990 with the IRS. However, note that they do not include information on religious organizations listed as “church or convention or association of churches,” which are exempt from filing a Form 990.
2. **Ask if the charity is licensed by state and local authorities.** Registration or licensing is required by most states and many communities. If the charity is not licensed, it may not be a credible organization.

3. **Ask whether your contributions are tax-deductible.** The group must be a 501(c)(3) organization for your contributions to be tax-deductible. While it is not necessary to get a tax deduction for your giving, it does not hurt to get a deduction.

4. **Check out the organization with the Better Business Bureau.** Find out what percentage of the organization’s donations go to pay for programs, fundraising, and administration. The BBB recommends the following:
   - A. At least 50 percent of the charity’s total income should be spent on programs discussed in the organization’s literature.
   - B. No more than 35 percent of contributions should be spent on fundraising.
   - C. No more than half of the charity’s total income should be spent on administrative costs.

Realize that if you support causes that do not follow all three of these guidelines, you may not be making the best use of your funds.

5. **Watch out for statements such as “all proceeds will go to the charity.”** This phrase can mean that the money left after expenses (such as the cost of written materials and fundraising efforts) will go to the charity. These expenses can have a big impact on the way your donations will be used, so check carefully. Make your giving go as far as possible and help as many people as possible.

6. **Don’t worry about unordered merchandise.** If unordered items such as key rings, greeting cards, or pens are enclosed with an appeal letter, remember that you are under no obligation to pay for or return the merchandise.

7. **When you are asked to buy candy, magazines, cards, or tickets to a dinner or a show to benefit a charity, be sure to ask what the charity’s share will be.** You cannot deduct the full amount paid for any such items because the IRS considers only the amount in excess of the fair-market value of the item to be a charitable contribution. For example, if you pay $10 for an $8 box of candy, you can only deduct $2 for tax purposes.

Once you decide to give to a specific charity, beware of the following pitfalls:

1. **Do not give cash.** Always contribute by check, and make your check payable to the charity, not the individual collecting the donation.

2. **Keep records of your donations (receipts, canceled checks, and bank statements) so you can document your charitable giving at tax time.** Although the value of your time as a volunteer is not deductible, out-of-pocket expenses (including transportation costs) directly related to your volunteer service are deductible at 14 cents per mile in 2012.
3. Don’t succumb to pressure to give money on the spot or allow a “runner” to pick up a contribution. The charity that needs your money today will welcome a donation just as much tomorrow. Often the tactic of pressuring an individual to give money on the spot is a way to get around postal regulations.

4. Call your local BBB if a fundraiser uses pressure tactics like intimidation, threats, or repeated and harassing calls or visits. Such tactics violate the BBB’s recommended Standards for Charitable Solicitations.

Dealing with Unwanted Solicitations

Now that you have learned what to look for in selecting a charity, how do you handle different solicitations, including mail, telephone calls, and door-to-door solicitations?

1. Unwanted mail: Do you ever wonder what to do about unwanted mail? It seems like the more you give, the more likely you will be on other mailing lists and the more likely you will be solicited for donations. What should you do?

I suggest you decide in advance which charities you want to support, then discard appeals from all other groups. Do not ever feel guilty about not supporting all the groups that write to you. Physically and financially, you cannot support them all. However, you can help the causes that are most important to you. If you stop giving to all of the organizations that mail you solicitations, these organizations will eventually stop soliciting you.

2. Unwanted phone and door-to-door solicitations:

My suggestion is to implement a family policy about unwanted solicitations. Decide in advance what your family policy is and stick with it. I personally tell solicitors the following policy that may wife and I implemented:

   We have a family policy that we do not give to over-the-phone or to door-to-door salespeople over 12 years old. If you will send material about your charity, I will be happy to review it later and make a decision.

Interestingly, I rarely get taken up on my request to be given information in response to our family policy.

My Personal Priorities of Giving

Although there are many wonderful charities, the last part of this chapter is an overview of my personal giving priorities. Please note that since I am a member of the Church of Jesus Christ of Latter-day Saints, my giving tends toward this organization. Your giving will likely be the same and will largely be directed toward your church or synagogue. This list is not all inclusive, but it is provided as a good place to start.
1. **Tithing.** Tithing is my first priority. Tithing is a debt of thankfulness for all that the Lord has given me. God has given me everything—He is my most important creditor.

I firmly believe in the blessings of paying an honest tithe. Doctrine and Covenants 64:23 teaches us the following: “Behold, now it is called today until the coming of the Son of Man, and verily it is a day of sacrifice, and a day for the tithing of my people; for he that is tithed shall not be burned at his coming.”

To me, tithing is not a sacrifice: it is an investment. As it has been humorously pointed out, “the returns are out of this world.”

2. **Fast Offerings.** Fast offerings are offerings given from the practice of fasting for 24 hours once each month and giving the money you would have paid for food to the Church to care for those in need. Fast offering is my second giving priority. I believe that fast offerings are a form of payment for the blessing of living on this earth. Paying these offerings is a covenantal obligation I made of my own free will and choice. Marion G. Romney made the following statement:

   Caring for the poor is a covenantal obligation. It follows, then, that we look after our poor and distressed not only because it is convenient, or exciting, or socially acceptable; we should do it first and foremost in fulfillment of our covenant with the Lord that we will do so.\(^{24}\)

The Lord gave the following counsel in Doctrine and Covenants 42:30: “And behold, thou wilt remember the poor, and consecrate of thy properties for their support that which thou hast to impart unto them, with a covenant and a deed which cannot be broken.”

Remember, at some point in the future, we will be accountable to Heavenly Father and Jesus Christ regarding the way we have used our financial resources.

3. **LDS Charities (Humanitarian Services/Perpetual Education Fund).** LDS Charities helps with humanitarian aid throughout the world, regardless of the recipient’s religious orientation. They are among the first to help with natural and other disaster aid. The Perpetual Education Fund gives very low-cost loans to individuals to help with education expenses. With LDS Charities and the Perpetual Education Fund (PEF), every penny of every dollar you give goes to those in need. LDS Charities gives to everyone, whether they are Church members or not, and the PEF gives to returned missionaries from other countries to help them gain an education.

4. **Ward, Stake, and Church-Wide Missionary Funds.** I believe the Lord helps those who help missionaries who preach His gospel. I have found that when I am trying to help in the service of the Lord, through both personal, family, and financial efforts, not only are others’ lives blessed but my life and the lives of my family are blessed as well.
5. Deseret Industries, Goodwill, and the Salvation Army. What better way is there to get rid of belongings that are still good than to allow someone else to use them? Give the best you have to offer to help the Lord’s poor.

6. Other Charities. Other good charities include college annual funds, university scholarships, United Way, Boy Scouts of America, and Habitat for Humanity.

Summary

We all wrestle with learning to give. This chapter discusses our covenantal obligations to share with others. Any discussion on giving takes us back to the first chapter of this course, where we discussed the four key principles of personal finance: ownership, stewardship, agency, and accountability. An important part of learning to give is developing an understanding of these four principles.

There are five myths of giving that are incorrect:
1. Giving does not make us poorer. Those who give are happier and healthier and are considered leaders by others.
2. People are not naturally selfish. Selfishness is a learned behavior. When we are at our best, we are givers.
3. Giving is not a luxury, it is a necessity. We need to give to be the best people we can be.
4. The government provides assistance, so we do not need to give. We must demand to take our place as givers and support the communities and people who need the services we can provide.
5. You do not need money to give. Giving is a state of your heart, not a state of your checkbook.

Much is written in the scriptures about money and giving. A number of parables in Matthew and Luke illustrate the principles Jesus taught about material wealth during his earthly ministry.

There is a different type of accounting done in heaven—not an accounting of dollars and cents but an accounting of our capacity and willingness to give.

Before you decide to give a penny to any charity, there are important steps you should take to ensure that your giving will be the most effective and in line with your personal goals. Set principles to help you select your charities, and commit to giving a fixed percentage of your income.

Remember we each fill our lives with our experiences. We have been given instructions as to what is good and what is bad. If we choose wisely, we will be able to enjoy the good things in life. If we fail to choose wisely, we must reap the consequences of our actions. The more we share with others, the greater our joy will be later on.
Assignments

Financial Plan Assignments

Your financial plan is not complete until you have determined the ways in which you are going
to share your blessings with others. How well are you using your resources in your families to
help build the kingdom? What goals will you set regarding how you will bless the lives of those
around you? Think about the goals you wrote down in an earlier chapter, particularly in response
to the question, “What does Heavenly Father want me to do or to be?” What can you do to
achieve these goals?

Learning Tools

The following Learning Tool may be helpful to you as you learn to give:

8. Tithing Share Transfer Example

This document is an example of a form you can use to pay your tithes and other offerings
with appreciated stocks or mutual funds.

Review Materials

Review Questions

1. Learning to give takes us back to the four pillars of personal finance. What are the four
pillars of personal finance?
2. A large majority of the parables in the New Testament are related to what topic?
3. What are at least five different reasons for giving?
4. Based on the quote from C. S. Lewis, what is the only safe rule of giving?
5. When you give to charities, it is important to give wisely and to know where that
money is going. What are two resources you can use to learn more about different
charities?

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2 Honesty, a Principle of Salvation,” Ensign, Dec. 1971, 72
4 Deut. 16:17
5 Mosiah 2:17
8 1 Corinthians 13:3
9 Lectures on Faith, comp. N. B. Lundwall, Salt Lake City: Bookcraft, n.d., 58
10 Mosiah 4:24, 27
11 Luke 21:1–4
Chapter 12. Learning to Give

13 Mosiah 18:27–28
15 Teachings of Gordon B. Hinckley, 1997, 565
16 Mosiah 4:26
17 Thomas, Carol B. “Sacrifice: An Eternal Investment.” Ensign, May 2001, 63
18 Doctrine and Covenants 81:5
20 Mosiah 2:20–21
21 Mere Christianity, 1952, 67
24 Romney, Marion, G. Caring for the Poor—A Covenantal Obligation,” Ensign, Nov. 1978, 87
13. Decide to Decide

Introduction

This has been a lengthy course on personal finance. If you have completed all of the previous chapters, you have spent over 40 hours getting your financial house in order, and you have dedicated even more time to working on your Financial Plan. The purpose of this last chapter is to help you realize that your financial future begins now and that there are critical decisions you must make today that will impact your life throughout eternity. As you come to understand these important topics, you will be better prepared to achieve your personal and financial goals. This chapter also serves as a review of the topics we have discussed in this series. The main theme for this chapter is taken from a talk by Spencer W. Kimball in which he said the following:

We hope we can help our young men and young women to realize, even sooner than they do now, that they need to make certain decisions only once. . . . We can push some things away from us once and have done with them! We can make a single decision about certain things that we will incorporate in our lives and then make them ours—without having to brood and re-decide a hundred times what it is we will do and what we will not do. . . . My young brothers [and sisters], if you have not done so yet, decide to decide!

After all the work you have completed thus far, the challenge now is to decide to decide. What are the important decisions you must make now to help you achieve your personal and family goals?

Objectives

When you have completed this chapter, you should be able to do the following:

1. Realize that your future begins today
2. Understand some of the key decisions you must make to be truly successful in life
3. Understand what wise financial stewards know
   . Learn about resources for additional readings on the subject of personal finance

You can make important decisions now, and will never have to question them. From the inspired words of Spencer W. Kimball, now is the time to decide to decide!

Realize That Your Future Begins Today

You have many challenges ahead of you. For students, some of these challenges may include going to graduate school or paying back student loans and credit card debt. For other individuals, challenges might include budgeting, spending, saving, investing, getting married, having children, serving in your communities, sending your children on missions, going on missions
yourself, and retiring. With so many challenges ahead of you, it is critical that you keep your priorities and your personal and financial goals in order.

**A Look Back On This Course**

As you look back on this course, I hope you feel it has helped you better understand the importance of having a gospel perspective on personal financial issues. There are more important things than money.

This course was also intended to help you in three important areas:

- **Knowledge:** This course was intended to give you an increased understanding and knowledge of how financial decisions affect your lifestyle.
- **Planning:** This course was intended to give you a greater understanding of the importance of preparing for the financial challenges and changes of life.
- **Wisdom:** This course was intended to help put personal finance in a correct perspective, as not separate from but part of the gospel of Jesus Christ. True wisdom is learning and using our resources to do what Christ would have us do.

The proper application of these three areas will help you make personal and financial decisions more wisely.

**Keys to Financial Success**

There are shelves full of books about the keys to financial success. How do the truly rich become truly rich rather than simply monetarily wealthy? As I have evaluated the situations of those around me, I have made a few observations that may be helpful.

My first observation is that the truly rich have their priorities in order. Their first priority is having hope in Christ. They follow the counsel of the prophet Jacob, who said:

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But before ye seek for riches, seek ye for the kingdom of God. And after ye have obtained a hope in Christ ye shall obtain riches, if ye seek them; and ye will seek them for the intent to do good—to clothe the naked, and to feed the hungry, and to liberate the captive, and administer relief to the sick and the afflicted.²
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The truly rich first establish their hope in Christ and then seek the wealth of this world, if that wealth is important to them. The truly rich also seek this wealth for the right reasons, not to build themselves up or for prideful purposes but to bless the lives of their families, their friends, and others.

My second observation is that the truly rich understand the difference between income and wealth. Remember, income is the money you earn; wealth is the money you keep after expenses, taxes, and inflation. They truly rich pay the Lord first and then themselves. They invest their money wisely and quickly convert their earned income into passive and portfolio income. They
do not spend more than they have and they live within their income and their budget. Living within your income is not dependent on salary but on your attitudes toward money and the gospel. The truly rich pay with cash when possible, and they earn interest instead of paying it.

Finally, the truly rich live like the millionaires next door. In other words, they practice discipline and frugality in their financial affairs. Frugality sets the stage for personal financial success. It helps you spend less on the purchases you do not care about and more on the purchases you do. Frugality helps you say “no” to current desires in order to say “yes” to more important future goals. It helps you realize that money and the things money can buy do not bring happiness.

Understand Some of the Key Decisions You Must Make to Be Truly Successful in Life

In this course, we have discussed many critical decisions that I hope you will be well equipped to make as you decide to decide. The following are some key decisions I believe you must make to be truly successful in life: decide to believe, learn, work, set goals, budget, protect yourself, save and invest wisely, give, and above all else, to maintain these habits throughout your life.

It is not enough to know what to do. You must do it!

1. Decide to Believe

Believe in God and believe in yourself. Believe that God is interested in you as an individual, and believe that He is anxious for you to succeed. He has provided the sure pattern for ultimate success in the gospel of His son, Jesus Christ. When our lives are consistent with His gospel, we are given confidence through His Spirit that allows us to meet our daily challenges. We can say, along with Nephi, that “The Lord is able to do all things according to his will, for the children of men, if it so be that they exercise faith in him . . . Wherefore, let us be faithful to him.”

2. Decide to Learn

Make learning a lifelong commitment. Gain both temporal and spiritual knowledge. Temporal knowledge makes it easier to avoid financial pitfalls and helps you recognize bad advice. Temporal knowledge also helps you handle the inevitable surprises that life will bring. Spiritual knowledge helps you discern what is truly important and helps you keep your priorities in order. Spiritual knowledge also helps you understand what God would have you do.

Plan for a lifetime of learning. Be sure to take the time to polish and upgrade your skills; the only true insurance you have is your ability to continue improving yourself and your job skills. To prepare for future job security, make sure your talents and skills are in demand. Continue to educate yourself and be the best employee you can possibly be.

3. Decide to Work

Hard work is necessary for you to reach your goals. J. Paul Getty, who was at one time considered to be one of the world’s wealthiest men, gave this formula for success: “Rise early, work late, and strike oil!”
Decide now to work, and decide to work as hard and efficiently as you can. Pray for God’s help as you work that you might work beyond your natural abilities.

4. Decide to Set Goals

Set goals. Spencer W. Kimball said that it is appropriate for men and women “to quietly, and with determination, set some serious personal goals in which they will seek to improve by selecting certain things that they will accomplish within a specified period of time.”

Goals are the things that allow us to say “no” to the temptations of today in order to say “yes” to things in the future. Decide now to set good, timely, and well-thought-out goals. Then work toward them. As you set your personal and family goals, keep a long-term perspective on your goal-setting.

5. Decide to Budget

Always spend less than you earn. Change your attitudes about spending and money. Eliminate the “I deserve this” mentality, and truly separate needs from wants. Learn to save for your wants.

Decide now to budget; decide to keep your priorities in order. Always pay the Lord first and pay yourself second. By doing this, you will learn to manage your finances instead of allowing your finances to manage you.

6. Decide to Protect Yourself

Realize that you are not indestructible. Get insurance for those you love. Having too little liability coverage can ruin your financial future. What types of insurance do you need? Life insurance? Sometimes—life insurance is a necessity if you are married with dependents. Disability insurance? Perhaps. Home and auto insurance are likewise necessary when you purchase a home and a car. Health insurance? Definitely.

However, your best and most important form of insurance is obeying the commandments and living the teachings of Jesus Christ. Decide now to protect yourself, your loved ones, and your belongings. Be sure you have sufficient insurance.

7. Decide to Save and Invest Wisely

Before you invest, review the top of the investment hourglass and answer the questions posed by the hourglass (see Chart 1). If you can agree with each of the statements, you are ready to invest. As you invest, consider not only the risks you are willing to take but the order in which you should make investments. Make sure your priorities are in order.

As you begin to save and invest, review the bottom of the investment hourglass (see Chart 2). Start with the basics: build your emergency fund and food storage, then work up the pyramid.
8. Decide to Give

Learn to give now. Many people say they will give more and serve more when they become rich. They want the miracle without having the faith, the fruit before the seed, the reaping before the sowing. But faith must precede the miracle.
Chapter 13. Decide to Decide

Decide now to give. I recommend that you think about your giving in percentage terms. Learn to give a certain percentage of your income so you will never truly change the amount you give no matter what your income is or what you are blessed with.

9. Decide to Remember

Remember your blessings. Let us not be like the Nephites of old, who were admonished:

Ye do not remember the Lord your God in the things with which he hath blessed you, but ye do always remember your riches, not to thank the Lord your God for them; yea, your hearts are not drawn out unto the Lord, but they do swell with great pride, unto boasting, and unto great swelling, envyings, strifes, malice, persecutions, and murders, and all manner of iniquities.⁵

We need to remember our blessings and how much we truly have.

Decide to remember the Lord’s blessings in your life, decide to always remember Him, and decide to give Him the only thing that is truly ours to give.

10. Decide to Maintain Good Habits Throughout Your Life

You have done much over the course of this series: You have developed solid financial skills, you have learned to live on a budget, and you know your financial situation. You have evaluated your tax situation; your cash-management system; and your life, health, auto, disability, and liability insurance. You have developed an Investment Plan, a retirement plan, and an estate plan, and you have written a will. You have developed good habits that will allow you to be financially self-reliant. Now you must decide to keep these good habits for the rest of your life.

Dallin Oaks’s final comments in his “The Dedication of a Lifetime” talk represent the lessons I most hope you will take from this course:

The “dedication of a lifetime” requires one to be tranquil and steady, steadfast and immovable. That is our standard and our goal. This steadfast standard requires us to avoid extremes. Our performance should be the steady 100 percent of a committed servant, not the frenzied and occasional 120 percent of the fanatic.¹⁴

My purpose and hope for this course on personal finance is that we can become the 100 percent committed servant of our Savior as we get our financial houses in order.

Understand What Wise Financial Stewards Know

In the more than 14 years I have taught courses in personal finance, I have realized that certain principles are critical for developing good financial habits. Following are the 10 things I believe we should know about personal finance as we strive to follow Jesus Christ, accomplish our divine missions for which we were sent here to earth, to return with our families to His presence, and to become wiser financial stewards.
1. Wise Stewards Recognize Their Stewardship

They realize that personal finance is simply living the gospel of Jesus Christ. They understand that perspective is based on the principles of ownership, everything they have is the Lord’s; stewardship, they are stewards over all God has blessed them with; agency, the gift of choice is one of God’s greatest gifts; and accountability, they will be held accountable for all their choices, including their financial choices.

Wise stewards recognize that nothing they have is their own—it is all God’s. They act accordingly.

2. Wise Stewards Have Their Priorities in Order

They seek first the kingdom of God and His righteousness. They know that the best things in life are free: families, relationships, and the teachings of Jesus Christ.

Wise stewards first goal in life is not wealth, power, or gratification but eternal life with their families. They seek the true riches first—the kingdom of God and the gift of eternal life. Then they seek the other riches, if they desire them, but it is with the intent to do good—to help and bless their families and others.

3. Wise Stewards Plan Their Future Early and Live Their Plan

They prayerfully plan their lives, establish their goals live worthy of the companionship of the Spirit, and with God’s help achieve their goals. They prayerfully develop a budget and follow it closely. They live on less than they make. They avoid debt. They build a reserve and save for their goals.

Wise stewards seek God’s help in all aspects of their lives, including planning and achieving goals, developing and living on a budget, avoiding debt, building a reserve, and saving for retirement and education.

4. Wise Stewards Know It Is What They Become That Is Most Important

They know that money is a tool to teach principles. They realize it is not what they earn, but what they save, that helps them acquire wealth. But more importantly, wise stewards know that it’s not what they save but what they become that makes them more like Jesus Christ.

5. Wise Stewards Know Money Cannot Buy Happiness

They know that money can eliminate a lot of financial and other problems in life. They know that money can provide security for them and their families. But they know it cannot buy them happiness. They must find happiness on their own.

Wise stewards use money to reduce their financial difficulties, be secure in their families, and bless the lives of others. Then they find happiness in the gospel of Jesus Christ, their families,
and serving others. They know money is only a tool, but an important one, in helping them to learn important lessons in life and become more like Jesus Christ.

6. Wise Stewards Understand Assets and Liabilities

Assets are things that have value. They are either income-generating (investments, savings, or rentals) or income-consuming (cars, toys, or houses). They know their choice of assets will largely determine how they will live their lives.

Liabilities are things they have borrowed to attain. Except for an education and a modest home, liabilities should be eliminated.

Wise stewards maximize income-generating assets, minimize income-consuming assets, and eliminate liabilities.

7. Wise Stewards Understand Income

Earned income is income they earn from their job or vocation. It is a good type of income. Passive income is income they earn from their investments, generally businesses or real estate. While they generally need to do work to earn and maintain this income, it is generally less work than they put into their earned income. Portfolio income is income they earn from their other investments. They do not need to do any work to earn income from these investments.

Wise stewards realize that the best income is not earned income but portfolio and passive income.

8. Wise Stewards Know They Are Responsible

In the book *Rich Dad Poor Dad*, Robert Kiyosaki and Sharon Lechter write:

You were given two great gifts: your mind and your time. It is up to you to do what you please with both. With each dollar bill that enters your hand, you and only you have the power to determine your destiny. Spend it foolishly, you choose to be poor. Spend it on liabilities, you join the middle class. Invest it in your mind and learn how to acquire assets and you will be choosing wealth as your goal and your future. The choice is yours and only yours. Every day with every dollar, you decided to be rich, poor, or middle class.\(^8\)

Wise stewards choose to be responsible.

9. Wise Stewards Know They Make a Living by What They Earn, but They Make a Life by What They Give

Wise stewards know that life is not measured by what they have or earn but by what they give. They know there is more to life than money—they learn to give more. “For what shall it profit a man, if he shall gain the whole world, and lose his soul?”\(^9\)
Wise stewards follow the example of the greatest giver of all time, Jesus Christ.

10. Wise Stewards Remember the Three Critical “Ifs”

Wise stewards remember three critical things. These are not just the things they must know, but things they must do.

1. The scriptures make us wise IF we learn to read them and obey the commandments. It is not enough to read the scriptures—we must obey the commandments: “O remember, my son, and learn wisdom in thy youth; yea, learn in thy youth to keep the commandments of God.”

2. The Savior makes us holy IF we repent. It is not enough to have a Savior—we must repent and take advantage of His atonement: “For, behold, the Lord your Redeemer suffered death in the flesh; wherefore he suffered the pain of all men, that all men might repent and come unto him. And he hath risen again from the dead, that he might bring all men unto him, on conditions of repentance.”

3. The storms make us strong IF we learn the lessons God wants us to learn. It is not enough to have storms in our lives—we must learn from them. The prophet Ether counseled:

   And if men come unto me I will show unto them their weakness. I give unto men weakness that they may be humble; and my grace is sufficient for all men that humble themselves before me; for if they humble themselves before me, and have faith in me, then will I make weak things become strong unto them.

The brother of Jared knew about storms. When he came to the ocean on his way to the promised land, he had two problems: light and navigation. The Lord helped the brother of Jared with both problems. The Lord touched the stones, which gave light to the ships. The Lord also sent the storms, to blow Jared and his family toward the promised land. The storms He sends (whether economic, financial, health-related, spiritual, or otherwise) will take us where He wants us to be so we can return and live with Him. The Lord is in our storms. He is trying to teach us those things that will take us to our promised land, to return to His presence.

If we will learn the lessons He is trying to teach us, we will become stronger, more valiant in the testimony of Jesus Christ, more willing and able to serve, and more ready for the next storm that will come. If we fail to learn the lessons from the storm, the Lord will need to teach us these lessons some other way. It may take even more severe storms for us learn what we need to know.

At the beginning of this course, I talked about how doctrine was the key to lasting change, whether it is in our families, our work, or our finances. I shared the following quote from Boyd K. Packer: “True doctrine, understood, changes attitudes and behavior. The study of the doctrines of the gospel will improve behavior quicker than a study of behavior will improve behavior.”
Now, at the end of this course, I add one final recommendation. The key to making permanent change for good in your family, your work, or your finances was given by Richard G. Scott when he said, “The best way to make a permanent change for good is to make Jesus Christ your model and His teachings your guide for life.”\(^\text{14}\)

Learn about Resources for Additional Readings on the Subject of Personal Finance

The following is a list of readings I recommend in addition to readings previously listed in this course. These readings may be helpful in your quest for greater financial understanding.

**General Finance**


**Investing**


**General Budgeting**


**Marriage and Money**

Summary

In the first chapter, we discussed the need to decide, educate, commit, believe and achieve. These are important parts of our work in personal finance.

Decide. You had to decide “why” you are doing this. Why did you want to learn personal finance? What did you expect personal finance to bring into your life? What did you hope it will help you accomplish? I hope you have come to more fully understand the “whys” of personal finance and its place in helping us come to Christ, accomplish our divine missions, return with our families back to Heavenly Father’s presence, and to be wiser stewards.

Educate. You needed to educate yourself to your available options. This is the “what” of personal finance. I hope you have learned a lot of important information and how that information can impact your life. Realize that much of this information changes every year, so you will need to stay abreast of developments including tax rates, tax tables, contribution limits for retirement, contribution limits for education savings, estate tax limits and percentages, etc. It may be a challenge, but it is doable.

Commit. Once you knew the “why” of your actions and the “what” that you need to do, it came down to choice. I hope you have determined your individual and family goals that will most likely take you to where you want to be. I also hope that you have realized the importance of those goals so you will really commit to accomplish them.

Believe. I have tried to help you to see who you really are, to believe that you can accomplish the things you set out to accomplish with God’s help. You must develop the vision to know that you can accomplish these things if you are willing to put in the effort, work, and prayer. I believe that God will help us accomplish our goals if we seek His help in setting and committing to our personal and family goals, and then trusting in His promises to us as we willingly work toward them.

Achieve. Finally, you must work to achieve the goals that you have set. You must be willing to make the necessary sacrifices. But we must also be sure that we keep balance in our goals and in our lives, ensuring that we accomplish all our goals in a consistent manner.

Assignments

Financial Plan Assignments

You have come to the end of this course. We have discussed many important topics related to putting your financial house in order. What are the important ideas you will take away from this series of discussions? What are the ideas you have been impressed with regarding personal finance? What should you decide to decide? Write these decisions down in the goals section of your financial plan so that you do not need to remake those decisions.
Finally, put all the sections of your Personal Financial Plan together. Put each section under its respective tab. Make your plan something you are proud of. Put a picture of your family on the cover and put it in a place where you will be able to easily find it. Review your financial plan often.

The purpose of this course has been to help you plan for your financial future. Now it is up to you to follow your plan.

**Review Materials**

**Review Questions**

1. What is the main focus of this concluding chapter, taken from Spencer W. Kimball’s quote?
2. In Jacob 2:18–19, Jacob tells us that we will obtain riches (if we seek them) only after we have done what?
3. According to Spencer W. Kimball, what should every family decide to maintain?
4. As a review, what are the four questions on the top half of the hourglass that you should ask yourself before you start investing?

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1 Kimball, Spencer W. “Boys Need Heroes Close By.” *Ensign*, May 1976, 45, emphasis added
2 Jacob 2:18–19
3 1 Nephi 7:12
4 *Ensign*, May 1976, 46
5 Helaman 13:22
6 Matthew 6:33
7 Jacob 2:18-19
Personal Finance Glossary

401(k)
An employer qualified retirement plan set up by a private company in which eligible employees may make salary-deferral (salary-reduction) contributions on a before- and/or after-tax basis. Employers may make matching or non-elective contributions to the plan on behalf of eligible employees and may also add a profit sharing feature to the plan. Earnings accrue on a tax-deferred basis.

403(b)
403(b) plans are salary-reduction plans. They are similar to 401(k) plans but are for employees of non-profit, tax-exempt companies and institutions such as schools.

457 Plans
457 plans are salary-reduction plans. They are similar to 401(k) plans but are for state and municipal workers.

529 Savings Plans
529 College Savings Plans are education savings vehicles designed to help save and pay for children, grandchildren, or other children’s educations. They are created by state governments (and differ state to state and year to year) to help prepare for the future costs of education (529 Savings Plan) or to prepay tuition costs for a specific in-state university (529 Prepaid Tuition Plan). With a 529 Savings Plan, the control of the funds resides with the contributor, who chooses the investments from among a set of approved alternatives set up by the state. Assets in these plans are not considered assets of the student, which increases the student’s ability to apply for other financial aid. Some states may even offer tax deductions for contributions you make to your local 529 funds (check by state). Earnings on these funds are tax free if principle and earnings are used for approved higher education expenses. With a 529 Prepaid Tuition Plan, parents pay a specific amount, which guarantees that tuition will be paid at some specific point in the future when the child enters college.

Acceleration Clause
An acceleration clause is a loan requirement stating that if the borrower misses one payment, the entire loan comes due immediately.

Accrued Interest
Accrued Interest is interest that has been earned on the bond but has not yet been paid out to the bondholder.

Active Income
Active income is income that comes from wages or a business.

Active Management
Active management is an investment strategy in which investors try to gain returns in excess of their benchmarks by actively buying and selling securities. This strategy requires considerable time and expense to maintain consistent performance.

Adjustable-Rate Mortgage (ARM)
An adjustable-rate mortgage (ARM) is a mortgage loan in which the interest rate charged fluctuates with the level of current interest rates. The loan fluctuates, or is adjusted, at set intervals (say, every 5 years) and only within set limits as specified in the loan agreements.

Adjusted Gross Income (AGI)
Adjusted Gross Income (AGI) is your total income less allowable deductions used in calculating income taxes.
Affinity Card
An affinity card is a credit card issued in conjunction with a specific charity or organization. It carries the sponsoring group's name and/or picture on the credit card itself and sends a portion of the annual fee or a percentage of the purchases back to the sponsoring group.

After-Tax Return
The after-tax return is the actual return you earn on taxable investments once taxes have been paid. It is equal to the taxable return times (1 - your marginal tax rate) + the non-taxable return.

Agency Bonds
Agency Bonds are bonds issued by government agencies other than the Treasury.

Amortized Loan
A loan paid off in equal installments, including both principle and interest.

Annual fee
An annual fee is a fixed charge imposed by a credit card company for the use of its credit card for one year.

Annual Percentage Rate
The annual percentage rate (APR) is the true simple interest rate paid over the life of the loan. It's a reasonable approximation for the cost of borrowing, although it does not take into account compounding. The Truth in Lending Act requires that all consumer loan agreements disclose the APR in bold print. It is calculated as the cost of interest and fees divided by the number of years, all divided by the average amount borrowed.

Annual Percentage Yield
The annual percentage yield (APY) is the simple annual percentage yield that converts interest rates compounded for different periods into comparable annual rates. It allows you to easily compare interest rates.

Annuity
A series of equal dollar payments coming at the end of each time period for a specified number of time periods, generally months or years.

Asset allocation
Asset allocation is the process of determining what percent of investor's assets should be invested in which asset classes to enable the investor to reach his or her financial goals.

Asset Management Accounts
Asset Management Accounts are comprehensive financial service packages offered by a brokerage firm, which can include a checking account; credit and debit cards; an Money Market Mutual Funds; loans; automatic payment of fixed payments such as mortgages; brokerage services (buying and selling stocks or bonds); and a system for the direct payment of interest, dividends, and proceeds from security sales into the MMMF.

Assets
Assets are things that you own. They can be physical (i.e. autos, homes, etc.), financial (stocks, bonds, cash) or intellectual (i.e. knowledge, trademarks or patents).

Automobile loans
A consumer loan that's secured with an automobile. Should the borrower fail to make payments, the lender can repossess the auto.

Average Daily Balance Method
Average Daily Balance Method is a method of calculating the balance on which interest is paid by summing the outstanding balances owed each day during the billing period and dividing by the number of days in the period.

Back-End Load
Back-End Load is a commission or fee that is charged only when the investor liquidates his or her holdings.

Balanced Mutual Fund
Balanced Mutual Fund is a mutual fund that tries to "balance" the objectives of long-term growth with current income and so includes portions of both risky
Balloon Mortgage Loan
Balloon Mortgage Loan is a mortgage with relatively small monthly payments for several years (generally 5 or 7 years), after which the loan must be paid off in full, in generally one large balloon payment.

Bank Credit Card
A credit card issued by a bank or large corporation, generally as a Visa or MasterCard.

Bankruptcy
A legal process whereby payment to creditors is administered by law.

Basic Health Insurance
Used to describe most health insurance, which includes a combination of hospital, surgical, and physician expense insurance.

Basis Point
A means of describing costs for a mutual fund or other financial instrument. A basis point is 1/100 of 1% or .01 percent.

Bear Market
A stock market characterized by falling prices.

Beneficiary
The individual designated to receive specific assets in the case of a will, or the person designated to receive the insurance policy proceeds upon the death of the insured.

Blue-Chip Stocks
Common stocks issued by large, nationally known companies with sound financial histories of solid dividend and growth records.

Bond Funds
Mutual funds that invest primarily in bonds.

Bonds
Bonds are debt and are issued for a period of time. Governments, districts, companies, and other types of institutions sell bonds. When an investor buys bonds, they are lending money.

Budget
A budget is a plan for controlling inflows of funds with outflows to pay expenses. Living on a budget is probably one of the single most important things you can do to help get your financial house in order.

Capital Gain
An increase in the value of a capital asset (investment or real estate) that gives it a higher value than the original purchase price. The gain is not realized until the asset is sold. A capital gain may be short-term (one year or less) or long-term (more than one year) and must be claimed on income taxes.

Cash Budget
A plan for controlling cash inflows and outflows. Its purpose is to balance income with expenditures and savings.

Compound Annuity
An investment that involves depositing an equal sum of money at the end of each year for a certain number of years and allowing it to grow.

Compounded
(annually, quarterly, daily, etc.) The number of periods during the year where interest is calculated. The shorter the compounding period, the higher the effective annual rate of interest.

Consolidation
Combining all debts into a single loan to help reduce interest.

Consumer Loans
Consumer loans are loans for generally larger valued items such as electronics, automobiles, furniture, recreational vehicles, etc., things that you generally don't need (at least not urgently).

Convertible Loans
Convertible loans are loans whose interest rate structure can change. They can begin as a variable rate loan and can be locked into a fixed rate at some predetermined time in the future.

Credit Bureaus
These are companies that collect and
report financial information on individuals or firms. The information is collected from creditors, public records, and a variety of institutions. There are three major credit bureaus: Equifax, Experian, and Trans Union.

Credit Counseling
Performed by agencies who work with individuals and their credit card companies to reduce or eliminate interest payments.

Credit Evaluation
The process potential creditors use to determine an individual's credit worthiness by analyzing specific information, such as personal demographics and credit history, provided by various sources and generally included on credit reports.

Credit History
A record of an individual's personal credit. It includes what credit is open, closed, balances, etc.

Credit Report
A public record of information on a specific individual's credit standing compiled by a credit bureau. Most credit reports include the individual's name, address, credit history, and information from public records such as bankruptcy filings and criminal convictions.

Credit Scores
These are ratings developed by financial institutions as a way of determining which borrowers are more likely to repay their loans. Credit scores are based on specific factors such as credit history, length of credit, repayment history, types of credit owned, and so on. Generally, the higher your credit score, the lower your risk, and the more likely you will repay your loans.

Custodial Account
An investment account where parents hold assets for children until they reach legal age. After legal age, the account becomes the property of the child.

Debt
Money that is borrowed.

Debt Elimination Calendar
A method of reducing debt by using a spreadsheet and listing all debts in order of interest rate from highest to lowest with the intent to pay off the debt with the highest interest rate first.

Debt Reduction
A method of reducing debt in an acceptable length of time

Defined Benefit Plan
A defined benefit plan (DBP) is a retirement plan funded entirely by the employer in which the payout amount is guaranteed based on a specific formula set by the company. Employees don’t contribute to the plan, but they receive a promised defined payout at retirement. This payout is generally based on a formula, including formula variables such as age at retirement, average salary level, and years of service.

Defined Contribution Plan
A defined contribution plan is a retirement plan into which the employer contributes a specific amount to the employee's retirement fund while the employee is working and then has no responsibilities once the employee retires.

Education IRA
The Education IRA is a type of individual retirement account that allows parents to save money to pay for their children's education. Investments accumulate tax free and the account creator determines how to invest the funds and how the funds will be spent. Eligible expenses include elementary, secondary, and college tuition, as well as the purchase of books and supplies. If the money is withdrawn for non-education expenses, federal taxes will be charged to the account holder at the account holder's regular tax rate plus a 10 percent penalty.

Effective Interest Rate
The actual rate (as opposed to the stated
rate) received after taking into account
the effects of compounding.

**Employer Qualified Plans**

These are retirement plans which
comply with government regulations
and allow you to place pretax dollars
into the retirement plans.

**Employee Stock Option Plan**

An employee stock options plan is a
type of defined contribution plan in
which retirement funds are invested in
company stock. This is a very risky and
non-diversified plan.

**Equity**

Ownership of a company or corporation
indicated by shares. These shares
represent ownership in the corporation's
assets and earnings.

**Equity Indexed Universal Life**

A permanent life insurance policy that
allows policyholders to tie their cash
value accumulation to a stock market
index.

**FICO score**

This is the most commonly used credit
score; it was developed by Fair, Isaac
and Company.

**Fixed expenses**

Expenses you don't directly control, e.g.,
mortgage, rent, tuition, books, life and
health insurance, etc.

**Fixed rate loans**

Fixed rate loans, which are the majority
of consumer loans, have the same
interest rate for the duration of the loan.
Normally they have higher initial
interest rates, because the lender could
lose money if the rates increase.

**Future Value**

The value of an investment at some
point in the future.

**Goal**

A goal is one of the most important
factors in accomplishing things in life. It
is generally something that is important
to you and which you are willing to put
effort toward. Goals should be "smart",
specific, measurable, achievable,
realistic, and time-bound.

**Home Equity Loan**

A debt consolidation loan against value
invested in a home

**Home equity loans**

Home equity loans are basically second
mortgages. You can use the equity in
your house, the difference between what
you paid for the house and what it is
worth today, to secure your loan. The
benefits are that they normally allow
you to borrow up to 80% of the equity in
your home. The interest payments are
generally tax deductible.

**Index Fund**

A mutual fund which has the goal of
matching the performance of a specific
benchmark or index.

**Indexes**

Statistical measures of change in an
economy, asset class, or securities
market. In the case of financial markets,
an index (plural indices) is essentially an
imaginary portfolio of securities
representing a particular market or a
portion of it.

**IRA (Individual Retirement Account)**

A retirement vehicle that allows you to
set aside money for retirement, while at
the same time possibly offering tax
advantages. IRA's can be invested in
numerous types of investments,
including stocks, bonds, mutual funds,
etc.

**Inflation**

An increase in the volume of money and
credit relative to available goods and
services resulting in a continuing rise in
the general price level.

**Installment loans**

Installment loans are loans repaid at
regular intervals. The payment includes
both principal and interest. It's normally
used to finance houses, cars, appliances,
and other expensive items.

**Interest**

A charge for borrowed money, often
calculated as a percentage of the amount
loaned.

**Interest Only Option**
An option on a fixed or adjustable rate mortgage that allows the borrower to make only interest payments for a specific number of years. After the interest only period is over the borrower must pay both principle and interest back within the stated mortgage period.

**Interest rate**
The stated rate that you will receive for investing for a specified time at a specified compounding period.

**Investment**
A current commitment of money or other resources in the expectation of reaping future benefits.

**Investment Constraint**
Investment constraints are factors which must be taken into account as you manage your portfolio. These include factors such as liquidity, investment horizon, taxes, and special needs.

**Investment Plan**
An investment plan is a detailed description of all the major areas of your investment strategy. It will help you understand yourself and sets the framework for every investment activity you will participate in.

**Investment strategy**
Investment strategy is the understanding of how you will invest your assets. It clarifies how to select, manage, prioritize, fund, and evaluate your investments.

**Investment vehicle**
A tax-law defined vehicle that has specific tax advantages, i.e. tax deferral or tax elimination. Examples include IRAs, 401(k) and Keogh plans, or 529 Plans

**Keogh Plan**
A Keogh plan is a retirement plan for small businesses that allows the business to make tax-deductible payments to the retirement plans of employees. This plan is similar to a corporate pension or profit sharing plan. There are three Keogh options that provide for increased flexibility: the profit sharing plan, the money purchase plan, and the paired plan.

**Liquidity**
Liquidity is the speed and ease with which an asset can be converted into cash.

**Marquis Strategy**
A method in which debts are paid off in order of smallest to largest with the intent to pay off as many debts as quickly as possible.

**Money Purchase Plan**
A money purchase plan is a type of defined contribution plan in which the employer contributes a percentage of an employee’s salary each year.

**Mortgage**
A loan to finance the purchase of real estate, usually with specified payment periods and interest rates.

**Mundis Strategy**
A method in which the total amount available to pay off debt is determined and a percentage of that amount pays off each debt.

**Mutual fund**
Mutual funds are pools of money managed by an investment company. These funds offer a variety of goals, depending on the fund and its investment objectives. Funds can impose a sales charge, or load, when investors buy and sell shares, or the funds may be no-load and impose no sales charge. Mutual funds may also be open-end funds, which create new shares on demand, or closed-end funds, which have set shares outstanding.

**Net worth**
The difference between the assets that you own and the debts that you owe to others.

**Nominal Return**
This is the return on your investment before taking into account the impact of
inflation or taxes.

**Open credit**
An agreement with a financial institution (for example, a credit card company) that allows you to borrow money up to a specific credit limit with the expectation that you will pay back the loan at a specific interest rate and also pay other attached fees. A credit card is one type of open credit.

**Passive management**
Passive management is an investment strategy where investors, instead of trying to earn returns in excess of their stated benchmarks, invest in index or exchange traded funds whose purpose is to simply mirror the performance of those benchmarks.

**Payday loans**
These are loans secured with a postdated check. They have very high interest rates, some in excess of 520% on an annual basis. I do not recommend anyone ever use these loans. They are short loans of one to two weeks.

**Personal Balance Sheet**
A snapshot of the financial position of an individual or institution on a given date, usually the end of the year or the end of the month. It is a numerical representation of the dollar amounts of what is owed and what is owned.

**Present Value**
The current value, which is the value in today's value of a future sum of money.

**Principal**
The money that you have to invest or save, or the stated amount on a bond or deposit instrument.

**Profit Sharing Plan**
A profit sharing plan is a type of defined contribution plan in which an employer's contributions vary year-to-year depending on the firm's profitability. (The contribution may be zero if the firm is not profitable).

**Qualified retirement plans**
A qualified retirement plan is a retirement plan that allows a company to make tax-deductible contributions to employees through either a defined-benefit plan or a defined-contribution plan. Some of these plans require no employee contributions and some of these plans require employee contributions that are employer matched.

**Real Return**
The real rate of return on an investment after removing the impact of inflation. The approximation formula is the nominal return less inflation. The exact formula is \([(1+ \text{nominal return})/(1 + \text{inflation})] -1\). In this class, we will use the exact formula.

**Reinvesting**
Taking money that you have earned on an investment and investing it again.

**Retirement planning**
The process of planning for your financial future. It entails knowing what you want to accomplish during retirement and how you want to live, and then preparing your finances to allow you to achieve these goals.

**Roth IRA**
The Roth IRA is a retirement plan that provides no tax deduction for contributions, but does provides a special benefit not available to other forms of retirement savings. All earnings and capital gains are distributed tax free when you retire after age 59½.

**Roth 401(k)**
A 401k retirement account that allows contributors to make contributions on an after-tax, rather than a pre-tax basis. Then when the contributor turns age 59½ the contributor can withdraw the funds without penalty and without tax.

**Roth 403(b)**
403(b) plans are salary-reduction plans. They are similar to 401(k) plans but are for employees of non-profit, tax-exempt companies and institutions such as schools. A Roth 403b retirement
account allows contributors to make contributions on an after-tax, rather than a pre-tax basis. Then when the contributor turns age 59½ the contributor can withdraw the funds without penalty and without tax.

**Sacrifice**
A current commitment of money or other resources in the expectation of reaping future benefits.

**Salary Reduction Plan**
In salary reduction plans, an employee contributes before-tax dollars to the employees, thus reducing the employee’s taxable income. The earnings that are accumulated are tax-deferred until retirement.

**Secured loans**
Secured loans are loans guaranteed by a specific asset such as a home equity loan or a car loan. They typically have lower rates, as the security, i.e., the home, car, etc., is considered collateral for the loan.

**SEP IRA**
A SEP-IRA is a Simplified Employee Plan Individual Retirement Account that allows a small business employer to contribute to the retirement of its employees. The employer contributes to each eligible employee’s SEP-IRA, with the same percentage contributed to all employees. Contributions are tax deductible and earnings grow tax-deferred.

**Compound Interest**
Compound interest is where interest is paid on previously earned interest, as well as on the principal.

**Series EE Savings Bonds**
Series EE are savings bonds issued by the United States Government that have a minimum maturity of five year. These are taxable bonds, which can be purchased in any combination of denominations up to specific annual limit. The bonds can be purchased in small denominations (as low as $25) over the Internet, and they have competitive interest rates that change every six months and are calculated at 90% of the average 5 year Treasury yield. If the principle and earnings from these bonds are used for qualified educational expenses, the earnings are tax-free. However, if the bonds are cashed before maturity, there is a three-month interest penalty.

**Series I Savings Bonds**
Series I Bonds are savings bonds issued by the United States Government that have a minimum maturity of five years. These are taxable bonds, which anyone can purchase in any combination of denominations up to specific annual limits. The bonds can be purchased in small denominations (as low as $25) over the Internet, and they have competitive interest rates that change every six months, calculated by computing the rate of inflation over the previous year and adding a real return component. If the principle and earnings from these bonds are used for qualified educational expenses, the earnings are tax-free. However, if the bonds are cashed before maturity, there is a three-month interest penalty.

**Shareholder**
A person or entity which owns equity or shares in a company.

**SIMPLE-IRA**
Savings Incentive Match Plan for Employees (SIMPLE-IRA) is a tax-sheltered retirement plan for small businesses or the self-employed that provides some matching funds by the employer similar to the matching of a 401(k) plan. Employees can contribute up to 100 percent of compensation to a maximum that changes year to year. Contributions are tax deductible, so there is a penalty for early withdrawals. The employer is required to match employees’ contributions.

**Single payment loans**
Single payment loans are balloon loans.
They are sometimes called bridge or interim loans because they're used until permanent financing is arranged. The loan is repaid in one lump sum including interest. Normally it is for short term lending of one year or less.

**Social Security**
A federal program that provides disability and retirement benefits based upon years worked, amount paid into the plan, and retirement age.

**Stock**
Ownership of a company or corporation indicated by shares. These shares represent ownership in the corporation's assets and earnings.

**Student loans**
These are loans with low federally subsidized interest rates used for higher education. Examples are federal direct and plus direct loans, Stafford and Stafford plus loans available to parents and students. These loans may have specific tax advantages. They may have lower than market rates, and payment on federal direct and Stafford loans are deferred until 6 months after graduation.

**Tax liability**
Taxes that are owed but not yet paid.

**Tax-adjusted Return**
This is the return on your investment after taking into account the impact of taxes (both federal and state).

**Tax-advantaged money**
This is money that has special tax advantages, mainly the elimination of all future taxes on capital gains, interest and dividends, or the deferral of taxes until retirement. A good example of a tax-eliminated money is the Roth Individual Retirement Account (Roth IRA). An example of tax-deferred money is the traditional IRA.

**Tax-deferred money**
An increase in the value of a capital asset (investment or real estate) that gives it a higher value than the original purchase price. The gain is not realized until the asset is sold. A capital gain may be short-term (one year or less) or long-term (more than one year) and must be claimed on income taxes.

**The Envelope System**
A simplified cash budget system where you put money for each expense in an envelope. When the money is gone, it is gone.

**Thrift and Savings Plan**
A thrift and savings plan is a type of defined contribution plan in which the employer matches a percentage of employee contributions.

**Time value of money**
The basic principle that money can earn interest. Therefore, something that is worth $1 today will be worth more in the future if it is invested wisely. This is also referred to as future value.

**Traditional IRA**
A traditional IRA is a retirement account in which an individual can contribute up to specific limits annually, depending on the contributor’s income level and whether he or she has other retirement savings plans. This money is tax-deferred until retirement; it is taxed as ordinary income on withdrawal after age 59½.

**Universal Life Insurance**
A type of permanent life insurance which offers life insurance and a savings component. Cash values are invested in money market investments, and the death benefit, savings, and premiums can be changed at the policyholders option.

**Unsecured loans**
Unsecured loans require no collateral and are generally offered only to borrowers with excellent credit history. However, unsecured loans normally have the highest interest rates, and can range in cost from 12% to 23%, or even higher.

**Variable expenses**
Expenses you have some control over,
e.g., food, entertainment, clothing, etc.

**Variable Life Insurance**
A type of permanent life insurance which offers life insurance and a savings component. Cash values are invested in stocks, bonds, mutual funds, etc.

**Variable rate loans**
Variable rate loans have an interest rate that is tied to an index such as the prime rate 6 month Treasury bill plus some interest rate spread. It adjusts at different intervals such as monthly, semiannually, or annually with a lifetime adjustment cap. Normally they have a lower initial interest rate.

**Variable Universal Life Insurance**
A type of permanent life insurance which offers life insurance and a savings component. Cash values are invested in stocks, bonds, mutual funds, etc., and the death benefit, savings, and premiums can be changed at the policyholders option.

**Whole Life Insurance**
A type of permanent life insurance which offers life insurance and a savings component. Cash values are invested in insurance company long-term bonds and mortgages.
# Index

12b-1 fees ..................................................... 172  
Acceleration clause ..................................... 98  
Acceptable and unacceptable asset classes ............. 282  
Accountability ............................................... 7  
Adjusted Gross Income ..................................... 50  
After-tax returns ........................................... 70  
Agency .......................................................... 6  
Amortized loan ............................................. 144  
Amortized loan ............................................. 128  
Annual percentage yield ..................................... 70  
Annual term ................................................... 163  
Annuity ......................................................... 128, 144  
Appropriate Uses for Credit Cards ....................... 83  
Assets .................................................................. 34  
Automobile loans ............................................. 99  
Automobiles and other vehicle assets ..................... 36  
Average tax rate ............................................... 58  
Balance Sheet ................................................... 25, 33  
Beneficiary ....................................................... 157  
Beta .................................................................... 263  
Bond mutual funds .............................................. 261  
Budgeting .......................................................... 25, 28, 29, 31  
Capital gains ..................................................... 58  
Capital Gains Taxes ............................................. 58  
Capitalized cost .................................................. 237  
Capitalized cost reduction ..................................... 237  
Cash management ................................................. 65  
Cash value .......................................................... 157  
Cash Management Options .................................... 66  
Certificates of Deposit (CDs) .................................. 68  
Bankruptcy .......................................................... 122  
Checking Accounts .............................................. 67  
Choosing a Financial Institution ............................ 73  
Compounding ..................................................... 128  
Computer Software Methods .................................. 27  
Consumer Loans .................................................. 94  
Conventional loans ............................................. 100  

Convertible loans .............................................. 97  
Convertible term .............................................. 163  
Covered ratio .................................................... 38  
Credit  
Bureaus .......................................................... 80  
Reports ............................................................ 80  
Scores .............................................................. 80, 82  
Current ratio ...................................................... 38  
Day trading ....................................................... 288  
Debt  
Consolidation .................................................... 121  
Negotiation ....................................................... 121  
Ratio ................................................................. 39  
Deductions ......................................................... 50  
Default risk ......................................................... 263  
Deferred acquisition taxes .................................... 171  
Deficiency clause ............................................... 98  
Effective interest rate .......................................... 128  
Effective marginal tax rate ..................................... 58  
Effort costs ......................................................... 17  
Emerging market stocks ....................................... 263  
Equivalent taxable yield ....................................... 71  
Escrow ............................................................. 219  
Escrow professionals .......................................... 221  
Exemptions ......................................................... 52  
Face value ......................................................... 158  
FICO Score ........................................................ 82  
Financial costs .................................................... 17  
Financial Planning .............................................. 14  
First-year expenses ............................................. 172  
Fixed rate .......................................................... 218  
Fixed-rate loans .................................................. 97  
Fixed-rate mortgages .......................................... 100  
For-profit credit counseling agencies ....................... 120  
Future value ......................................................... 128  
Global stocks ..................................................... 262  
Gross Income ..................................................... 49  
Home equity lines of credit ................................... 98
Home equity loans .................. 98, 119
Housing or real estate assets ........ 35
How Credit Cards Work .............. 85
How to Manage Credit Cards and Open
Credit............................................. 86
Income ........................................ 58
Income statement ....................... 25
Income Taxes ................................ 58
Income-Based Taxes ..................... 59
Inflation ........................................ 71, 143
Installment loans ....................... 96
Insurance clause ....................... 97
Insured .......................................... 158
Interest or discount rate ............... 128
Interest rates ................................ 70
Interest-only options: variable or fixed
interest ........................................... 218
Intermediate funds ..................... 261
International stocks ................... 262
Investment
Assets ........................................... 35
Benchmarks .................................... 283
Horizon ......................................... 281
Management fees ...................... 172
Risk .............................................. 166
Yield ............................................. 164
Jumbo loans ................................... 100
Key Principles of Using Wealth Wisely .... 3
Large-cap stocks ......................... 262
Lease term ..................................... 237
Lenders .......................................... 221
Liabilities ....................................... 36
Liquidity ....................................... 281
Major Tax Features ...................... 58
Marginal tax rate ......................... 58
Market capitalization .................. 262
Measuring Your Financial Health ... 25
Mid-cap stocks ......................... 262
Mileage Deductions .................... 51
Modified Adjusted Gross Income .... 70
Monetary (or current) assets ........... 35
Money Market Accounts (MMA) ....... 68
Money Market Mutual Funds (MMMFs) . 68
Monthly administrative fees ........ 172
Mortality and expense charges ......... 172
Mortality risk ............................... 166
MSRP ........................................... 237
Net capitalized cost ..................... 237
Net Worth ...................................... 36
Nominal return ............................ 129
Non–Income-Based Taxes ............... 59
Nonprofit credit counseling agencies .. 120
Other fees .................................... 173
Overall expense ratio ................... 172
Ownership ...................................... 4
Payday loan ................................... 99
Personal Financial Plan .................. 14
Personal property assets ................ 36
Piggyback loans ............................. 100
Policy cost ...................................... 166
Policy loans .................................... 173
Premium ........................................ 158
Premium payments ..................... 164
Present value .................................. 129
Principal ........................................ 129
Principles of Car Ownership .......... 232
Principles of Cash Management ...... 65
Principles of Effective Goal-Setting ... 17
Principles of Successful Budgeting ... 26
Ratios ............................................. 38
Real return ..................................... 129, 143
Real Returns ................................. 136
Real estate assets ......................... 35
Realty ............................................. 221
Recourse clause ............................ 98
Regional stocks ......................... 263
Reinvesting .................................... 129
Renewable term ............................ 163
Residual value .............................. 237
Retirement assets ....................... 35
Safety .......................................... 71
Sales charges or front-end load ....... 171
Savings Accounts ......................... 67
Secured loans ............................... 97
Short-term bonds ......................... 261
Single-payment loans ................... 95
Small-cap stocks ......................... 262
SMART .......................................... 21
Special-needs ............................... 282
<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spreadsheet Methods</td>
<td>27</td>
</tr>
<tr>
<td>Standard Deductions</td>
<td>50</td>
</tr>
<tr>
<td>State premium taxes</td>
<td>171</td>
</tr>
<tr>
<td>Stewardship</td>
<td>5</td>
</tr>
<tr>
<td>Stock investment</td>
<td>261</td>
</tr>
<tr>
<td>Stock market secrets</td>
<td>288</td>
</tr>
<tr>
<td>Strategies to Minimize Tax Payments</td>
<td>55</td>
</tr>
<tr>
<td>Student loans</td>
<td>98</td>
</tr>
<tr>
<td>Surrender charges</td>
<td>173</td>
</tr>
<tr>
<td>Tax considerations</td>
<td>282</td>
</tr>
<tr>
<td>Tax Freedom Day</td>
<td>48</td>
</tr>
<tr>
<td>Tax Process</td>
<td>48</td>
</tr>
<tr>
<td>Tax Tables</td>
<td>53</td>
</tr>
<tr>
<td>Taxable bonds</td>
<td>260</td>
</tr>
<tr>
<td>Tax-adjusted return</td>
<td>129</td>
</tr>
<tr>
<td>Tax-free bonds</td>
<td>260</td>
</tr>
<tr>
<td>The 60% Solution</td>
<td>27</td>
</tr>
<tr>
<td>The Envelope Method</td>
<td>26</td>
</tr>
<tr>
<td>The Tax Process</td>
<td>49</td>
</tr>
<tr>
<td>Time costs</td>
<td>17</td>
</tr>
<tr>
<td>Title insurance professionals</td>
<td>221</td>
</tr>
<tr>
<td>Trading rules</td>
<td>288</td>
</tr>
<tr>
<td>Types of Financial Institutions</td>
<td>72</td>
</tr>
<tr>
<td>U.S. Series EE and Series I Savings Bonds</td>
<td></td>
</tr>
<tr>
<td>MAGI Limits</td>
<td>70</td>
</tr>
<tr>
<td>U.S. Series EE Bonds</td>
<td>69</td>
</tr>
<tr>
<td>U.S. Series I Bonds</td>
<td>70</td>
</tr>
<tr>
<td>U.S. Treasury Bills</td>
<td>69</td>
</tr>
<tr>
<td>Unsecured or signature loans</td>
<td>97</td>
</tr>
<tr>
<td>Variable or adjustable rate</td>
<td>218</td>
</tr>
<tr>
<td>Variable- or adjustable-rate mortgages</td>
<td>101</td>
</tr>
<tr>
<td>Variable-rate loans</td>
<td>97</td>
</tr>
<tr>
<td>Variance</td>
<td>263</td>
</tr>
<tr>
<td>Zero sum game</td>
<td>283</td>
</tr>
</tbody>
</table>