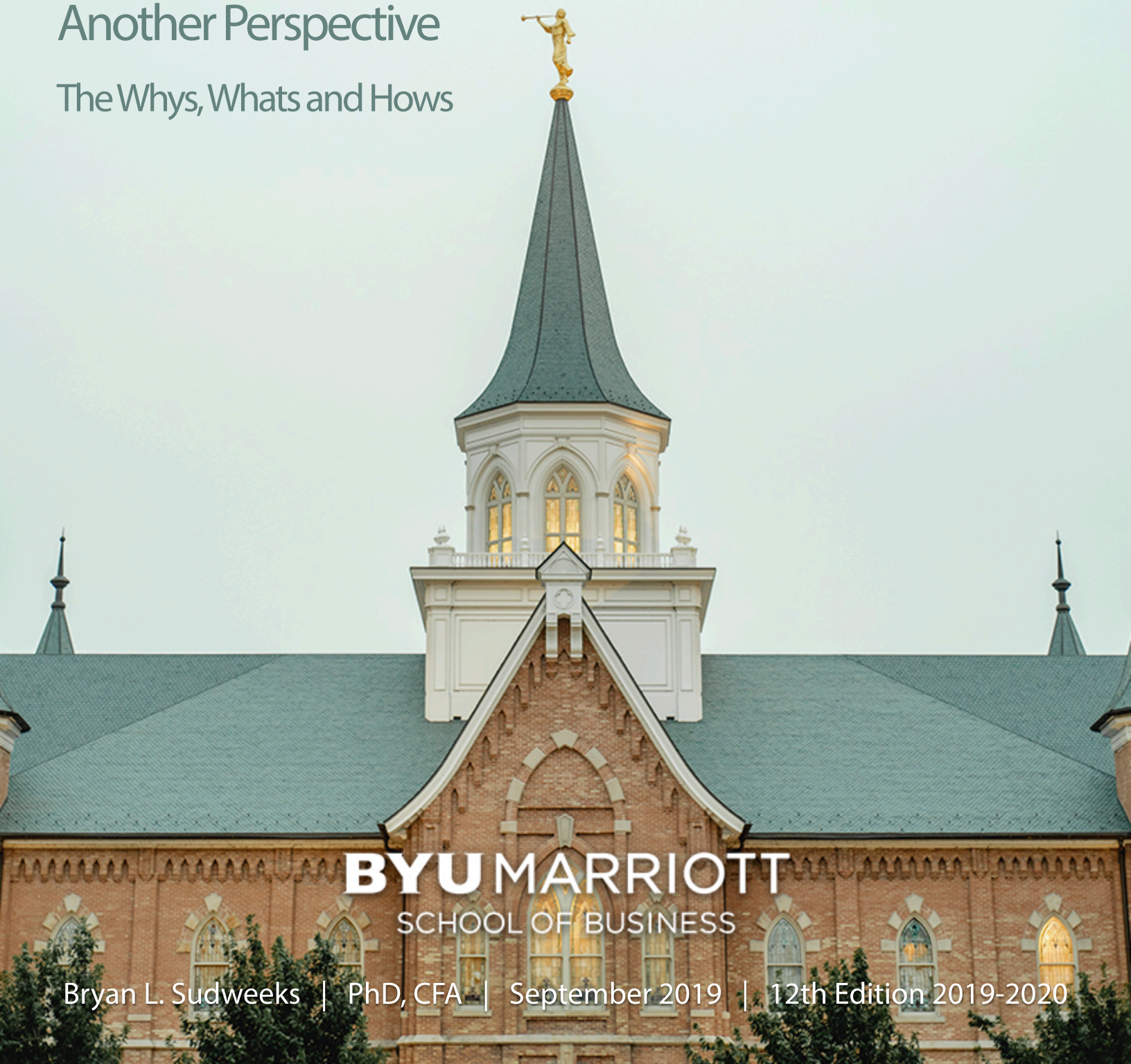
Complete College
Course Manual and Workbook

Personal Finance: Another Perspective

The Whys, Whats and Hows



BYU MARRIOTT
SCHOOL OF BUSINESS

Bryan L. Sudweeks | PhD, CFA | September 2019 | 12th Edition 2019-2020

Introduction by the Dean

Welcome to the BYU Marriott project on personal finance. 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 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 the faculty and staff at BYU Marriott. 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 over time, even as the financial environment around you changes.

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). Think through and write down your vision and 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 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,

Brigette C. Madrian
Dean and Marriott Distinguished Professor
Brigham Young University Marriott School of Business

Author's Note

Welcome to this manual and the accompanying website at http://personalfinance.byu.edu on Personal Finance. We have compiled information on what we consider 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 a Christian audience with membership in The Church of Jesus Christ of Latter-day Saint; however, the principles taught can be extended to members of any Christian faith. Readers who are not of the this faith may encounter a few unfamiliar terms within this text. While these terms may provide valuable insights to members of the Church of Jesus Christ, 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://ChurchofJesusChrist.org/topics) for more information.

This manual and website are updated every year for new information, changes to tax laws, improvements in teaching methodologies, etc. 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 Business 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 Business, the faculty, or Brigham Young University.

Bryan L. Sudweeks, Ph.D., CFA

August 2019

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 four 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 influences 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.'"[1]

Our perspective in this manual is unique. It is that personal finance is not separate from our Christian lives. Rather, personal finance is simply part of our Christian lives, and part of living the gospel of Jesus Christ. In this course, our perspective on personal finance is based on a long-term view of what truly matters, which will guide you as you make financial choices.

Second, we take a principles, doctrines and applications-based approach to personal finance. This helps us change our perspective on what we are doing. Unlike investment theory, investment vehicles, and financial assets, principles and doctrines never change. A sound understanding of the correct principles and doctrines 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.[2]

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

Third, we don't just talk about what you can do, we give plans and strategies to help you in creating your own personal plans in 16 important areas. Seeing what others have done and are doing in specific areas can give you ideas and strategies on how you can create your vision in those areas.

Finally, we take an applications-based or creative approach to personal finance. Application is an invitation to learn and create. We discuss the creative process in terms of how we are all creators of our vision, goals and lives. It is not enough to know what you want to do in our lives and families—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. This is part of Ezra Taft Benson's advice to "Plan your financial future early, then live your plan."[3]

To help you apply your learning and planning, we offer a multi-disciplinary companion website at http://personalfinance.byu.edu. As one of the advanced lessons, it includes this book,

PowerPoint presentations, learning tools, videos of personal finance classes taught at BYU, and other personal finance manuals compiled and developed by the faculty and staff at Brigham Young University. These tools will help you catch your vision, set goals, and develop plans and strategies to help you 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.

We believe that by changing your perspective, learning the doctrines, principles and applications that support successful financial management, giving examples of visions, goals and strategies in each key area, and then having you apply this knowledge to your own life in creating your own personal Financial Plan with the tools we've provided, will increase your financial literacy and motivation, and will help you achieve the vision and goals that are most important to you and your family. If you do this thoughtfully, carefully and prayerfully, it will help change behavior. Best of luck to you as you begin this wonderful journey to increased financial self-reliance.

Special Thanks

I express appreciation to the Rollins Center for eBusiness of the Marriott School of Business for its help and support in maintaining the website, the H. Taylor Peery Institute of Financial Services at the Marriott School for its help and support with the content, and the BYU Center for Teaching and Learning for its help with website hosting, design and implementation. Thanks also to Laura Dearden for the cover photos and design of the printed versions.

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Finally, special thanks goes to my wonderful wife, Anne, and our seven children, Kimberly (and Lane, Logan, Ryan, and Marcus Aldrich), Natalie (and Taylor, Halle, Dylan, Jordan and Wesley Barrett), Laura (and Devin Dearden), Clinton (and Abby), 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.

Copyright and Other Restrictions

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[1] *The Story of Philosophy*, New York: Simon and Schuster, 1927, 1
[2] "The Power of Correct Principles," *Ensign*, May 1993, 32
[3] Ezra Taft Benson, "To the Elderly in the Church," *Ensign*, Nov 1989, 4.

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1. Building a Strong Foundation: Another Perspective on Wealth[1]

Introduction

Personal finance. These 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 unchartered 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: happiness and joy. Others have learned how to bring Christ into their finances, learned their available options, determined the key doctrines, principles and applications, applied them in a creative process to their financial habits and goals, and have accomplished the vision and goals that they have set for themselves and their families, including happiness in this life and eternal life 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, and to apply it in your lives.

Objectives

A. Understand how to bring Christ into your finances.
B. Understand the importance of perspective and our perspective for this course.
C. Understand our framework for learning: doctrines, principles and application.
D. Understand the implications of that learning framework.
E. Remember that "Life is Good."

Understand how to bring Christ into your finances

As we have read and studied scriptures, it is apparent that Jesus Christ wants to be a greater part of our lives and finances. He will not barge in and tell us what to do; He cannot, as He will not violate our moral agency. But He will plead, exhort, counsel and guide us back to our Father if we will allow Him more into our lives and finances.

Why do we want to bring Christ more into our finances? M. Russell Ballard reminded us: "In my judgment, we never will have balance in our lives unless our finances are securely under control."[2] Christ can help us bring balance and control into our lives and finances. How do we bring Christ more into our lives and finances?

Seek to learn and love the Savior and His atonement more. We study, pray, learn more about Him, and contemplate His amazing atonement and what it means in our lives. Christ knows us by name and loves us perfectly, and has designed a detailed, individual, and customized curriculum (called life) exactly tailored to our needs, mission and destiny. Managing our finances is one of the pieces of that curriculum, and personal finance is simply part of the gospel of Jesus Christ.[3]

Strive to change daily and become more like Him. God's grace, repentance and the atonement of Jesus Christ are perfect tools to help us change and to become more like our Savior. He has given us everything we need to become more like Him. He has taught through His servants that "a" pattern to change behavior is to understand doctrines and principles, and have them confirmed by the Spirit.[4] Boyd K. Packer 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. . . That is why we stress so forcefully the study of the doctrines of the gospel."[5] However, it is not enough to know the doctrines—we must understand them as well. David A. Bednar commented, "President Packer did not teach that simply knowing true doctrine changes us. Rather, doctrine must be understood. . . Thus, true doctrine confirmed in the heart as true by the witness of the Holy Ghost changes attitudes and behavior.[6] He also reminds us "The answers are always in the doctrines and principles, and the doctrines and principles need to be in us."[7]

Learn to apply His words and create our lives more closely with Him. As we strive to develop and grow, application is an invitation to learn and create.[8] As we do, we become creators with God of ourselves, our families and our lives. We learn important lessons from the creation[9] that we can use in our lives as we remember that "Creation is a spiritual gift."[10] We were born creators, and had our first lessons in creation when as pre-existent spirits we helped create the earth we live on.[11] We create each day in our prayers, families, the environment in our homes, budgets, goals and our lives. We are all creators, and learn best when we learn and follow the Master Creator, even Jesus Christ. Not only does He know the way, He is the way.[12]

Always remember Him. We need Christ's inspiration and guidance daily if we are to return with our families to His presence. We already covenant to "always remember Him" each week in the Sacrament. We must strive to keep those and our other covenants. We must remember that our conduct on our journey is as important as our final destination.[13] We must, like the pioneers, make "a covenant and a promise to keep all the commandments and statues of the Lord"[14] as we daily remember the Savior and follow the covenant path.

To bring Christ more into our finances, we must bring Him more into our lives. If we want to have balance in our lives, we must bring our finances securely under control. We can do this best with Christ's help. We bring Christ into our finances as we seek to learn and love the Savior and His atonement more, work to change and become more like Him, learn to apply and create with the Creator of the World, and always remember Him. Then with His help, we can accomplish all things.

Understand the Importance of Perspective and Our Perspective for this Course

The dictionary defines *perspective* as "one's point of view, the choice of a context for opinions, beliefs, and experiences."[15] The historian Will Durant wrote of the human 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.'"[16]

The challenge then is to see things in a consistent perspective--as they will be 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?"[17]

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? Neal A. Maxwell commented:

> We see the world and the people in it differently, because, as C. S. Lewis observed, it is by the light and illumination of the gospel that we see everything else. . . The gospel is like the lens of a cosmic kaleidoscope that, instead of showing life, man, and the universe as senseless, unconnected fragments, shows us pattern, beauty, and purpose! It is this vision that can give us a special sense of proportion about the things in life that matter most. . . This perspective can make so many differences in so many ways that, unintentionally, we may be unconscious of the implications of our difference in outlook.[18]

The purpose of this section is to articulate "another" perspective on wealth, an 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, we take a different view from the world. We 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*![19]

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, work and finances.

Our perspective is simple: *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".[20] It is the temporal application of eternal principles.

Understand our Framework for Learning: Doctrines, Principles and Application

Our learning framework for this class is unique. We use the framework for learning used by David A. Bednar in his book "Increase in Learning." It is based on doctrines (the whys"), principles (the "whats"), and application (the "hows"). It brings balance to the things we do. Bednar calls it, "A flexible tool that can be used to enhance our gospel learning and can be a useful aid as we apply the principles of prayerful inquiry and the pattern of asking, seeking, and knocking."[21]

Too often when we encounter problems in life, we are drawn to application as the way to make life better. But is it the best way? Bednar writes:

> Somehow we seem to be drawn to application as the primary way to 'fix" things, to make life better. . . And far too often we emphasize application without the necessary understanding and divorced from the doctrinal content. . . Whatever the reasons, emphasizing the application to the exclusion of fundamental doctrines and principles does not produce spiritual power, protection, and direction. . . Appropriate applications are necessary but can never stand alone. What is needed is a balance among doctrines,

> principles and application. . . *The answers always are in the doctrines and principles*. And the doctrines and principles need to be in us.[22]

This learning framework is unique. It asks three critical questions that can lead us to learning and life. They are:

> 1. Why should we *learn and become better at personal finance*? (this is a "why" or doctrine question).
>
> 2. What are the principles on which how we *learn and become better at personal finance are based*? (this is a "what" or principles question).
>
> 3. How do we *learn about and become better at personal finance*? (this is a "how" or application question).

Doctrines or "Whys" of Personal Finance

Doctrines are the truth about ourselves, our lives, our history, and our relationship to our Father in Heaven and his Son Jesus Christ. Boyd K. Packer 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. . . That is why we stress so forcefully the study of the doctrines of the gospel."[23]

David A. Bednar reminds us,

> President Packer did not teach that simply knowing true doctrine changes us. Rather, doctrine must be understood. The word understanding in the scriptures frequently is linked to and associated with the heart and refers to a revealed result or conclusion. Thus, true doctrine confirmed in the heart as true by the witness of the Holy Ghost changes attitudes and behavior. Knowing true doctrine is necessary but is not sufficient.[24]

Why should we learn doctrines? Doctrines are critical as they give us the perspective, motivation and strength to do the right things even when they are difficult.

We have been counseled to understand the "why" or doctrines of the gospel of Jesus Christ. Dieter F. Uchtdorf said:

> Seek out the majesty, the beauty, and the exhilarating joy of the 'why' of the gospel of Jesus Christ. "The 'what' and 'how' of obedience mark the way and keep us on the right path. The 'why' of obedience sanctifies our actions, transforming the mundane into the majestic. It magnifies our small acts of obedience into holy acts of consecration.[25]

Before we can decide more about wise money management, we must understand and answer the question, "Why should we learn and become better at family finance?"

While there are likely many different "whys", let me share a few thoughts on doctrines of why we believe God wants us to learn personal finance. Since perspective is so important, this question must be addressed from many different perspectives. Possible perspectives include spiritual, temporal, family, and personal. While there are an innumerable number of perspectives, these four seem to be important and will be addressed here.

Spiritual: Personal finance can help bring us to Christ. From a spiritual perspective, the ultimate purpose of everything we do, and God does, is to bring us to Christ. Because God's work and glory is to bring to pass the "immortality and eternal life of man"[26] and the only way we can have eternal life is through Jesus Christ[27], then the purpose of all mortal experience is to bring us to Christ, who then brings us to the Father. Learning to manage our finances according to gospel principles will help us grow spiritually as well as help build up our families and the kingdom of God.

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.[28]

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.[29]

Perspective also adds significantly to motivation. 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 to do these things.

Temporal: Personal finance can help us become wiser stewards. From a temporal perspective, managing resources is a skill that Heavenly Father wants us to develop during mortality. "For he who is faithful and wise in time is accounted worthy to inherit the mansions prepared for him of my Father."[30]

Personal finance helps us learn to be wiser financial stewards over the things with which God has blessed us. 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."[31]

I believe a critical question at judgment day from our Savior will not be, "How much money did you make?" Rather, it will be, "How well did you use the resources I blessed you with in the service of your family and fellow men?"

Family: Personal finance can help us return with our families back to Heavenly Father's presence. The third perspective is family. An eternal perspective on finances helps us keep our priorities in order. David O. McKay reminded us, "No other success can compensate for failure in the home."[32]

We show our love for our Savior as we pay our tithes and offerings. We are examples to our children as we put the Lord first and sacrifice through service, hard work, church and temple attendance. We build our communities and nation as we seek opportunities for service to our family, friends and fellowmen.

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. In short, an eternal perspective on finances can prepare us for eternal marriage, strengthen existing marriages, and be a conduit for positive parenting.

Individual: Personal finance can help us prepare for and accomplish our divine missions. The fourth perspective is individual. 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. Many of our missions will required material resources. 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."[33]

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?"

Clearly, perspective is important, and by looking at many different perspectives we can understand more fully "why we should learn and become better at family finance."

So if money management is part of the gospel of Jesus 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."

Principles or "What's" of Personal Finance

Principles are fundamental laws or doctrines, which, if understood, will allow us to live or act according to truth. 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. 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.[34]

What are those principles or "what's" to which we must adhere whose results are so eternally worthwhile that they merit our every sacrifice? Let me propose a few principles that relate to understanding and using wealth wisely.

Principle 1: Ownership. Everything we have is the Lord's. The Psalmist wrote, "The earth is the Lord's, and the fullness thereof; the world, and they that dwell therein."[35] The apostle Paul, writing to the Corinthians, stated the same message, "For the earth is the Lord's, and the fullness thereof."[36]

We know from scriptures that the Lord was the creator of the earth[37], the supplier of our breath[38], the giver of our knowledge[39], the provider of our life[40], and the giver of all we have and are.[41]

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. These blessings 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. We are stewards over all that the Lord has, is, or will share with us. 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."[42] 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."[43]

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 gift of "choice" is man's most precious inheritance. President Thomas S. Monson taught, "When we came to the earth, we brought with us that great gift from God—even our agency. In thousands of ways we are privileged to choose for ourselves."[44]

The prophet Joshua counseled the people about agency when he said, "Choose you this day whom ye will serve; . . . but as for me and my house, we will serve the Lord."[45]

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.[46]

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 are accountable for every choice we make, including our financial choices. We have been blessed with the 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."[47]

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 covenants 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.

Neal A. Maxwell put things of this world into a correct perspective when he taught:

> The submission of one's will is really the only uniquely personal thing we have to place on God's altar. The many other things we "give," brothers and sisters, are actually the things He has already given or loaned to us. However, when you and I finally submit ourselves, by letting our individual wills be swallowed up in God's will, then we are really giving something to Him! It is the only possession which is truly ours to give![48]

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 choose and do.

Application or the "How's" of Personal Finance

Once we understand the doctrines and principles of finance, it is important to understand how to apply what you are learning to your daily lives. I call this application or the creative process. Question 3 then becomes "How do we learn about and become better at family finance?"

In 2019 we took 24 BYU students to Europe for a Global Finance Investment Internship. One of the companies we visited in Germany was a large sport and apparel manufacturer. I was impressed with their marketing slogan "Calling all Creators."[49] Their point was we all are

creators, which we truly are.

On the importance of creation, Elder McConkie said, "The three pillars of eternity, the three events, preeminent and transcendent above all others, are the creation, the fall, and the atonement."[50] Why is it so important that we understand the creation? I believe it is because this knowledge will help us to be better creators ourselves. Let me share eight lessons that I have learned from the creation. You will likely have your own lessons from your reading and study.

God is creative. The creation shows that Heavenly Father and His son are very creative beings. We are taught in the scriptures that we are created in the image of Heavenly parents and in Their likeness. As such, we should also very creative beings. We were meant to create, and this capacity is God-given.

Christ worked under the direction of the Father. The restored gospel has helped us to know that Jesus Christ created the heavens and the earth under the direction of the Father. Likewise when we create, we should be under the direction of the Father as well. To really accomplish all we need to in this life, we will need His help.

The earth was created from existing matter. The earth was created, not from nothing, as many suppose; rather, it was organized from existing matter.[51] Likewise, when we create, we are not starting from nothing. We take our existing vision, education, talents, skills and abilities, and match those with the resources and materials we have in our home, neighborhood, community or nation.

Creation is a two-step process. The Lord speaking to Moses said, "For I, the Lord God, created all things, of which I have spoken, spiritually, before they were naturally upon the face of the earth."[52] Once He created things spiritually, then came the physical creation of everything on the earth. We likewise must create things spiritually through our vision, goals and plans, and then we can create it physically—and we can create with confidence.

There is an order in creation. Notice that there is an order in creation, first the world was organized, and then light came into the world. Next the waters were divided. Clearly there is order in creation and in the universe. Likewise, there is order in our creative processes, and we must learn what that order is.

Creation takes time. The creation of the earth did not happen overnight, but took six creative periods. How long those periods were has not been revealed, but we do know it was a long time. Likewise, when we create, we should realize that this is a time-consuming process.

Creation was a planned event. The creation was planned from the beginning under the direction of Heavenly Parents. The creation, fall and atonement of Jesus Christ were all part of the Father's plan, "to bring to pass the immortality and eternal life"[53] of His children. We should make sure, as we go through our lives, that we to have a plan on how we will live our lives, so that we can, under the direction of the Father, support His same work and return to His presence.

We create every day of our lives. Some do not think they create; however the reality is that we create every day of our lives. Perhaps a few creations can help make the point.

Prayer. David A. Bednar commented on our spiritual and physical creation of each day. On the subject of prayer, he said,

> We learn from these verses that the spiritual creation preceded the temporal creation. In a similar way, meaningful morning prayer is an important element in the spiritual creation of each day—and precedes the temporal creation or the actual execution of the day. Just as the temporal creation was linked to and a continuation of the spiritual creation, so meaningful morning and evening prayers are linked to and are a continuation of each other.[54]

Family. We are co-creators with God in the creation of our families. We work with Him as creators of our marriages and in which our children are raised. We should make sure, as we work to create the environment in our marriages and in which our children are raised, that we do it as co-creators with Heavenly Father. We are reminded to always, "Create homes filled with love and serenity. Relieve suffering. Create enduring testimonies of eternal truths in ourselves and others."[55]

Vision and Goals. When we set and work toward our vision and goals, it is again the spiritual creation followed by the physical creation. Alma uses different words to describe this spiritual creation, such as "Do you exercise faith," "Do you look forward with an eye of faith," and "Can you imagine to yourselves."[56] God's ultimate goal for us is to learn both the spiritual and physical creation process so we live in such a way as we, with our families and through the Savior's atonement, can return to live with Him eternally.

Finances. Regarding our finances, the preparation of our budgets can be envisioned as the spiritual creation first, followed by the physical creation second as we spend the money. President Kimball said" "Every family should have a budget."[57] Living on a budget does not mean that you do not spend money; rather, you spend money on things that are planned for (the spiritual creation) and that are important to you.

Ourselves. Finally, the reality is that we create ourselves in every day and in everything we do. Our life then is the sum of each of our daily individual creations. As such, we recognize the importance of our daily creations in the creation of our overall lives.

Creation is a wonderful subject for additional study. We were born creators, and had our first lessons in creation when as pre-existent spirits we helped create the earth we live on.[58] David O. McKay taught, "Sculptors of life are we, with our uncarved souls before us. Everyone of us is carving a soul."[59] That we might help create and carve ours and other souls well is our prayer for each of you.

The application or the creative process is how we go from the spiritual creation to the physical

creation. It entails five steps. Each of these steps is important to the process, and this process can be applied to all areas of our lives. While it is possible to create without thinking through the creative process and many do exactly that, if we understand and apply this process it can help us to accomplish more and to be even more creative in our lives and our finances.

The Lord speaking to Joseph Smith said, "I will give you a pattern in all things, that ye may not be deceived."[60] David A. Bednar reminds us,

> Interestingly, the Lord gave us "a" and not "the" pattern for all things. I do not believe the Lord is suggesting with the language "a pattern in all things" that He has only one pattern to be used in every situation. Rather, the Lord's way includes a variety of patterns that can be employed to achieve different spiritual objectives.[61]

Let me share one possible pattern.

The Creative Process

Vision: We Catch our Vision. The scriptures teach "Where there is no vision, the people perish."[62] Why is vision so important? Vision is a critical precursor to effective goals, planning, writing, and accomplishing our personal and family goals. The best vision is from the longest perspective. Patricia T. Holland said, "Our prayers ought to be to see as God sees, to adjust our minds so we may see things from an eternal perspective. If we listen too often to the voices of the world, we will become confused and tainted. We must anchor ourselves in the spirit and that requires daily vigilance."[63]

Goals: We Develop our Goals. Goals are tools to help us keep us focused on our vision. Robert D. Hales gave advice on your choice of goals. He recommended:

> I would like to suggest a few of the most important goals in life that will give you joy as you fulfill your mission on this earth—eternal goals that will help you return with honor to your Father in Heaven. They include: Marry in the temple and cultivate eternal family relationships by prayerfully balancing the many facets of life, such as family, occupation, continuing education, hobbies, and entertainment. Faithfully and obediently live your religion and be true to the baptismal and temple covenants, always treasuring up the good things of life. Hold on to the eternal perspective, remembering that the things of the kingdom are eternal and the things of the world are temporal or temporary. Remember to give dedicated service throughout your life and always care for the needy who may require your love and other support.[64]

Plans and Strategies: We Make our Tactical Plans and Strategies. He continued and said, "Making these goals is not enough; we must make a plan to carry them out."[65] Goals are the destination, where we want to be, and our plans are the process by which we will get from where we are now to where we want to be. We need to be detailed in our plans to accomplish our goals and hence our vision.

Constraints: We Determine our Constraints. Whereas goals are the clear objectives for what you want to accomplish, and your plans are how you will accomplish those goals, then your constraints are given conditions or circumstances that your solution must satisfy. These are things that must be taken into account as these constraints can have a major impact on your ability to accomplish your goals and vision.

Accountability: We Share our Vision with Accountability Partners Who Can Help. Accountability is the process by which we make known our vision, goals and plans to others. This could be for three reasons.

- It may be because we need their moral or personal help to accomplish our goals and vision. Sharing your goals with your spouse and children is a good way to get help in accomplishing your goals. Having others help you be accountable for your goals is a great motivator.

- It also may be because they are part of our creative process and necessary to help us accomplish our goals. Mentors and friends can help when we fall short and help us know what to do to improve.

- As we share our vision with others, we give others permission to catch their own visions.

Regardless of the reason, accountability is an important part of the creation process.

For example, Heavenly Father's vision is the happiness and exaltation of his children. His goal is to "bring to pass the immortality and eternal life of man."[66] His plan is the Plan of Salvation or the Plan of Happiness. He has no constraints as his plan is for all people, and He communicates his plan with His children through prophets, apostles and scriptures. Just as He has a vision, goal, plan, constraints, and accountability, so we should too.

The manual will share concrete ideas and experiences on how you can apply the creative process to the personal finance area, how you can create your vision of what you want to become, set goals, develop a plan, work on constraints, and then communicate it to help you accomplish your vision. This process is applicable to all areas of your Personal Financial Plan.

Ezra Taft Benson reminded us to "Plan your financial future early, then live your plan."[67] As part of planning your financial future, you will develop your own Personal Financial Plan (PFP). Your PFP includes 16 different Plans, including your:

- Plan for Life (Vision, Goals, and Plans)
- Saving, Income and Expense Plan (Budget)
- Tax Plan
- Cash Management Plan
- Credit Plan
- Consumer Loans and Debt Plan

- Insurance Plan
- Family Financial Plan
- Investment Plan
- Retirement Plan
- Advance Plan
- Mission Plan
- Education Plan
- Housing Plan
- Auto/Toy Plan
- Individual/family Giving Plan

Our Conduct on the Journey is as Important as our Destination

As Anne and Bryan Sudweeks were driving home from our service in Nauvoo this year, they were listening to the book "Revelations in Context" and the section on D&C 136. Brigham Young was with the vanguard company in Winter Quarters, Iowa, and was praying for inspiration to get the Saints to the west. This section was guidance by the Lord on how to organize the Saints for their trip from Nauvoo to the Great Salt Lake.

As they thought about this inspired document, they wondered if there was more to this section than a standard organizational chart. Did it have a greater meaning that extended beyond the lessons for 1847? Chad M. Orton wrote:

> Some have assumed that the revelation is a simple how-to guide for organizing pioneer companies and have underestimated the role it played in refocusing Brigham Young and the Church. By helping the Saints remember that their conduct on the journey was as important as their destination, the revelation helped transform the westward migration from an unfortunate necessity into an important shared spiritual experience.[68]

Could the Lord be not only letting us know what Brigham needed to do, but also giving us a pattern that we can use in our financial lives as well?

Some have said, "The end justifies the means," meaning that "a desired result is so good or important that any method, even a morally bad one, may be used to achieve it."[69] Here in D&C 136 the Lord is saying that the means is as important as the end.

Brigham Young's vision and goal was simple, namely the largest single migration of an entire people, institutions, and culture in the history of the United States. To do this, the Lord inspired Brigham to organize the Saints "into companies, with a covenant and promise to keep all the commandments and statues of the Lord" (v. 2). Organization into companies was not new and had been discussed by the prophet Joseph. However, that combined with the covenant of righteousness was an inspired addition. Orton continued, "Brigham came to understand that

rather than simply blazing a trail that others would follow, the 1847 vanguard company was establishing a covenant path."[70] He knew that thousands would be following their path and direction, so inspiration was crucial. As the Saints kept their covenants and walked in the ordinances of the Lord, they had the help of heaven as they worked toward their destination.

Likewise, how we conduct ourselves on a day-to-day basis in our finances is as important as the final destination of financial self-reliance or saving money. The important thing is what we learn and become from our experiences with our finances, not just the amount saved, and the inspiration of heaven is critical. Our challenges may not be as daunting as Brigham's, but they are important. As we work toward our vision and goals of greater financial self-reliance, we should likewise be organized and prepared, as well as make that same covenant that we will "keep all the commandments and statues of the Lord" (v. 2) and "walk in all the ordinances of the Lord" (v. 4). As we do these things, we too can have heaven's help as we go along our journey to our financial and other goals.

What should our conduct entail? Thankfully, the Lord shared three important points.

Follow the prophets and stay on the covenant path. As soon as Brigham received this revelation, he and the other apostles worked to ensure that the Saints knew what the Lord expected of them. The results were instructive and impressive. Hosea Stout observed that following the revelation would bring needed calm and unity in the face of unexpected trials; it would "put to silence the wild bickering" that had complicated the journey across Iowa.[71] Richard E. Bennett noted that as they followed the prophet, the exodus became "the most carefully orchestrated, deliberately planned, and abundantly organized hegira [migration] in all of American history."[72]

As the pioneers kept all the commandments and statutes of the Lord (v. 2), followed the prophets (v. 3), and walked in all the ordinances of the Lord (v. 4), the Lord blessed them that they would be able to get to their destination. Likewise, as we keep the commandments and statues, listen to the prophets and stay on the covenant path, we too will get to our destinations, whether it is budgeting, investing, retirement planning, or other activities.

Be wise stewards over all the Lord has freely given you. The Lord reminded the saints that they were His agents and the blessings they had received were from Him and should be used to prepare for what and who were coming later (v. 7, 9). They were to use their intellect, resources and property to help others (v. 10), be honest in their dealings, not covet (v. 20), return things borrowed (v. 25), return what they find to their rightful owners (v. 26), and be diligent in preserving what they have (v. 27). They were counseled against contention, pride (v. 19), taking the name of the Lord in vain (v. 21), speaking evil one with another (v. 23), drunkenness, and unedifying conversations (v. 24). As they did these things with pure hearts, they were promised "Ye shall be blessed; you shall be blessed in your flocks, and in your herds, and in your fields, and in your houses, and in your families" (v. 11). Likewise, as we are wise stewards over our financial resources and work to avoid contention, we too will be blessed in the things we are striving to achieve.

Remember the poor and needy on your journey. While the Saints were to be wise stewards, they also had a covenant responsibility to share an equal proportion for taking care of the poor, widows, and fatherless (v. 8). Likewise, as we work toward our financial goals, we also must remember our covenant responsibility to remember the poor and the needy along our way and to bear our "equal proportion" through our fast and other offerings and helping and serving others.

Because of both organization and righteous conduct, the pioneers were able to make the journey to the west. They established not only a physical but a covenant path as well, a path we can follow today. The Lord reminded the Saints that their conduct on the journey was as important their destination. Likewise, how we do the things we need to do as we work toward our financial goals is as important as what we do.

The Lord then shared what that conduct should include. They must follow the prophets and stay on the covenant path, be wise stewards over all the Lord has freely given, and remember the poor and needy on their journey. As the Saints followed this inspired guidance and improved their conduct, they made progress toward their ultimate goal in the west. Likewise, that guidance has relevance to us today. As we remember the importance of our conduct and these same three areas of concern, the Lord will likewise help us in our financial vision, goals and destinations.

By emphasizing the importance of what we do, our conduct, and what we have, our blessings, we tie everything, including our finances, back to the gospel of Jesus Christ. Moreover, we transform our finances from an unfortunate necessity to an important shared spiritual experience as we work together with our spouse and families to accomplish our financial vision and goals.

Understand the Implications of this Learning Framework

This learning framework is important for six specific reasons.

1. This framework helps us ask the important questions about our lives and our finances, such as "What doctrines and principles, if understood, would help me:

- "Change my attitudes and behaviors toward my finances to become better at them?"
- "Teach my children the place of money in our lives, instead of just the world's ways?"
- "Better live the commandments to live on a budget, spend less than I earn, and be more exact in my record keeping?"

Understanding doctrines and principles can help us ask important questions that can be used to enhance our learning as we ask and seek deeper answers to the difficult questions of life.

2. This framework reminds us where the answers really are. Bednar reminds us, "Appropriate applications are necessary but can never stand alone. What is needed is a balance among doctrines, principles and application. . . The answers always are in the doctrines and principles. And the doctrines and principles need to be in us."[73]

3. This framework allows us to lift our perspective and vision, which can help us gain greater motivation. By finding our higher purpose (or doctrines) in what we are doing, we gain greater motivation to do the things that we need to do. Ted Callister reminds us "With increased vision comes increased motivation."[74]

4. This framework encourages us to take a long-term eternal perspective rather than a checklist approach. Paul declared "In the dispensation of the fullness of times [God] might gather together in one all things in Christ."[75] How do we gather together in one all things and how does this framework help?

David A. Bednar wrote, "The principle of gathering together in one can aid us in changing the conventional checklist [of family finance] into a unified, integrated, and complete whole in receiving the transforming power of the gospel of Jesus Christ in our lives."[76] For most of us our lives revolve around the checklist of things necessary for us to do including living on a budget, getting out of debt, saving for long-term goals, etc. These things are often considered separately, rather than in relation to each other and in relation to our overall lives. As we gather together in one, we put all these things together and see that these things, including our finances, are simply part of the gospel of Jesus Christ and hence we know what is necessary for us to do. We must "obey the commandments."[77] "bridle all our passions,"[78] "perform every word of command with exactness,"[79] "strip ourselves of all pride,"[80] "offer [our] whole souls as an offering unto Him,"[81] and "endure to the end."[82]

5. This framework reminds us of the importance of Christ and our daily conduct. It is not enough to know these things and even to have a testimony of their truthfulness, we must do them every day. It is crucial that we daily stay on the covenant path daily and we will achieve our destination.

6. Finally, this framework helps change our thinking. While principles and application keep us on the right track, understanding the doctrines and principles allows us to transform those hourly and daily mundane acts of obedience we must do in our finances into the majestic purposes that our Heavenly Father has planned for us. It magnifies, as Dieter F. Uchtdorf says, "our small acts of obedience into holy acts of consecration" to our Savior Jesus Christ.[83] Louise Y. Robison reminds us, "If we only half do our work we will have no pleasure, if we do it from a sense of duty we will have no joy, but if we feel . . . that our Father in Heaven has felt us to be worthy . . . and that we can carry this work when it is here to do, then we will have joy.[84]

Summary

We must strive to bring Jesus Christ more into our lives and finances. To do that, we must seek to learn and love the Savior and His atonement more, strive to change daily and become more like Him, learn to apply His words and create our lives more closely with Him, and always remember Him. Our learning framework supports each of those activities.

Perspective is important in studying personal finance. Our perspective 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 others and ourselves 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 with our lives and finances, as perspective influences our choices.

We shared our important learning framework of doctrine, principles and application. Doctrines are revealed truth. The first critical question was "why should we learn and become better at family finance? Four key concepts constitute the doctrines, each related to a different perspective.

1. Spiritual- To bring us to Christ
2. Temporal- To help us become wiser stewards.
3. Family- To help us return with our families back to Heavenly Father's presence.
4. Individual- To help us accomplish our divine missions.

Principles are guidelines for the proper use of agency. The second question was "what are the principles on which how we learn and become better at personal finance are based? Four key concepts constitute the principles or "what's" on which this perspective is based. They are:

1. Ownership- None of what we have is ours.
2. Stewardship- We are stewards over all God has blessed us with.
3. Agency- The gift of choice is one of God's most precious gifts.
4. Accountability- We will be accountable for all our choices, including our financial choices.

Application is how we accomplish what we need. The third question was "how do we learn about and become better at personal or family finance? This application or the creative process is critical to our accomplishing all we need to in life. The five key concepts are:

1. Vision- Our vision is what we want to become or how we want to live our lives. It is our ultimate destination and what we want to be like.
2. Goals- Goals constitute our destination or where we want to get to become our vision.
3. Plans- Plans are our tactical strategies or plans that will allow us to accomplish our goals.
4. Constraints- These are the conditions or circumstances that are critical for us to accomplish our goals.
5. Accountability- Finally, accountability is how we let others know what we are trying to accomplish and how we enlist their help in our process.

In summary, our learning framework was designed to help us bring Christ into our finances.

- We must seek to learn and love the Savior and His atonement more. As we do, we realize the personal finance is simply part of the gospel of Jesus Christ.

- We strive to change daily and become more like Him. We know that doctrines and principles, confirmed by the Spirit, change behavior.
- We learn to apply His words and create our lives more closely with Him. For we know that application is an invitation to learn and create.
- We always remember Him. As we do, we remember our conduct on our journey is as important as out destination.

It is our responsibility to be financially wise and use the resources we have been blessed with in blessing the lives of our families and others. We do that best when we daily bring Christ more into our lives and finances. 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 doctrines ("why's"), principles ("what's"), and application ("how's") of personal finance. Why is this learning framework different? What things will this framework help us understand? These are the reasons we should be learning this material and we have a process on how to do it. With this framework we can change, as Dieter F. Uchtdorf states, "our small acts of obedience into holy acts of consecration."[85] With this understanding, we can avoid the problems that come with the world's different perspectives on wealth – generally incorrect ones. To become truly wealthy, we must first have a correct perspective and understand the key doctrines and 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."[86] 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.ChurchofJesusChrist.org/.

As you begin your PFP, start by filling our your PFP Introduction Template (LT01-01). What will happen if you don't prepare carefully this PFP? What will happen if you do? Think through the benefits of putting together a thoughtful Plan.

Learning Tools

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

Personal Financial Plan (PFP) Table of Contents (LT01)

This is a recommended table of contents for your Personal Financial Plan. It includes the 16 separate plans which make up your PFP.

Review Materials

Terminology Review

Accountability. This is a principle is that states we are accountable for every choice we make. We do not make choices with no consequences or accountability; rather, we will be held accountable for the decisions and choices we make.

Agency. This principle is that we have choice in our lives. We are agents of will, who can make choices consistent with our beliefs and values. Moreover, the gift of "choice" is man's most precious inheritance, and we should protect it carefully.

Application. Application is the "how' of how we do things. It is how we apply the doctrines and principles in our lives.

Constraints. Constraints are given conditions or circumstances that must be satisfied in order to enable us to accomplish our goals.

Accountability. Accountability is the process of letting others know what your vision, goals, plans, and constraints are to enlist your help in the creative process. It can also be enlisting others in helping accomplish your goals as you need their help for certain specific parts of your plans and strategies.

Creative Process. It is the way we get from an idea or vision to its eventual accomplishment. It has five critical areas: vision, goals, plans, constraints, and accountability.

Doctrines. Doctrines are the reasons behind why we do things. They answer the "why" questions of our lives, which are generally the most difficult questions to answer.

Goals. Goals are tools to help us keep our vision in focus. They are intermediate stepping stones that will take us to our eventual vision of what we are trying to accomplish.

Ownership. This is the principle that everything we have is the Lord's, and we do not own the things we have and are. It is based on scripture and helps us to see our blessings as gifts on loan from a loving Father in Heaven.

Perspective. Perspective is how we look at things. It is important because it influences choice. We can take many different perspectives in our view of different aspects of our lives, with the best perspective being the perspective that last the longest—an eternal perspective.

Plans. Tactical plans are the roadmaps by which we will accomplish our goals. It is how we will get from where we are now to where we want to be to accomplish our goals.

Principles. These are doctrinally based guidelines for how we should live our lives. Whereas doctrines answer the 'why" questions, the principles are the "what" questions, i.e., what are the things and guideline we should be following and doing.

Stewardship. This is the principle that we are stewards over all that the Lord has, is, or will share with us. This view helps us realize the things we have are a gift and we should take care of them.

Vision. This is the act or power of seeing or imagination, where we come to solidify in

our minds who we are and what we can accomplish. It is a creative work through which the power of thought, imagination, and effort combine to help us thoughtfully consider possible future events that may come to pass.

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?
6. What are the benefits of this doctrines, principles and application learning framework?

Case Studies

<u>Case Study 1</u>

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.

<u>Case Study 2</u>

Data

Brenda continues to ask you questions regarding your perspective and principles for using wealth wisely. 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 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.
   - 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, including our financial 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.

Case Study 3

Data

Brenda was concerned as one of her friends was blessed with material riches, and made poor choices which caused him to lose his testimony. She asks: "If wealth is so bad, should we seek for riches?"

Application

What did the prophet Jacob in Jacob 2:18-19 say about this question? What should we seek for first?

Case Study 3 Answers

The prophet Jacob said seeking for riches is OK "if" we first seek the Kingdom of God, and if we seek riches for the right intent--for righteous purposes.
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 (Jacob 2:18-19).

First, we should seek for the Kingdom of God and doing His will. Then we can seek for riches—but with the intent to do good. Gordon B. Hinckley said: "The Lord will love us, I think, to the degree to which we lift and bless those in distress. I believe that with all my heart, mind, and soul. The accumulation of means is not a bad endeavor when those means are used to bless the needy of the earth."[87]

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2. Your Personal Financial Plan: Planning Your Financial Future

Introduction

Once you have a correct perspective on wealth and understand this important framework for learning, including doctrines (the "whys"), principles (the "what's"), and application (the "how's"), the next important step is to begin your Personal Financial Plan (PFP) and to plan for your financial future. Ezra Taft Benson counseled: "Plan your financial future early; then follow the plan."[1]

My purpose is to help you plan for your financial future, catch your vision of who and what you will become, set meaningful goals, develop detailed plans, and then encourage you to accomplish those goals through the creative process. In this chapter, I will share a few steps I have found helpful as I have considered my own life and vision. I hope these suggestions will be useful in your life.

Catching the vision for your life is not simply writing a list of goals you would "like" to accomplish. Rather, it is a process of understanding yourself, who you really are, your aspirations, desires, values, and what you want to become and accomplish. Then it is trying to understand what God wants you to accomplish, your divine mission or destiny. 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:

A. Understand the importance of planning your financial future and your PFP
B. Understand how to create your "Plan for Life."
C. Understand how to catch your vision of what you want to accomplish in life and the different types of goals.
D. Understand and apply the principles of effective goal setting.

Understand the Importance of Planning your Financial Future and your PFP

The purpose of financial planning is to help you plan for your financial future. What are the most important things we should do in our lives? As you ponder this question, it naturally brings us back to our previous discussion, our "why's" or doctrines of finance. They are, from an eternal perspective:

- Spiritual- To bring us to Christ
- Temporal- To help us be wiser stewards
- Individual- To help us accomplish our divine missions
- Family- To help us return with our families back to Heavenly Father's presence

What are the principles or "what's" that we should follow as we plan for our financial future? Again, they are the principles we discussed: ownership, stewardship, agency and accountability. If, as David A. Bednar states, "the answers are always in the doctrines and principles,"[3] shouldn't our study begin here first as we plan for our financial future? Additionally, we have been 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.[4]

Ezra Taft Benson's counsel above from nearly 30 years ago warned us against not living frugally, not planning for retirement, get-rich quick schemes, mortgaging homes, investing in uncertain ventures, and making poor financial decisions.

So how do you plan for your financial future? You do financial planning. Its purpose is to help you become a wiser steward over the blessings God has blessed you with, so you can achieve your personal mission and individual and family vision and goals. It is determining where you are, helping you catch your vision and goals of where you want to be, and helping you detail your plans and constraints for how you will get there.

Will Financial Planning help you make more money? It may not, but it will help you in your stewardship and accountability areas to:

- Set your vision and goals high.
- Develop better plans and strategies.
- Be better and more informed stewards.
- Make wiser personal and financial choices.
- Make sure to get to the end of your life and you feel successful because you did those things that were most important.

Your ultimate goal in personal finance, since it is simply part of the gospel of Jesus Christ, is to show, with every dollar you spend, that you have chosen to take an eternal and Christian perspective rather than the world's materialistic perspective. The sooner you realize this, the sooner and greater your motivation to obey the commandments to get your financial house more in order.

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 includes your vision, goals, tactical plans, constraints, and accountability to achieve those goals. It includes your plans for budgeting, taxes, cash management, debt reduction, insurance, investing, retirement and estate planning. It includes plans for your home and auto decision, plans to help pay for your children's education and missions if you so choose to help. Finally, it includes your giving plan on how you will give back, to help make the world a better place. All of this is a critical part of Ezra Taft Benson's admonition to "plan for your financial future early, and then follow the plans."[5] It requires you to catch your vision of who you are and 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 creating your future with confidence by implementing and revising the plan as needed.

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

Step 1: Catch Your Vision for your Life

Someone said, "Don't tell me what to do, teach me who I am. Once I know who I am, I will know what to do."[6] Do you really know who you are? Understanding who you are is critical in understanding and having a vision for your life. "At a training session for General Authorities, the question was asked "How can we help those struggling with [challenges in life]? Elder Russell M. Nelson stood and replied, "Teach them their identity and their purpose."[7]

You are more than just matter and 90% water. You are a "child of God."[8] As such, you need to decide who you are, what you want, what is important to you, and what God would have you accomplish. These decisions express your core values and beliefs. Think through the things that you need to decide. What is truly important to you? What do you feel Heavenly Father wants you to do or be? What is your mission in life?

Look ahead. How would you like to be remembered when you leave this life? What do you want to accomplish with your life before you leave this earth? These are probably the most important questions you will ever ask and answer. If we can prepare with vision early in our lives, it will be so much easier to set those goals and plans to help us create that vision through accomplishing our personal and family goals.

Step 2: Decide How You Will Evaluate Your Life

Decide the criteria for how you will evaluate your life. What is truly important to you? Will it be possessions, power, prestige, or prominence? Will it be faith, family, service and relationships? What measure will you use to determine if your life is a success? Be careful, "for where your treasure is, there will your heart be also."[9]A good read for this section is Clayton Christensen, "How Will You Measure your Life."[10]Decide what is important to you, and make that your measure of success so that when you leave this life, as we all will do, you will judge your life a success.

Step 3: Create your Plan for Life, your Personal and Family Goals

Once you have your vision for your life, know what is important to you and where you are financially, it is critical to define your personal and family vision and goals. You will achieve what you set your mind to, and you will accomplish the vision and goals that are important to you. Think of your vision as what you want to do or become, your goals as your destination, and your plans and strategies as what you need to do to create your vision and accomplish your goals.

Once you determine your goals, 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 constraints or obstacles. By identifying the constraints or obstacles early in the analysis and determining how you will avoid them, 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 SMARTER: specific, measurable, achievable, reportable, time-bound, evaluated, and reassessed often. Then, share them with others so they may hold you accountable for your goals.

Step 4: Evaluate Your Financial Health

Evaluating your financial health helps you determine where you are financially. If you do not 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 5: Develop Your Plans and Strategies, Constraints, and Accountability in each of the 15 Areas

Once you have your vision and your goals, you must develop your tactical plans on how you will achieve those goals 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 should the need arise.
- 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. You will develop 16 separate plans for this course. Develop a Saving, Income and Expense Plan (also called a budget) and use it wisely. Plan for big-ticket purchases, such as houses and cars/toys, and develop a plan for being wise in these areas. Plan for managing credit and debt, and remember that debt is the enemy to growth. Decide now what you will go into debt for and what you will not go into debt for. Plan for insurance and protect yourself. Determine and write your Investment Plan and follow that plan on how you will invest your assets for long-term goals. Plan for the expenses of children, including missions and education. Plan for retirement. Plan for how you will give back, your "giving plan." Most importantly, plan your financial future early; then live your plan.

Step 6: Implement Your Plan and Revise as Necessary

Once you have your plan, implement it and begin creating. 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 with which to beat yourself. 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!

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. In this course we will help you do Steps 1 – 4.

Understand How to Catch Your Vision and the Different Types of Goals

Once you have a correct perspective and understand the key doctrines, principles and application, the next step is to catch your vision. Webster's gives four definitions for vision, "the act or power of seeing, something seen in a dream. . . that conveys a revelation, the act or power of imagination, and something seen."[11]

The scriptures teach, "Where there is no vision, the people perish."[12] Vision ranges from the simple effort of observation to the diligent, challenging, and creative work through the power of imagination and the Holy Ghost to thoughtfully visualize and imagine past and future events. But is vision only for prophets? We believe having vision is for all of us.

Why is vision so important? What should we have a vision of, and what will having vision allow us to do? These are important questions that should be answered, especially as vision is necessary before we begin planning, writing, and accomplishing our personal and family goals.

The scriptures encourage us to have a vision for our lives. Paul speaking of the righteousness of the faithful, wrote "These all died in faith, not having received the promises, but having seen [visualized] them afar off, and were persuaded of them, and embraced them, and confessed that they were strangers and pilgrims on the earth."[13] Alma admonished his people to have vision for the future when he asked "Do ye exercise faith in the redemption of him who created you? Do you look forward with an eye of faith [with vision], and view this mortal body raised in immortality, and this corruption raised in incorruption, to stand before God to be judged according to the deeds which have been done in the mortal body?"[14] Ether, sad for the unbelief and lack of vision of his people wrote, "And it came to pass that Ether did prophesy great and marvelous things unto the people, which they did not believe, because they saw [visualized] them not."[15] And later, speaking of the faith of the righteous wrote "And there were many whose faith was so exceedingly strong, even before Christ came, who could not be kept from within the veil, but truly saw with their eyes the things they had beheld with an eye of faith [visualized], and they were glad."[16] Clearly, having a clear vision of what may happen in the future is a skill that many have developed and have used to accomplish great things.

We have been encouraged to develop this skill in our day. M. Russell Ballard said:

> Over the years, I have observed that those who accomplish the most in this world are those with a vision for their lives, with goals to keep them focused on their vision and tactical plans for how to achieve them. Knowing where you are going and how you expect to get there can bring meaning, purpose, and accomplishment to life.[17]

Since we all want meaning, purpose and accomplishment in our lives, we should work to develop that vision for our lives.

Your Vision, Mission and Values Statements

To aid you with catching your vision, we have prepared an assignment to help you work on your vision, mission and values. It may be helpful to put together before you begin working on your goals and plans for your PFP.

Begin your thinking with the Vision, Mission, and Values (VMV) Assignment (LT38). It is simply a tool to help you develop and create each of these statements.

Write your Vision Statement. What is it you want to become? What things do you behold "with an eye of faith"[18] but have not seen yet with your natural eyes. I recommend you separate it into four different perspectives and write a vision statement, like we have done in previous sections, for spiritual, temporal, family, and individual perspectives.

Then work on your Mission statement. What is your life's purpose and passion? You can separate it into the four perspectives if desired. Think through these important questions:

- What is your divine mission?
- Do you have a purpose here on earth?
- What do you want to accomplish before you leave this life?

Finally, work on your values. What values will you live by to help you accomplish your vision and mission? This is only a starting point. You can also include other things such as family mottos, family mission statements, what you stand for, etc. Note that these will change as you think them through and work on them carefully. The Spirit teaches us "line upon line"[19] just as he does the prophets.

Once you have that vision for your life of what you want to become, accomplish and do, the next step is to set goals. If vision is your overall plan, then goals are your intermediate destinations. Ezra Taft Benson spoke on the importance of goals when he 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.[20]

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.[21] 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 philosopher over a century ago said, "We are not human beings having a spiritual experience. We are spiritual beings having a human experience."[22] 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 like the framework by Steven Wheelwright that there are three different types of goals we should be aware of: goals related to identity, integrity, and temporal measures.[23] 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 of divine parentage with "Heavenly Parents."[24]
- We are "all the children of God by faith in Jesus Christ"[25]
- We may be spouses.
- We may be parents to 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:

- Our "divine mission and destiny"[26]
- 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 that 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.

Understanding the different types of goals can help 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 you are not careful, life can easily become an "unending stream of extenuating circumstances."[27] 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:

> 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.[28]

Having balance in the types of goals you set can be helpful in understanding and setting your goals.

Understand and Create your Plan for Life

An important part of your Personal Financial Plan is to plan your life through setting your personal and family goals. Understanding the creative process 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.[29]

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

1. Know Yourself, and Catch Your Vision and Goals

"Where there is no vision, the people perish."[30] What is your vision for your life? M. Russell Ballard said:

> Over the years, I have observed that those who accomplish the most in this world are those with a vision for their lives, with goals to keep them focused on their vision and tactical plans for how to achieve them. Knowing where you are going and how you expect to get there can bring meaning, purpose, and accomplishment to life.[31]

Since we all want meaning, purpose and accomplishment in our lives, what should that vision for our lives entail? Let us share a few ideas on vision: of who you are, of what you can do, of what you can accomplish, and of what God would have you do or become.

Of who we are. Russell M. Nelson said, "Understand who you are in God's plan."[32] Understanding who we are is critical to understanding and having a vision for our lives. "If we are to prosper rather than perish, we must gain a vision of ourselves as the Savior sees us."[33]

The scriptures, prophets and the Holy Ghost remind us that we are of divine parentage with "Heavenly Parents."[34] We are "all the children of God by faith in Jesus Christ,"[35] each "with a divine mission and destiny."[36] Paul reminds us, "And if children, then heirs; heirs of God, and joint-heirs with Christ."[37]

We are literally sons and daughters of a living God, and that opens immense possibilities. How powerful is the statement, "I am a child of God?" The scriptures write of Moses, who being tempted by Satan responded, "Who are thou? For behold, I am a son of God, in the similitude of his Only Begotten."[38] Moses response to all of Satan's temptations was to remind Satan that he knew who he really was, a son of God.

Why is this correct vision of who we are so important? Because it motivates us to improve. Bruce R. McConkie taught, "No doctrine is more basic, no doctrine embraces a greater incentive to personal righteousness . . . as does the wondrous concept that man can be as his Maker."[39] Thomas S. Monson taught, "We are sons and daughters of a living God, in whose image we have been created. Think of that truth: "Created in the image of God." We cannot sincerely hold this conviction without experiencing a profound new sense of strength and power."[40] Donald L. Hallstrom said, "This doctrine is so basic, so oft stated, and so instinctively simple that it can seem to be ordinary, when in reality it is among the most extraordinary knowledge we can obtain. . . Further, it provides continual motivation for us to make and keep our indispensable eternal covenants."[41]

Once we know our identity, it will help motivate us become that vision and accomplish that destiny. Boyd K. Packer wrote,

> You are a child of God. He is the father of your spirit. Spiritually you are of noble birth, the offspring of the King of Heaven. Fix that truth in your mind and hold to it. However many generations in your mortal ancestry, no matter what race or people you represent, the pedigree of your spirit can be written on a single line. You are a child of God![42]

We love the poem my Marianne Williamson that shares the importance of that one single line when she writes,

> Our deepest fear is not that we are inadequate.
> Our deepest fear is that we are powerful beyond measure.
> It is our light, not our darkness, that most frightens us.
> We ask ourselves, who am I to be brilliant, gorgeous, talented; and fabulous?
> Actually, who are you not to be? You are a child of God.
> Your playing small does not serve the world.
> There is nothing enlightened about shrinking so that other people won't feel insecure around you.
> We are all meant to shine, as children do.
> We were born to make manifest the glory of God that is within us.
> It's not just in some of us; it's in everyone.
> And as we let our own light shine, we unconsciously give other people permission to do the same.
> As we are liberated from our own fear, our presence automatically liberates others.[43]

Tad R. Callister related, "I would like to discuss with you a vision of who we are and what we may become. At a recent training session for General Authorities, the question was asked: "How can we help those struggling with pornography [or any challenges in life]? Elder Russell M. Nelson stood and replied, "Teach them their identity and their purpose."[44]

Of what we can do. Some think that in order to believe something they must first see it. The prophet Ether taught us differently; we will see it when we believe it. "And it came to pass that Ether did prophesy great and marvelous things unto the people, which they did not believe, because they saw them not."[45] The people were so hard in their hearts that they could not imagine or visualize these wonderful things happening, so they did not believe that they could happen. Later in that same chapter, Ether shares about other people who believed it first and then saw it. He writes, "And there were many whose faith was so exceedingly strong, even before Christ came, who could not be kept from within the veil, but truly saw with their eyes the things which they had beheld with an eye of faith, and they were glad."[46] As we catch the vision of what we can do, if we will believe it and work toward it, we can see it come to pass.

Tad R. Callister asked, "Why is it so critical to have a correct vision of this divine destiny of godliness of which the scriptures and other witnesses so clearly testify? Because with increased vision comes increased motivation."[47] Not only will it help us understand what we can do, it will help motivate us to become better and to accomplish more of what God and we would have us accomplish.

Of what we want to accomplish. Once we have the vision of who we are and what we can do, our challenge then becomes one of deciding what it is we want out of life. Do you have that vision of what you want out of life so you can set goals to accomplish it? Have you thought about your desires and goals, what you want to accomplish? Have you thought about those things that you will do to make this world a better place, how you will give back? Have you prayed about your desires and goals to make sure they are ones that Heavenly Father would have you accomplish? Have you read and pondered your patriarchal blessing and other blessings and pondered and prayed to understand God's plan for you?

If your vision requires financial considerations, have you thought about how much you will need to save each month to do the things you have planned? Most importantly, are you willing to sacrifice for them? Nelson Mandela said, "Once a person is determined to help themselves, there is nothing that can stop them."[48] As our vision of what we want and want to become increases and becomes more clear, our willingness to set the goals and then do the things necessary to achieve those goals and vision increases as well. I love the poem from Jesse Rittenhouse that says:

> 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.[49]

We will get out of life what we are willing to have a vision for, set a goal for, and then work to achieve. We will not get more than this. Once we have our vision for ourselves, we can then work on setting our goals. Melvin J. Ballard said, "I believe that one important key to happiness is to learn how to set our own goals and establish our own plans within the framework of our Heavenly Father's eternal plan. If we focus on this eternal path, we will inevitably qualify to return to His presence."[50]

Of what God would have us do or become (our divine mission or destiny). Correctly understanding who you are is critical to understanding your destiny and what you can become. The Proclamation on the Family states, "All human beings—male and female, are created in the image of God. Each is a beloved son or daughter of heavenly parents, and, as such, each has a divine nature and destiny."[51] How do we come to know what that divine destiny is?

Tad R. Callister said, "It is this doctrine of identity that defines our potential destiny of godhood. If one does not correctly understand his divine identity, then he will never correctly understand his divine destiny. They are, in truth, inseparable partners."[52]

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.[53]

Russell M. Nelson said,

> Find and fulfill your mortal missions. My dear friends, premortally you and I were each given wonderful missions to fulfill while we are here on earth. We have opportunities to fulfill our mortal missions, but we don't have to. No one will make us. We have our agency to choose how we spend our time and energy, our talents and resources. In fact, what we choose to do is actually part of our testing. The choice is yours and mine. Will we choose to do whatever it takes to fulfill the wonderful missions for which we were sent to earth?[54]

Finding out what Heavenly Father would have us do or become 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."[55]

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.

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 Markets Department of the World Bank, and trying to be a good husband and father. The leader of our local congregation asked me to teach seminary, an early morning scripture study class for high school students each weekday morning at 6 a.m. 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 getting to know those amazing young people, and while I filled this calling, with God's help I was able to complete my PhD program in less than three years.

In addition, as we come to understand who we are, we can be empowered through the enabling power of the atonement of Jesus Christ to accomplish all that God would have us do. David A. Bednar writes:

> I suspect that many Church members are much more familiar with the nature of the redeeming and cleansing power of the Atonement than they are with the strengthening and enabling power. It is one thing to know that Jesus Christ came to earth to die for us—that is fundamental and foundational to the doctrine of Christ. But we also need to appreciate that the Lord desires, through His Atonement and by the power of the Holy Ghost, to live in us—not only to direct us but also to empower us.[56]

Without the vision of knowing who we are, what we can do, what we want to accomplish, and what God would have us do, we cannot set correct and critical goals and then develop those specific plans and actions to accomplish them. Without knowing who we truly are, we cannot know what we can do. Without knowing who we are and what we can do, we cannot we know what we can and are able to accomplish. And without knowing who we are, what we can do, and what we can accomplish, we cannot know our divine destiny--our mission in life. Only with having a correct vision of who we really are, what we can do, what we want to accomplish, and our divine destiny can we truly set the goals and develop the plans that will allow us to bring meaning, purpose, and accomplishment to our lives.

2. Decide How you will Evaluate Your Life

What is your purpose of being here on earth? Why are you here? What are you to do? These are important questions that you must understand.

How will you determine that your life is a success? This too is an important decision. Decide now the criteria that you will live by to determine success, and then strive for it.

Will it be power, prestige, or privilege? Will it be service to your spouse and family? Will it be striving to become like our Savior? How will you plan on judging your life when you are at the end of it? Live so that when you leave for the other side, you will have been successful. Don't lose this critical perspective.

Clayton Christensen shared his metric for judging his life. He wrote:

> This past year I was diagnosed with cancer and faced the possibility that my life would end sooner than I'd planned. Thankfully, it now looks as if I'll be spared. But the experience has given me important insight into my life. I have a pretty clear idea of how my ideas have generated enormous revenue for companies that have used my research; I know I have had a substantial impact. But as I've confronted this disease, it's been interesting to see how unimportant that impact is to me now. I've concluded that the metric by which God will assess my life isn't dollars but the individual people whose lives I've touched. I think that's the way it will work for us all. Don't worry about the level of individual prominence you have achieved; worry about the individuals you have helped become better people. This is my final recommendation: Think about the metric by which your life will be judged, and make a resolution to live every day so that in the end, your life will be judged a success.[57]

3. Seek, Receive, and Act on the Spirit's Guidance

We have been promised to "Ask, and it shall be given you; seek, and ye shall find; knock, and it shall be opened unto you."[58] We were also told to "receive the Holy Ghost"[59] at baptism and given the right to the constant companionship of the Holy Ghost, based on worthiness.

God would love to help us with our vision, goals, and developing plans for achieving those goals. However, we must ask and stay worthy. Personal revelation is critical to seeing who we truly are and setting real personal goals to accomplish our vision. How do you receive revelation for your goals?

The key is acting on the "small and simple things" spoken of by Alma. He said "Now you may suppose that this is foolishness in me; but behold I say unto you, that by small and simple things are great things brought to pass."[60]

What are the "small and simple things?" These are the things that we must do regularly which I believe will bring about great things, even the guidance of the Holy Ghost. These include:

- Scriptures. "Feast upon the words of Christ; for behold, the words of Christ will tell you all things ye should do."[61]

- Sabbath observance and church attendance. "Remember the Sabbath day to keep it holy."[62] "And that thou mayest more fully keep thyself unspotted from the world, thou shalt go to the house of prayer and offer up that sacraments upon my hold day."[63]

- Prayer and fasting. "Also I give unto you a commandment that ye shall continue in prayer and fasting from this time forth."[64] "Search diligently, pray always, and be believing, and all things shall work together for your good" (D&C 90:24).

- Tithing. "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."[65]

- Father's, Priesthood and Patriarchal Blessings. "And again, verily I say, whomsoever you bless I will bless."[66]

- Family history and temple attendance. "Therefore, renounce war and proclaim peace, and seek diligently to turn the hearts of the children to their fathers, and the hearts of the fathers to the children."[67]

God would like to help 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."[68] As we do the "small and simple thing," God will direct our paths.

4. 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 really important to you.

5. Write Your Goals, Plans, Constraints and Accountability with Prayer

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.

6. Make Your Goals SMARTER

We have all heard about SMART goals. Yours should be SMARTER. SMARTER 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 at 5:30 a.m. on Monday, Wednesday and Friday mornings.

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 or to have a savings goal of 20% of your gross income each year saved in retirement or other savings accounts.

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. When we share our goals with others, it increases dramatically our likelihood of working toward them.

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.

E = Evaluated. In the process of goal setting, your goals should be evaluated often. You should judge the effectiveness of the goal and its impact and ability to bring you toward your higher goals often.

R = Reassess. Over time you will need to evaluate your goals and reassess the goal as your situation changes. Goals are written on paper, not in stone. As such, they need to be evaluated and reassessed periodically to make sure you are working toward where you should be working.

7. Review Your Vision and Goals Often – They May Change

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. Generally, setting a specific time each week to work on your goals, i.e., Sunday evenings at 8:30 p.m. is a much better option.

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.

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. 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.[69]

Finding Balance

As we work through the principles of successful goal setting, finding balance among doctrines, principles and application is important in not only deciding what to do, but also in motivating ourselves that the goals are worth working for and working toward. Below are a few ideas for doctrines on which these principles are based.

As we discuss vision and goals, we make an interesting observation that the major principles in determining your vision and goal setting in life relates to stewardship and accountability. This is consistent, considering we are here in mortality to act, and not be acted upon.

From this point on, I will not discuss the doctrines in detail; rather, I will state them and leave them to your own personal study. Although they will not be discussed further in this manual, I strongly recommend you make them a part of your daily study.

Principles	Doctrines
Prepare your life with vision	Identity
Seek, receive, and act on the Spirit's guidance	Obedience
Start with the end in mind	Stewardship
Write down your goals	Accountability
Keep your goals SMARTER	Accountability
Review your goals often as goals may change	Stewardship
Set fun goals	Accountability
Success is measured by striving	Accountability

From Obedience to Consecration

Setting effective goals is not just an activity to be checked off each day; rather, it is part of a lifetime of continual improvement and following the Master. Instead of "we are setting goals," it is,

> We are children of Heavenly Parents (identity), endowed with the ability to act and not just be acted upon (agency), with an understanding of God's plan for our eternal happiness (Plan of Salvation), and striving to live worthy of the Spirit (obedience). Using our God-given talents and abilities (identity), we are living so we can have the guidance of the Spirit (obedience). With that guidance, we can plan our lives with vision (stewardship), use our available resources and talents wisely as we set goals and develop our plans and strategies (accountability), wisely think through our constraints that could keep us from our vision (agency), share that vision with our accountability partners, so that we can accomplish our personal missions in life (Plan of Salvation) and our personal and family vision and goals.

Key Doctrines

If "the answers always are in the doctrines and principles" [70] then to improve our finances and change behavior we must understand those principles and doctrines. Below is a short summary of the key doctrines, which, if understood and confirmed by the Spirit, can help us be better at our finances. We will discuss these here for this chapter only, and in later chapters, we will only share the key doctrines.

Identity**.** The doctrine of identity is who we really are, we are children of God. Identity involves the way we see ourselves, as well as the way we perceive ourselves to be seen by others. Identity is not a concept we are born with; rather, we find our identity through a process that continues throughout our lives.

Questions such as "Who am I?", "Why am I here," or "What is my purpose in life" are critical to understanding and defining ourselves. The scriptures teach we are "all the children of God by faith in Jesus Christ."[71] Paul reminds us, "And if children, then heirs; heirs of God, and joint-heirs with Christ."[72] Bruce R. McConkie said, "No doctrine is more basic, no doctrine embraces a greater incentive to personal righteousness . . . as does the wondrous concept that man can be as his Maker."[73]

The Proclamation on the Family reminds us, "All human beings—male and female—are created in the image of God. Each is a beloved spirit son or daughter of heavenly Parents, and, as such, has a divine nature and destiny."[74] As children of heavenly Parents, we are known by name and loved unconditionally. For God said, "This is my work and my glory—to bring to pass the immortality and eternal life of man."[75]

As children and heirs of all God has, we can accomplish anything that the Lord commands us, including obeying the commandments to live within our means, stay out of debt, and to save. "It is this doctrine of identity that defines our potential destiny of godhood. If one does not correctly understand his divine identity, then he will never correctly understand his divine destiny. They are, in truth, inseparable partners."[76] Russell M. Nelson said, "If the Lord were speaking to you tonight, He would urge you to understand your identity—to know who you really are."[77]

Obedience. The doctrine of obedience is the source of divine guidance and power in our lives. As we choose to obey God's commandments and listen for the promptings of His Spirit, we will be guided in all we do, including our financial choices. Joseph F. Smith said, "Obedience is the first law of heaven."[78] As such, it should be a critical component of our doctrine and understanding.

The scriptures state, "There is a law, irrevocably decreed in heaven before the foundations of this world, upon which all blessings are predicated—And when we obtain any blessing from God, it is by obedience to that law upon which it is predicated."[79] Blessings are predicated or built upon our obedience. When we fail to obey the commandments or sin, "this eventually, but invariably, leads to diminished happiness and forfeited blessings."[80]

Obedience is a misunderstood doctrine. Spencer W Kimball said, "The very first thing before beginning our world here, the Lord said, 'I'm going to give you your . . . agency. I want men and women that are strong because it is right to be strong. I don't want weaklings who are righteous only because they have to be righteous.'"[81] Dale G. Renlund reaffirmed this when he said,

> Our Heavenly Father's goal in parenting is not to have His children do what is right; it is to have His children choose to do what is right and ultimately become like Him. If He simply wanted us to be obedient, He would use immediate rewards and punishments to influence our behaviors. But God is not interested in His children just becoming trained and obedient "pets" who will not chew on His slippers in the celestial living room. No, God wants His children to grow up spiritually and join Him in the family business.[82]

Stewardship. The doctrine of stewardship states that we are all the Lord's stewards over the things we have and are. We are the Lord's hands here on earth, and are not to be "commanded in all things."[83] We are to "make use of the means the Lord has provided"[84] in accomplishing our finances and other challenges. As His stewards, we need to be wise in how we spend the time and resources in our care. We are counseled to "not spend money for that which is of no worth, nor your labor for that which cannot satisfy."[85] We need to understand those things of eternal and true value and work toward them.

There are great blessings promised to wise stewards. "And whoso is found a faithful, a just, and a wise steward shall enter into the joy of his Lord, and shall inherit eternal life."[86] "And he that is a faithful and wise steward shall inherit all things."[87] Surely this is a wonderful doctrine and a key to our understanding and being wise stewards over our blessings.

Agency. Agency is "the ability and privilege God gives people to choose and to act for themselves."[88] The Lord said, "Behold, I gave unto him [men and women] that he should be an agent unto himself."[89] The prophet Joshua wrote, "And if it seem evil unto you to serve the Lord, choose you this day whom ye will serve; . . . but as for me and my house, we will serve the Lord."[90] As we serve the Lord, we become more like Him.

When we were created spiritually, we were given knowledge, and in the Garden, we were given our agency. "The Lord said unto Enoch: Behold these thy brethren; they are the workmanship of mine own hands, and I gave unto them their knowledge, in the day I created them; and in the Garden of Eden, gave I unto man his agency."[91]

As we come to understand agency, we will learn that we must use it correctly or we will lose it. We can choose to take drugs and alcohol, but the coming addictions reduce our agency in the future, especially our agency to choose what we want to do and become. We can choose to disobey the law of chastity, but the coming guilt, disease, and broken relationships limit our choices later, including our chance for an eternal family. We can choose to not live on a budget, but the coming lack of savings for future needs such as missions, education and retirement cannot be avoided. There are consequences to our choices. Perhaps that is why the Lord reminds us to take an eternal perspective when He said: "Hearken ye to these words. . . *Treasure these things up in your hearts, and let the solemnities of eternity rest upon your minds*."[92]

Accountability. The doctrine of accountability is how we are accountable to God for our choices. The second Article of Faith reminds us that, "We believe that men will be punished for their own sins, and not for Adam's transgression.[93] The Apostle John understood ultimate accountability and wrote, "And I saw the dead, small and great, stand before God; and the books were opened: and another book was opened, which is the book of life: and the dead were judged out of those things which were written in the books, according to their works."[94]

Alma expands our understanding about accountability when he taught, "For our words will condemn us, yea, all our works [including how we manage our finances] will condemn us; we shall not be found spotless; and our thoughts will also condemn us."[95]

The Lord said to the Prophet Joseph, "It is wisdom in me; therefore, a commandment I give unto you, that ye shall organize yourselves and appoint every man his stewardship; That every man may give an account unto me of the stewardship which is appointed unto him."[96]

David A. Bednar reminds us that "The gospel is so much more than a routine checklist of discrete tasks to be performed; rather, it is a magnificent tapestry of truth "fitly framed"[97] and woven together, designed to help us become like our Heavenly Father and the Lord Jesus Christ, even partakers of the divine nature."[98]

Summary

We have been counseled to plan our financial futures early then follow the plan. We cannot do

this unless we have a plan in place. This chapter has discussed a process for doing just that.

We used the learning framework of principles, doctrines and application to approach how we approach planning our financial future. We are not just planning our financial future, we are

> Children of God with a divine mission and destiny (identity), agents unto ourselves, to act and not be acted upon (agency). We are here on this earth not by chance but by choice (Plan of Salvation), and we use our agency wisely as we plan for the future and anticipate future constraints (agency). We plan effectively to show we are wise stewards over all God has or will bless us with (stewardship), and we use these things to accomplish our individual and family vision and goals.

Since personal finance is simply part of the gospel of Jesus Christ, our ultimate goal then is to show, with every dollar we spend, that we have chosen to take an eternal perspective rather than the world's materialistic perspective.

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. Know yourself, and create your vision and goals.
2. Decide how you will evaluate your life.
3. Seek, receive and act on the Spirit's guidance.
4. Start with the end in mind.
5. Write your goals, plans, constraints and accountability with prayer.
6. Make your goals SMARTER.
7. Review your goals often--your goals may change.
8. Have some fun goals.
9. Remember, success is not measured by achievement, but by striving.

We shared the doctrines behind effective goal setting, and how by taking a principles and doctrines approach, we can go from obedience to consecration.

As you develop your Personal Financial Plan, think about your future. Catch your vision of what you want to accomplish in every aspect of your life—not just the financial aspects. Think about how you will measure your life, and don't let others decide the grading criteria for a successful life for you. Put thought and prayer into it. Write your vision in great detail and then your 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. Then determine what things could keep you from accomplishing your goals, your constraints, and determine how you will avoid these roadblocks. Finally, determine who you will share your vision and goals with, your accountability partners. These can be great motivators to help you accomplish your vision and goals.

Assignments

Financial Plan Assignments

Get a standard binder with a clear cover. Generally, 1½ to 2 inches is fine. I prefer a three hole punch, but whatever is available is fine. We would prefer a new binder, as this is a new plan.

Make this binder yours. Get a family picture or one of you doing something you enjoy and put it on the cover. Personalize this binder with a heading, i.e. "Personal Financial Plan of . . . . " and put your name. Print out your PFP Table of Contents (Roadmap) (TT01), which is a summary of all the sections your PFP will include. As you review this Roadmap, print out PFP Binder Tabs, 16 tabs for each of the 16 sections of this Roadmap. Label the tabs, and we prefer printed and not hand-written or numbered tabs (Avery 11453, 11417, or 23285 printable tabs are good, inexpensive and easy to use).

As you work on your PFP, I would download the PFP Vision and Goals Template (LT01-02). This will help you as you put this section together.

Vision and Goals. Next, think through your vision, goals, and your plans for accomplishing your vision and goals. 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 vision, goals and plans 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."[99] Be very specific with the vision and goals you set.

As a help, start with your Vision, Mission and Values Statement assignment (LT 38). This is not an easy or simple assignment, so don't expect to have it done in a few hours. Think about your vision for your life. Who are you? What do you see in your mind's eye? What do you want to accomplish?

Start with your vision in the four key areas: spiritual, temporal, family and individual. There are various parts of that assignment that can help you determine your vision for your life.

As you work on your vision, bring in the Lord to help expand your mind. The scriptures remind us "Behold I am Jesus Christ, the Savior of the world. Treasure these things up in your hearts, and let the solemnities of eternity rest upon your minds."[100] Once you have your vision, then think what your goals should be to create that vision. Recognize the many different ways to organize your goals. 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 plan, 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 the vision of what you planned to be.

Along with your goals, think about how you will judge your life to be a success. Will your criteria for success be money, fame, position or power? What will it be? This is critical as you do not want to get to the end of your life and find you were chasing the wrong things?

Next, answer the question: What do you think God wants you to do or become? The challenge 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. Learning about your mission will be a lifetime activity.

Next, 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:

Complete Personal Financial Plan (LT2A–2017)
Complete Personal Financial Plan (LT2C–2012)

These are examples of completed Personal Financial Plans. They includes an example of vision and goals from students who took this course previously. There are many more on the website at www.personalfinance.byu.edu, and Learning Tools.

Vision, Mission and Values Assignment (LT38)

This assignment is to help you put together your Vision, Mission and Values statement as a tool to help you determine your vision, goals and tactical plans.

Review Materials

Terminology Review

Action Plan. This is your plan to accomplish our individual and family goals.
Financial Planning. This is the process of helping yourself and others to use their resources more wisely to achieve their personal and family goals. It should help determine where you are, where you want to be, and how you will get there.
Goals. These are things we would like to accomplish. They are often divided by time, i.e., short-term, in the next 12 months; medium-term, from 2-10 years; and long-term, beyond 10 years. They may also be divided by type, i.e., identity, integrity, and temporal goals. They will take effort and resources, but are things that are important to us and are

what we want to accomplish.

Identity goals. These are goals that relate to your long-term view of who you are and how you see yourself. These goals help you be better in your long-term view of who you are and what you want to become.

Integrity goals. 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 and live, what we will and will not do, and characteristics and skills we wish to attain.

Mission Statement. This can be your individual and family purpose and passion. It can also include other things such as family mottos, family mission statements, what you stand for, etc.

Personal Financial Plan. This is a document that contains all critical areas of your personal financial life. It is your individual and personal roadmap for achieving your personal and family goals. It entails 6 steps: 1: Decide What You Want, 2: Evaluate Your Financial Health, 3: Define your Personal and Financial Goals, 4: Develop a Plan of Action, 5: Implement Your Plan, and 6: Revise Your Plan as Necessary.

Real Goals. These are goals you really want to accomplish, and are willing to work hard and seek Heavenly Father's help in accomplishing them.

SMARTER Goals. SMARTER is an acronym for helping you as you strive to set effective goals. It is: S = specific, M = measurable, A = assignable, R = realistic, T = time-bound, E = evaluated, and R = reassessed.

Temporal Goals. These are goals that relate to the temporal measures of success. It could be money, title, fame, positions at work or in industry, include influence, rank or power, or assets, investments, or possessions.

Values Statement. These are the values you will live by to help you accomplish your vision and mission.

Vision Statement. This is your vision of what you want to become. It is seeing or visualizing with your mind's eye what you will be in the future. It is often divided into four areas depending on four different perspectives: spiritual, temporal, family and individual.

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 vision, 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 are "some of the dangers of not setting goals?"

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[2] "The Word Is Commitment," *Ensign*, Nov. 1983, 61.

[3] Bednar, p. 170.
[4] Ezra Taft Benson, "To the Elderly in the Church," *Ensign*, Nov. 1989, 4, italics added.
[5] Ibid.
[6] Anonymous.
[7] Tad R. Callister, "Our Identity and our Destiny," BYU Speeches, Aug. 14, 2012.
[8] Galatians 3:26.
[9] Matt 6:21.
[10] Clayton Christensen, "How Will You Measure your Life," Harvard Business Review HBR.org, July–August 2010.
[11] Webster's Online Dictionary at https://www.merriam-webster.com/dictionary/vision.
[12] Proverbs 29:18.
[13] Hebrews 11:13.
[14] Alma 5:15.
[15] Ether 12:5.
[16] Ether 12:19.
[17] M. Russell Ballard, "Return and Receive," General Conference Afternoon Session, April 2017.
[18] Ether 12:19.
[19] 2 Nephi 28:30.
[20] Ezra Taft Benson, "Do Not Despair," *Ensign*, Nov. 1974, 65.
[21] Moses 1:39.
[22] Pierre Teilhard de Chardin.
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[24] Gordon B. Hinckley, "Proclamation on the Family," 1995
[25] Gal. 3:26.
[26] Gordon B. Hinckley, "Proclamation on the Family," 1995.
[27] Clayton M. Christensen, "How Will You Measure Your Life," *Harvard Business Review*, July-August 2010.
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[29] *Preach My Gospel*, Intellectual Reserve, Inc., 2004, 146, italics added.
[30] Proverbs 29:18.
[31] M. Russell Ballard, "Return and Receive," *Ensign*, May 2017.
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[35] Gal. 3:26.
[36] Gordon B. Hinckley, "The Family: A Proclamation to the World," *Ensign*, November 1995.
[37] Romans 8:17.
[38] Moses 1:13-16.
[39] Bruce R. McConkie, *The Promised Messiah: The First Coming of Christ* (Salt Lake City: Deseret Book, 1978), 133.
[40] Thomas S. Monson, "Canaries with Gray on Their Wings," Ensign or Liahona, June 2010, 4; emphasis added.
[41] Donald L. Hallstrom, "I am a Child of God," *Ensign*, May 2016.
[42] Boyd K. Packer, "To Young Women and Men," *Ensign*, May 1989, 54.
[43] Marianne Williamson, *A Return to Love: Reflections on the Principles of a Course in Miracles*, Harper Collins, 1992, pp. 190-191.
[44] Tad R. Callister, "Our Identity and our Destiny," BYU Speeches, Aug. 14, 2012.
[45] Ether 12:5.
[46] Ether 12:19.
[47] Ted R. Callister, "The Power in the Priesthood in the Boy," *Ensign*, May 2013.
[48] Nelson Mandela.
[49] Quoted in *Think and Grow Rich*, Napoleon Hill, 1960, p. 40.
[50] M. Russell Ballard, "Return and Receive," General Conference Afternoon Session, April 2017.
[51] Gordon B. Hinckley, "Proclamation on the Family," 1995
[52] Tad R. Callister, "Our Identity and Our Destiny," BYU Speeches, Aug. 14, 2012.
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[58] Luke 11:9.

[59] 2 Nephi 31:13.
[60] Alma 37:6.
[61] 2 Nephi 37:2.
[62] Exodus 20:8.
[63] D&C 59:9.
[64] D&C 88:76.
[65] D&C 64:23.
[66] D&C 132:47.
[67] D&C 98:16.
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[72] Romans 8:17.
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[74] Spencer W. Kimball, "The Family: A Proclamation to the World," 1995.
[75] Moses 1:39.
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3. Saving, Income and Expense Planning: Giving Every Dollar a Name

Introduction

Once you have a correct perspective on wealth, have begun your Personal Financial Plan, and have set your personal vision and 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 understand financial record keeping, 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:

A. Understand family record keeping.
B. Understand the principles, methods and levels of successful saving, income and expense planning (budgeting) and its methods and process.
C. Calculate your net worth using a personal balance sheet.
D. Develop a personal income statement and use ratios to analyze your spending.
E. Understand and create your Saving, Income and Expense Plans (budget).

To determine where you are financially, you must first understand record keeping. There are many different types of records that should be kept. Some should be kept for a short period of time, others longer, and others indefinitely. Moreover, there are records that should be constantly updated for operating, tax and planning purposes.

Key records include several different kinds of financial statements. A saving, income and

expense plan records expected saving, income and expenses for the future, generally for a month or a year. I like saving, income and expense planning better than simply budgeting, as it emphasizes the importance of planning not only expenses, but saving and income as well. However, due to the universal use of the term budgeting, I will use them interchangeably.

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 future spending, a balance sheet is a record of your spending (as represented by your assets and liabilities) as of the present time, and an income statement is a record of your past spending.

Public companies are required by law to prepare financial statements, and most do so monthly. Successfully companies use financial statements to determine how to manage themselves better, so as to achieve their shareholders' goals and objectives. Similarly, individuals and families can use financial statements to their advantage to help them understand where they are financially and to help them meet their vision and goals.

Understand Family Record Keeping

In planning, budgeting and measuring your financial health, record keeping is critical. Different records should be kept for different periods of time. Certain records should be kept forever, others should be keep forever and updated as needed, others should be kept as long as the contract is in force or you are the owner, others should be saved for at least 7 years, and all records should be stored carefully.

Records to Update and Keep Forever

Records you keep forever include Advance Directives (living wills, wills, and advance healthcare directives); family and personal journals; family and personal photos, videos, audio recordings; household inventory (via video); life histories (Family Search); password lists; Powers of Attorney; safe deposit box inventory (if you have one); and your Social Security statement (for the current year).

Records to Keep as Long as in Force or You are the Owner

Records to keep as long as you are the owner include any contracts; home purchase and improvement records; life insurance policies; loan documents; real estate deeds; receipts for items under warranty; receipts for large purchases (and for tax purposes); service contracts and warranties; stock and bond certificates (if you still have these); vehicle titles; vaccination records and wills.

Records you save for at least 7 years

Records you save for 7 years includes anything that could be used in an I.R.S. audit; tax deductible receipts (e.g., end-of-year contribution receipt given to you by ward clerk); Donations-in-Kind receipts; donation receipts from Deseret Industries; access to bank statements, brokerage accounts, and credit card statements; medical receipts; W-2 forms; and any other documents for deductions.

Where Should you Store Your Records?

Storage is an important topic. For valuables, a safe deposit box; for less valuable but important items a fireproof storage safe; digital copies with cloud back up for secure online storage; and multiple hard copies to relatives (copies to executor of the estate). The key is that if it is not replaceable, have a copy somewhere else!

Understand the Principles of Successful Saving, Income and Expense Planning

In this manual, we talk of saving, income and expense planning and budgeting interchangeably. The reason we emphasize saving, income and expense planning is that too many people, when they think of budgeting, think only of recording their expenses—they leave out two critical parts. Saving and income planning are also important areas for everyone to consider.

For most individuals, using a saving, income and expense plan 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. In addition to keeping a record of expected saving, 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 create your saving, income and expense plans, it takes discipline and sacrifice to actually follow through on the plans you outlined. While not easy, the results are apparent. Research has shown that those who effectively budget accumulate more wealth than those who do not.

Savings Planning

Much has been written on the importance of saving for retirement and other long-term goals. While we have been counseled to save, the recommend percentage remains elusive. L. Tom Perry said:

> 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."[1]

There's a lot of debate about "the magic number" used to describe how much money you need to save of your income to live a financially comfortable retirement. It is an individual decision as a financially comfortable retirement means different things to different people. However, few people have complained when they have too much money at retirement.

As a starting point in this book, I recommend to students and others that they save 20% of gross income, with 15% allocated for retirement and the remainder for other long-term goals. As you go through this course, you will see additional reasons to support this percentage. For additional support, see How Much Should I Save: Insights into the Recommended 20%. Regardless of your chosen percentage, the principle is to get and stay in the habit of saving each month.

There are many ways we can increase our savings, which is the difference between our income and our expenses. For starters, the purpose of a budget is to help you save, not just record your expenses. Do not make the mistake of not having a saving plan or strategy.[2] For many, a key is getting the company match from a 401k or 403b retirement plan. With a majority of company retirement plans, if employees will save a specific percentage, i.e., 6%, the company will match that with a specific amount, i.e., 4%. Your total savings is your contribution plus the company match.

Income Planning

Income planning is where we plan for our income, which will likely not be static. We should be continually improving and getting better at whatever we choose to do, and our income will likely increase as well. Change and improvement are part of the gospel of Jesus Christ. I like to think of repentance as "continual improvement."

There are many ways for income planning and increasing our income. Examples include:

- Increased education, i.e., associates, bachelors, masters degrees, etc. and increased certification, i.e., Certified Public Accountant (CPA), Certified Financial Planner (CFP), Chartered Financial Analyst (CFA), etc. These should tie into your Education Plan which we will discuss later in the course.
- Increased ability to do the job better, through spending time with more experienced workers who have been there longer and understand the process better.
- Increased ability to work faster, through thought, automation and computerization.
- Improved attitude and an ability to motivate our coworkers.
- We should be praying daily that we can "work beyond our natural abilities" and that we can "work as one" with others.
- Improved willingness to "go the extra mile" and do more than what is expected.
- Improving our job resume to help us be more attractive to other employers.
- Keeping our attitude positive and remembering "your boss wants to give you a raise." You just need to show them why they should do it and continue getting better at what you do.

Expense Planning

Having an expense strategy is critical to saving and accomplishing your goals. It is not only the process of recording what you spend, but also planning your spending and striving to reduce your expenses. Ideas include:

- I will record every dollar that I earn and spend.
- I will minimize fixed expenses, and keep them low.
- I will only spend on things in my SIE Plan.
- I will ensure the cares of the world will not impact spending and hence reduced saving.
- I will have patience and save for purchases instead of going into debt.
- I will not make large purchases that are not in our SIE Plan and not without prayer and fasting.
- I will not sell my birthright for a mess of pottage.

Principles

With our learning framework, we start with principles. The principles of effective saving, income and expense planning are simple:

1. Know yourself. This includes understanding your vision, goals, and plans. These have to be important for you if you want to work toward them. What do you want out of life? What are you willing to do to accomplish it?

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, and living worthy of the Spirit's guidance and then acting on it once it is received.

3. **Understand key areas of saving, income and expenses**. Understand each of these three key areas, and become proficient at each. Become a wise consumer that if focused on your vision and goals.

4. Have a saving strategy--spend less than you earn. Someone said, "if you find yourself in a hole, stop digging."[3] It is critical to understand that a wise steward does not spend more than they earn, and will save for future expenses.

5. Keep good records for spending, taxes, and other purposes. These will be needed to help you minimize your tax payments to the government.

6. Use a budgeting method that meets your individual and family needs and objectives. There is not one "right way" to budget.

7. Eliminate (unproductive) consumer debt and minimize (productive) mortgage and education debt. As discussed earlier, debt is an enemy to growth.

Doctrines

As shared earlier, once you have the principles, the next step is to determine the doctrines that go with those principles. Here are a few ideas.

Principles	Doctrines
Know yourself, your vision and goals	Identity
Seek, receive, and act on the Spirit's guidance	Obedience
Understand key areas of budgeting	Agency
Save-spend less than you earn	Stewardship
Keep good records for spending, taxes, etc.	Stewardship
Use a method that meets your needs	Accountability
Eliminate unproductive debt	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just living on a budget, which is an application,

> We are children of Heavenly parents with an unlimited potential (identity); striving to live worthy of the Spirit (obedience) and being wise stewards over the things that God has blessed us with (stewardship); and keeping good records, so we can minimize our payments to the Government (accountability). We are using a method that most meets our needs (accountability), so we can do it as quickly and as accurately as we can (stewardship); so we can accomplish what God would have us do, including attaining our personal mission and our individual and family and vision goals.

Saving, Income and Expense Methods and Process

There are five main types of SIE budgeting methods to help meet your needs and objectives. There are different requirements for each method. Whatever method you choose, it should accomplish the above five principles.

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

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 significantly 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. You also determine your savings and budget each period for savings. The key is to work within your budget for each spending and saving 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.

In summary, budgeting is a broad term that can mean different things to different people. It is simply income and expense planning. A budget is more than a record of your income and expenses—it's a tool to help you accomplish your vision, goals and plans. However, too many use budgets for record keeping and nothing else. That is not a budget--it is an income statement—which is a record of your spending.

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

1. Are low cost and relatively easy to use;
2. Allows downloading of bills from banks and credit card companies—it makes data entry easier;

3. Allows adequate categorization of spending for income, spending, reporting and tax purposes; and
4. Minimizes 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. As record keeping helps, what I recommend for most individuals and families is Mint.com for those starting out (they use military grade encryption so they are very safe), spreadsheets for the few Excel wizards among us, and Quicken for more advanced users.

There is a process to creating an effective saving, income and expense plan or budget:

1. Know what you want to accomplish.
2. Track your income, saving and expenses.
3. Develop a cash saving, income and expense plan.
4. Implement your plans for saving, income and expenses.
5. Compare your actual income to planned, actual expenses to planned, actual saving to planned, and make changes where necessary to achieve your goals.

An example of a saving, income and expense plan is found in Chart 1. In addition, examples of more detailed budgeting spreadsheets can be found in the Learning Tools section of the website.

Chart 1. Monthly Saving, Income and Expense Plan

Monthly Plan for the Month of _____ 20XX

Income:	Budget	Actual	Difference
Wages/Salaries (After Taxes)	_____	_____	_____
Other Income	_____	_____	_____
Total Income	_____	_____	_____
Expenditures			
Tithes and Offerings	_____	_____	_____
Total Savings	_____	_____	_____
Food	_____	_____	_____
Mortgage or Rent	_____	_____	_____
Utilities	_____	_____	_____
Transportation	_____	_____	_____
Debt Payments	_____	_____	_____
Insurance	_____	_____	_____
Medical	_____	_____	_____
Clothing	_____	_____	_____
Other	_____	_____	_____
Total Expenditures	_____	_____	_____

Income minus Expenditures _____ _____ _____

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.

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 your vision and goals. In the previous section, you thought about what you wanted out of life, and you wrote down your vision and 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 SMARTER: specific, measurable, achievable, reportable, time-bound, evaluated, and reassessed.

Step 2: Track your Saving, Income and Expenses

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

Budgeting software may also be helpful as you track your expenses. Software such as Quicken, YNAB, 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.

Step 3: Develop a Cash Saving, Income and Expense Plan (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.

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, a cell phone 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.[4]

The Old Way. 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. The old method for preparing a cash budget is found in Chart 2. I recommend a different pattern.

The Better Way. After you have paid your tithes and offerings to the Lord, *pay yourself a predetermined amount directly into savings* and then budget and live on the remaining income. Using this pattern will help you keep your priorities in order (see Chart 3). 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.[5]

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 vision and goals.

Chart 2. Budgeting: The Old Way

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.[6]

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.

Step 4: Implement Your Saving, Income and Expense Plan

The fourth step in creating an effective income and expense plan is to try it 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 3. Budgeting: The Better Way

Chart 4. Saving, Income and Expense Plan Example with Differences

Bill and Suzy Smith
Monthly Budget for the Month of September 20XX

Income:	Budget	Actual	Difference
Wages	2,875	2,760	-115
Taxes	375	360	15
Wages/Salaries (After Taxes)	2,500	2,400	100
Other Income	200	250	50
Total Income	2,700	2,650	-50
Expenditures			
Tithes and Offerings	325	318	-7
Total Savings	405	398	-7
Monthly Living Expenditures			
Food	300	320	20
Mortgage or Rent	700	700	0
Utilities	300	325	25
Transportation	180	165	-15
Debt Payments	50	50	0
Insurance	150	150	0
Medical	40	40	0
Clothing	150	100	-50
Other	100	75	-25
Monthly Living Expenditures	1,970	1,925	-45
Total Expenditures	2,700	2,641	-59

Total Income minus Expenditures	0	9	-9

For income and taxes, 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*.[7]

Step 5: Compare Your Actual Saving, Income and Expenses to Plan and Make Changes Where Necessary

The fifth step in creating an effective budget is to compare your budget to your actual income, saving and 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.

I recommend, after you have your budget, actual and differences, that you look over those differences and try to understand why. This is where the learning takes place. It is not enough to just record and categorize the data, you must use it to make decisions and to be better stewards.

Creating a Saving, Income and Expense Plan 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 Budget, Balance Sheet and Income Statements template (LT04) and Balance Sheet and Ratios (LT04B).

Chart 5. Balance Sheet Example

Bill and Suzy Smith
Balance Sheet as of: March 15, 20XX

Assets:	Amount	Liabilities:	Amount
Current (or Monetary) Assets		Current Liabilities	
Cash and Checking	$1,000	Current Unpaid Balances	$200
Savings/CDs	5,000	Visa/MasterCard	500
Other Assets	0		
Investments			
Stocks/Bonds	0	Long-Term Liabilities	
Mutual Funds	2,500	Mortgage Loan	0
Other Investments	0	Auto Loans	500
Retirement Plans		College Loans	3,000
401(k), 403b, 457 Plans	1,200	Other Debts	0
IRAs	500		
Housing			
Primary Residence	0		
Automobiles			
Automobiles	3,500	Total Liabilities	4,200
Personal Property			
Misc. Assets	750		
Total Assets	$14,450		

Net Worth (Assets minus Liabilities) $10,250

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.

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.

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 intermediate- 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.

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.

Chart 6. Income Statement Example, Bill and Suzy Smith

Monthly Income Statement
for the Month of January, 201X

Income:	Actual
Wages/Salaries (After Taxes)	2,400
Other Income	250
Income Available for Living Expenses	2,650
Expenditures for Donations/Savings	
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

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!

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!

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?

Develop a Personal Income Statement and Use Ratios 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.

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, 401k 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. They will help you understand where you are financially. To answer these questions you will calculate six financial ratios.

To answer these questions, all it takes is a balance sheet and five pieces of information

1. How much are you saving each period?
2. How much are your period living expenses?
3. What is your period income less taxes?
4. How much are your period long-term debt payments?
5. What is your gross period income?

A useful tool to help you calculate your six financial ratios is Balance Sheet and Ratios (LT04B). Your period can be either monthly or annually. These questions and ratios can tell you much about how well you are doing financially.

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.

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.

Understand and Create Your Saving, Income and Expense Plan

In creating your Saving, Income and Expense plans, there are two parts, the framework and the data. The framework is in the traditional form, with your vision and goals. The data can be in any of the means discussed, as long as it includes planned, actual and differences.

There are also short-term monthly or weekly, and long-term annual plans. Both are important for your lives and finances. Following are a few ideas that may be helpful as you create your own Plans.

Vision

- This should be from your "Plan for Life." Other ideas include:
    - Through proper use of my financial resources, I will have sufficient to accomplish my individual mission and our individual and family vision and goals
    - We will save 20% gross after college, and will save it for retirement, education, missions and other goals.

Goals

- Savings. I will keep monthly records of my saving, income and expenses, along with a 1 year annual plan.
- I will not purchase anything major unless it is in my SIE Plan.
- Income. I will grow my income by 1% above inflation through hard work and careful study and prayer.
- I will work to be the best employee I can be, and I will pray daily that I can work beyond my natural abilities.

- Expenses. I will be a wise steward over the resources I have been given.
- I will never spend more than $20 (or whatever amount you determine) without my spouse's approval.

Plans and Strategies

Savings

- I will always pay the Lord first and myself second.
- I will always get the company match.
- I will save 20% of income, 15% for retirement, 2% for children's missions/education, and 3% mortgage.
- I will have specific bank accounts for specific goals and children.
- I will start saving in Roth accounts as soon as possible.

Income

- I will get as much education as I possibly can.
- I will work on gaining accreditation (CFA, CFP, CPA) to keep me more marketable in my field.
- I will read 2 books a month in my area of work.
- I will pray each day to work beyond my natural abilities so I can be more effective at work and so my employer will want to pay me more to keep me.
- I will find additional ways to make money for my family.
- I will continue to network in my area of expertise.
- I will keep my resume current and improve it dail.y

Expenses

- I will live cheap.
- I will carefully divide my expenses into fixed (those that cannot be changed except over long periods) and variable expenses.
- I will try to limit my fixed expenses by not going into debt.
- If married, we will discuss any spending over $50 before we make the purchase.
- I will not buy anything that is not included in my annual Saving, Income and Expense Plan.
- I will barter for services with others in our same financial condition, i.e., trade babysitting, etc.
- I will remember that happiness is not bought with money.

Constraints

- Loss of the Spirit will cause me to lose perspective on what is really important in life.
- Focusing on the things of the world instead of what is really important.
- Being impatient and not saving for big-ticket purchases can have a significant negative effect.
- Not being careful with the little things, the pennies, can have a major impact.

Accountability

- I will share my vision, goals and plans and strategies with God and my spouse and children.

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 and keep important family records. Family record keeping is important if you are to do better financially and if you want to minimize your tax payments to the government.

Of these financial statements, the most important is your budget or income and expense plan. 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. Living on a budget and saving is the single biggest contributor and constraint to individuals and families achieving their financial and other goals.

In this chapter, I have recommended a "better 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 (I recommend 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.[8]

Assignments

Financial Plan Assignments

While the previous chapter helped you determine your vision and where you wanted to be, this chapter helps you see where you are right now. Financial statements help you understand your current financial position. I recommend you use the PFP Financial Statements Template (LT01-03) to put together your Saving, Income and Expense Plan and prepare your financial statements.

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 income and expense plan or 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 give every dollar a name and plan where your money should go and then see that you follow your plan.

Your budget is a record of your planned expenses, your actual expenses, and the difference. One possible spreadsheet is the Simple Saving, Income and Expense Plan Spreadsheet (LT04C) or the more detailed Budget, Balance Sheet and Income Statements template (LT04). Your budget is your spreadsheet that documents your planned, actual and differences in your saving, income and expenses. Your budget template is where the thinking and analysis takes place. What did you do well during the month? Where did you do poorly and why? It is not enough to just record your expenses and income. You must use that information to be a better steward.

You can use any of the first four useful methods (sorry but the DNAH-ial method is no longer useful). We encourage you to use programs such as Mint.com or Quicken, or spreadsheet programs such as Simple Saving, Income and Expense Plan Spreadsheet (LT04C), Budget, Balance Sheets, and Income Statements (LT04), Debt Free Planning Spending Spreadsheet (LT31) or one you prepare yourself. Start by determining the categories for your spending, such as Auto, Charity, Education, Family Activities, Gifts, Groceries, Household, Insurance, Investments, Kids, Lunches, Medical, Tax, Utilities, Vacation, etc. Then have your days in a specific column, which sum to your total. The key columns are your budget, your actual (also called your income statement), and the difference.

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? A useful tool to help you calculate your financial ratios is Balance Sheet and Ratios (LT04B). You can use monthly or annually for your period, although I recommend monthly.

After you have put together your balance sheet, it only takes 5 pieces of information to calculate your ratios.

Learning Tools

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

Simple Saving, Income and Expense Plan Spreadsheet (LT04C)
This is the most simple of the excel budgeting spreadsheets on the website.

Budget, Balance Sheet and Income Statements template (LT04)
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.

Balance Sheet and Ratios (LT04B)
This tool helps you create your balance sheet and key financial ratios. With five additional pieces of information from your income statement, you can calculate your six key ratios to help you understand how you are doing financially.

Debt Free Planned Spending Spreadsheet (LT31A)
This is a very detailed excel spreadsheet that includes a one-year budget. It also includes Debt Free Planned Spending Instructions (LT31B) for putting this together.

Financial Calculator Tutorial (LT03)
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.

Excel Financial Calculator (LT12)
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

Terminology Review

60% Solution Budgeting Method. A process of budgeting where you determine your gross salary each month, take 60% of that amount and only spend that amount each month. Do not spend beyond that amount. This leaves 20% of your salary for long-term goals and 20% of your salary for taxes at year-end.

Appreciating Assets. These are assets which may or which have historically appreciated in value.

Assets. These are things that you own that have value.

Automobiles and Other Vehicles. These are depreciating assets, such as cars, trucks, and RVs that normally must be inspected and licensed.

Balance Sheet (personal). This is a financial snapshot of your financial position on a given date.
Budgeting Process. These are the steps you take to create your budget. It includes: 1. Know what you want to accomplish, 2. Track your spending (your expenses), 3. Develop your cash budget, 4. Implement your budget, 5. Compare it to actual expenses, then make changes where necessary to achieve your goals.
Budgeting the Better Way. This is a budgeting process where you pay the Lord first, and yourself second, then pay your bills. This makes paying yourself a higher priority.
Budgeting the Old Way. This is a budgeting process where whatever was left at the end of the month went into savings. The challenge is that there is never anything left at the end of the month.
Computer Software Budgeting Method. This process uses commercially available budgeting software such as such as Mint.com (free), Quicken, Mvelopes, or others. Determine your gross salary and take home each month after taxes and other deductions, determine spending by category, and budget each category. Work to within your budget for each spending category. You will obtain receipts and credit card information directly via internet from financial institutions.
Current ratio. This is your monetary assets divided by your current liabilities. This ratio tells you how many times you could pay off your current liabilities with your liquid cash on hand.
Debt ratio. This is your total liabilities divided by your total assets. This ratio tells you whether you could pay off all your liabilities if you liquidated all your assets. This represents the percentage of your assets financed with borrowing.
Depreciating Assets. These are assets which depreciate. Often, the minute you take ownership of these assets, i.e. drive these assets off the car lot, they drop in value.
DNAH-ial Budgeting Method. This is a method many people use. It stands for DNAH ial - Do nothing and hope. It is not recommended.
Envelope Budgeting Method. A process of budgeting where you prepare divide spending each month into categories, create envelopes for each category of spending, and once a bill comes, take the money from the corresponding envelope and pay the bill.
Expenses. This is where your money goes. There are two types of expenses: fixed expenses, which are expenses you don’t directly control; and variable expenses, which are expenses you can control.
Financial Ratios. These are ratios that can help you to analyze your spending.
Gross Savings Ratio. This is your income for savings divided by your gross income. This ratio tells you what proportion of your total income is being saved.
Housing. These are appreciating tangible assets, such as land, dwellings, vacation home, or rental property used for personal goals or capital income.
Income Statement (personal). This is a financial record your inflows and outflows of cash. It is on a cash basis. The statement is based entirely on actual cash flows, not accruals.
Income-consuming Assets. These are assets perhaps listed above which require a constant infusion of cash to keep operative.

Income-generating Assets. These are the best type of assets. These assets generate income or capital gains which may eventually allow you to have income without your having to work.
Investment Assets. These assets include stocks, bonds, mutual funds that are invested for the future. These are also income-producing assets used to accumulate wealth to satisfy specific goals.
Liabilities. This is what you owe to others. Liabilities come in two major forms: current liabilities, liabilities that must be paid-off within the next year, and long-term liabilities, liabilities that extend beyond one year.
Long-term Debt Coverage Ratio. This is your income available for living expenses divided by long-term debt payments. This ratio tells how long you could make monthly payments on your debt based on the amount of money you have available for living expenses (which is wages less taxes). The inverse of this ratio is the Debt Service ratio.
Monetary (or Current) Assets. This is cash or other assets that can be easily converted into cash. These may be also income-producing assets. They provide necessary liquidity in case of an emergency.
Month's Living Expenses Covered Ratio. This is your monetary assets divided by your monthly living expenses. This ratio tells you how many months you could survive in the event of the loss of all current income. Your living expenses do not include charitable contributions, taxes or savings.
Net Worth or Equity. This is the difference between your assets, the things you own of value, and your liabilities, what you owe to others.
Personal Property. These are depreciating tangible assets, such as boats, furniture, clothing, etc.
Retirement Plans. These are income-producing assets, such as pensions, IRAs, 401Ks, Roths, SEPs. etc. by you or employer used to accumulate wealth for retirement.
Savings Ratio. This is your income for savings divided by your income available for living expenses. This ratio tells you what proportion of your after-tax income is being saved.
Spreadsheet Budgeting Method. Using a computer and spreadsheets, determine your gross salary and take home each month after taxes and other deductions. Determine spending by categories (rows) and dates (columns), and budget for each category. As bills come in, input the spending on each date (column) and row (category).

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. Using Balance Sheet and Ratios (LT4B),

Personal Balance Sheet (LT4B) for Steve and Mary Jo
January 31, 2019

Directions: Fill in the green cells with your data. Be careful not to modify the blue cells. Key inputs for ratios comes from your budget and income statements for the π Frequency: Annual

Month: January | Day: 31 | Year: 2019

Assets		Liabilities or Debts	
Current or Monetary Assets		**Current Liabilities**	
Cash, Checking, Saving	5,000	Unpaid Other Balances	1,150
Other Monetary Assets		Unpaid Credit Cards	
A. Total Monetary Assets	5,000	Other Credit Cards	
Investments & Retirement Plans		**I.** Total current liabilities	1,150
B. Mutual Funds, securities		**Housing Loans**	
C. Qual./Ind. Retirement Plans		Mortgage Outstanding	100,000
Total Investments (B+C)	-	Other Housing Debt	
Housing		**J.** Total Housing	100,000
Primary Residence	150,000	**Vehicle Loans**	
Other Housing		Automobiles	20,000
D. Total Housing (at market value)	150,000	Other vehicle loans	
Vehicles		**K.** Total Automobile Loans	20,000
Automobiles	20,000	**Other Loans**	
Other vehicles, ATVs, RVs, etc.		Students Loans	10,000
E. Total Automobiles	20,000	Other borrowings	
Personal Property & Other Assets		**L.** Other Loans	10,000
Personal Property	10,000	**M. Total Debt/Liabilities**	131,150
Other assets			
Other miscellaneous assets		**Net Worth**	
F. Personal Property & Other	10,000	**N.** Total Assets	185,000
		O. Less: Total Debt	131,150
H. Total Assets (A+B+C+D+E+F)	185,000	**P.** Equals: Net Worth	53,850

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 Financial Calculator Tutorial (LT03) and Excel Financial Calculator (LT12).

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

Overall Situation	Actual	Recommended
Liquidity		
Current Ratio	4.4 Times	> 2
Month's LEC Ratio	1.9 Times	> 3 – 6+
Debt		
Debt Ratio	70.9%	0% (See Note 1)
LT Debt Cov. Ratio	2.6 Times	> 2.5
% Inc. 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.

Using Balance Sheet and Ratios (LT4B), it is

Annual Financial Ratios for Steve and Mary Jo

as of January 31, 2019

Q.	Savings - Annual (How much did you save this period? - IS)	5,000
R.	Living Expenses - Annual (What were your living expenses? - IS)	31,500
S.	Income less Taxes - Annual (What was your income less taxes? - IS)	42,500
T.	Long-term debt payments - Annual (Sum of all LT debt payments? - IS)	16,300
U.	Gross Income - Annual (How much did you make this period? - IS)	50,000

6 Key Ratios Differences

1. Current Ratio (%): (Mon. Assets (A)/Current Liabilities(I))	4.35
2. Month's Living Exp. Cov. Ratio (x): (Mone. Assets (A)/Living Exp. (Q))	1.90
3. Debt Ratio (%): (Total Liabilities (M)/Total Assets (N))	70.9%
4. Long-term Debt Coverage Ratio (x): (Inc. after Taxes (S)/LT Debt Pmts (T))	2.61
Debt Service Ratio (1/LTDCR)	38.3%
5. Net Saving's Ratio (%): (Savings (Q)/Inc. after taxes (S))	11.8%
6. Gross Savings Ratio (%) (Savings (Q)/Gross Income (U))	10.0%

- Page 1 of 3 -

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. As such, 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. After a three-to-six month emergency fund, I would help them to take additional funds and use it to pay off debt.

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[1] L. Tom Perry, "Becoming Self-Reliant," *Ensign*, Nov. 1991, 64.
[2] Evan Targer, "6 Investing Mistakes the Ultra Wealth Do Not Make", Investopedia, 08/2018.
[3] Anonymous.
[4] Gospel Standards, compiled by G. Homer Durham, 1941, 111.
[5] "To the Boys and to the Men," *Ensign*, Nov. 1998, 51.
[6] "Becoming Self-Reliant," *Ensign*, Nov. 1991, 64.
[7] "It's No Fun Being Poor," *Ensign*, Sept. 1982, 72; italics added.
[8] "Patience, a Key to Happiness," *Ensign*, May 1987, 30.

4. Taxes: Paying All You Owe and Not a Penny More

Introduction

The present tax system in the United States was established in 1913 with the passage of the Sixteenth Amendment to the Constitution. This amendment gave Congress the power to impose an income tax. When this tax was first established, only about one percent of the population had to pay income taxes. Since that time, tax laws have changed immensely. Now, paying taxes has become one of the most complex procedures citizens must go through to fulfill their civic responsibilities.

Whether we like it or not, taxes are a fact of life. Taxes are also a critical part of any financial plan. We include a discussion of taxes early in this course because taxes have an impact on nearly every part of financial life: investing, saving, managing cash, dealing with debt, owning a home, planning for retirement, securing insurance, and planning your estate. Since taxes are such a crucial financial element, you need to understand and plan for them so you can achieve your personal and family goals.

Objectives

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

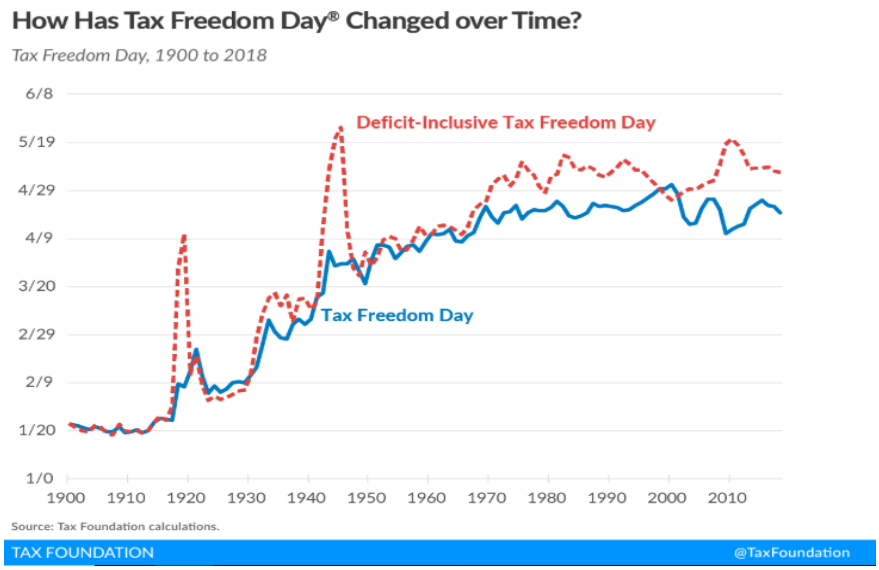
A. Understand how tax planning can help you attain your personal goals and the principles of tax planning.
B. Understand the Federal tax processs.
C. Understand the major tax features of the U.S. tax system and tax strategies to help you lower your taxes (legally and honestly).
D. Understand and create your Tax Plan.

Understand How Tax Planning Can Help You Attain Your Personal Goals and the Principles of Tax Planning

Tax planning is important because taxes are the largest single annual expense for most families. The average American spends more on taxes than on food, clothing, and medical care combined; he or she must work for more than three months just to earn enough to pay taxes. In 2011, Americans needed to work 104 days to cover the costs of their federal, state, and local taxes. The day on which taxes were covered, called Tax Freedom Day, fell on April 19 in 2018, 110 days into the year (See Figure 1).

The statistics in Figure 1 illustrate why tax planning and tax strategies should be critical parts of your financial life. The less you owe Uncle Sam, the more you can save for your personal and financial goals.

Figure 1. Tax Freedom Day, 1900-2018[1]



Regarding taxes and the other laws of the land, the Lord has said, "Let no man break the laws of the land, for he that keepeth the laws of God hath no need to break the laws of the land. Wherefore be subject to the powers that be, until he reigns whose right it is to reign and subdues all enemies under his feet."[2]

Some citizens have tried to minimize their obligation to pay income taxes. We all should obey the laws of the land, including the laws that require us to pay taxes. However, we should learn to be wise stewards so that we pay all the taxes we legally owe—and not a penny more.

Principles of Tax Planning

There are five key principles of effective tax management:

> **1. Know yourself, your vision, goals, and plans.** This is critical. Who are you? What are you trying to accomplish during your life for yourself and your family? What do you want to become? What is the vision of what you see for yourself and your family? What are the values you will follow as you strive to accomplish these things?
>
> **2. Seek, receive and act on the Spirit's guidance**. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of the tax system so you can make wise decisions regarding your finances. It is important that you understand how taxes are calculated so you can use this knowledge to help you legally reduce your tax bill. After all, it is likely one of your larger bills each year.

4. Keep good records for tax and other purposes. It is important that you keep good records, including records of spending, donations, investments, etc. so you can take your earned deductions. Taxes impact so many areas of our lives. As such, it is important that we keep good records so that we pay every dollar we owe, and not a penny more.

5. Get good help if needed to make better decisions. Often, we do not have enough information to make the best decisions for ourselves. As such, don't be afraid to pay to have help of certified tax experts to help you understand and reduce your tax bill.

6. Finally, pay everything you owe for taxes, and not a penny more. It is a blessing to live in the countries we all live in. As such, we are responsible to pay our taxes, consistent with our leader's counsel.

Finding Balance

Once you have your problem, the next step is to determine the principles. These might include:

Principles	Doctrines
Know yourself, your vision, goals, and plans	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Understand the key areas of the tax system	Accountability
Keep good records for tax and other purposes	Stewardship
Get good help if needed to make better decisions	Stewardship
Pay everything you owe for taxes	Integrity

From Obedience to Consecration

When we are planning for taxes, we are not just doing tax planning. From a higher perspective or with greater vision,

> We are children of Heavenly Parents (identity), striving to live worthy of the Spirit (obedience), who are learning important information about the tax system (accountability), wisely keeping records of our income and expenses (stewardship), and getting good help when needed (stewardship). We act with integrity to minimize our tax payments to the government (honesty), so that we can have sufficient assets to accomplish our personal missions and to accomplish our individual and family vision and goals.

Understand the Federal Tax Process

Preparing your income tax is a seven-step process:

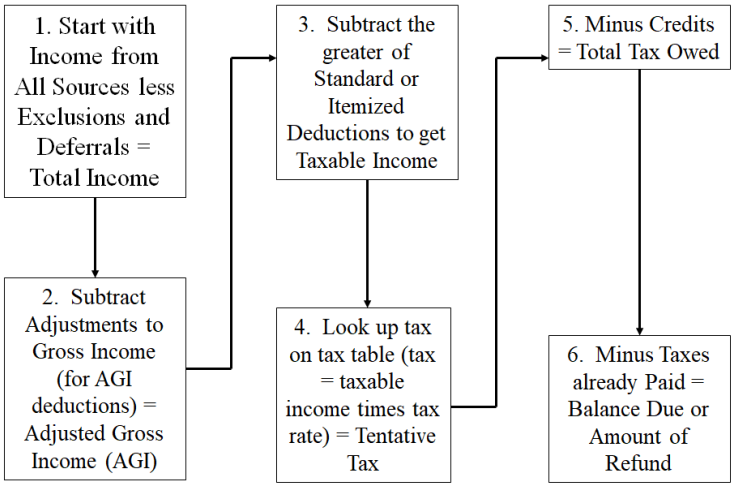
1. Calculate your gross income from all sources minus IRS-allowed losses, exclusions, and deferrals.
2. Subtract adjustments to gross income to get your adjusted gross income (AGI).
3. Subtract the greater of your standard deduction or your itemized deductions.
4. Refer to the IRS tax table and calculate your tentative tax.
5. Subtract your credits; the result is your total tax owed.
6. Subtract any taxes already paid. This leaves the amount of your balance due or amount of your refund.

To help you with the federal tax process, we have created a spreadsheet titled Federal Tax Worksheet (LT39). Set the year for 2019 and it will help you understand the process and calculate your taxes.

Step 1: Calculate Your Total Income

Your gross income comprises income from all sources unless it is allowed to be specifically excluded or deferred by the IRS. It includes active income from wages or a business; passive income from activities in which the taxpayer does not actively participate; and portfolio income from interest, dividends, and capital gains from securities. Total income also includes alimony, business income, taxable IRA distributions, tax refunds from the previous year (but only if the excess was deducted in the previous year), royalties, farm income, unemployment compensations, taxable Social Security benefits, and any other income.

Table 1. The Tax Process



Occasionally the IRS allows certain sources of income to be excluded from your total income. These waived amounts are called exclusions. They include certain employer-provided fringe benefits, *contributions to qualified retirement accounts (401k, 403b, 457, SEP plans, etc.)* that are not Roth retirement plans, life insurance proceeds that were received because of a death, scholarships or grants not in excess of college expenses, interest on U.S. Series I or EE savings bonds (when the principal and interest from these bonds have been used for qualified educational expenses), municipal bond interest, inheritances (up to a specific amount), child support payments, and some welfare benefits.

The IRS also allows certain sources of income to be deferred and recognized and a later date. These amounts are called deferrals. Deferrals include contributions, earnings, and interest on qualified retirement accounts. Taxes on these accounts are deferred until the individual retires and withdraws funds from these accounts.

Step 2: Subtract Adjustments to Get Your Adjusted Gross Income (AGI)

Adjustments are deductions from your total income allowed by the IRS. The resulting number is your adjusted gross income. Adjustments include items that are paid for on a before-tax basis and items that reduce income for specific payments or taxes. Items paid for on a pre-tax basis include contributions to flexible spending plans or health savings accounts, where money for medical expenses is paid before tax. Contributions to individual retirement accounts (IRAs) that are not in Roth accounts are also adjustments. Reductions in income for specific payments include interest payments on student loans, tuition and fees deductions, and deductions of one-half self-employment tax. Note that as your adjusted gross income increases beyond a specific amount, certain adjustments to your income are phased out or eliminated, such as the ability to contribute to certain kinds of individual retirement accounts. Total income minus adjustments gives you your Adjusted Gross Income (AGI).

Step 3: Subtract Itemized or Standard Deductions

Once you know your AGI, the next step is to determine your itemized deductions. Itemized deductions are IRS-allowed reductions in adjusted gross income that are used to calculate taxable income. There are two different ways to determine deductions; one way you must calculate yourself, and the other way is calculated for you. It is important for you to understand what can and cannot be deducted because every deduction results in less tax money you must pay and more money you can keep and use to achieve your personal goals.

Table 2 Standard Deductions

Year	Standard Deduction (MFJ)
2015	$12,600
2016	$12,600
2017	$12,700
2018	$24,000
2019	$24,400

The first method of calculating deductions is to let the government calculate them for you. Each year, the government determines a "standard deduction," which is an estimate of what the average family would be able to deduct by itemizing. Unlike itemized deductions, which are limited for higher levels of AGI, the standard deduction remains the same for all income levels. The standard deduction amount does vary depending on your filing status: the amount will be different depending on whether you are single, married filing jointly, head of household, or married filing separately. The following has been the standard deduction for married filing jointly (MFJ) for the last few years (see Table 2).

The second method for determining deductions is for the taxpayer to itemize all the deductions he or she can legally take. The government allows taxpayers to remove certain expenses it deems important from a taxpayer's income. It is the taxpayer's responsibility to determine and document those deductions. Some of the most common deductions include medical and dental expenses, tax expenses, state and local taxes (SALT), interest on home mortgages, charitable contributions, and investment-related expenses.

The government allows deductions for medical and dental expenses that exceed 10 percent of your AGI, casualty and theft losses that exceed 10 percent of AGI. For example, if your AGI is $50,000, you can only deduct medical expenses that are more than $5,000 (50,000 * .10). The definition of acceptable medical and dental expenses can be found in IRS Publication 17.

Certain expenses are also deductible against your income earned. These expenses include investment losses up to $3,000 per year, real estate taxes, and county or city income taxes. Some states impose a personal property tax (generally a tax on vehicles), which is also deductible. The government also allows you to deduct either state and local taxes or state and local general sales taxes, property taxes on principle residence, etc. up to $10,000 per year.

Table 3. Mileage Deductions

Charitable Mileage deductions:	2017	.14 per mile
	2018	.14 per mile
	2019	.14 per mile
Business Mileage Deductions:	2017	.535 per mile
	2018	.545 per mile
	2019	.580 per mile
Moving/Medical Mileage Deductions:	2017	.170 per mile
	2018	.180 per mile
	2019	.200 per mile

You may also deduct contributions to charitable organizations. The requirement for this deduction is that the charitable organization must be qualified (registered as a 501(c)(3) nonprofit organization). Regardless of the size of the donation, you should get a receipt for your donation from the charity.

Further deductions can be taken for certain expenses relating to investing. The government wants

to encourage investment, so interest paid on investments is deductible, although the deduction is limited to the amount of investment income you earn. You can also deduct investment costs; after offsetting investment income, you can deduct up to $3,000 in investment losses per year. Losses in excess of $3,000 can be carried forward to deduct in future years.

Certain mileage deductions may also be made, depending on the usage of your personal vehicle (see Table 3). These uses may be related to charity, business, moving, or medical expenses.

If your income rises above a certain level, you begin losing a percentage of your deductions. The higher your income gets, the more your allowable itemized deductions are reduced. While these calculations are complicated, be aware that these adjustments may be applicable.

The challenge to the taxpayer is to determine whether his or her calculated deductions are greater than the government's standard deduction. It may be to your advantage to itemize your deductions. If the government's standard deduction is greater than your itemized deduction, then it is to your advantage to take the standard deduction. Once you understand the tax system, you can utilize the deductions that minimize your tax payments and maximize the amount that is left over for your personal goals. A good tool to help you determine whether to use itemized or the standard deduction is the Federal Tax Worksheet (LT38).

Step 4: Refer to the Tax Table and Calculate Your Tentative Tax

Once you have determined your taxable income, determine your filing status. Your filing status is based on your marital and family situation. Filing status is a factor in determining your standard deduction and your correct amount of tax. Your marital status on the last day of the year determines your status for the entire year. The five filing status options are:

> **1. Single:** Generally, if you are unmarried, divorced, or legally separated, your filing status is single.
>
> **2. Married filing jointly***:* If you are married, you and your spouse may file a joint return.
>
> **3. Married filing separately:** Married taxpayers may elect to file separate returns.
>
> **4. Head of household:** If you are unmarried and paid more than half the cost of maintaining a home for you and a qualifying person, you may file as head of household.
>
> **5. Qualifying widow(er) with dependent child:** If your spouse died during the last two years, you have a qualifying child, and you meet certain other conditions, you may file as a qualifying widow(er) with dependent child.

Once you have determined your filing status, check the IRS tax tables for the current year. Find the table and the line that represents your taxable income for the year. Cross-reference this amount with your filing status to determine your tax amount. Table 5 shows the last few years of

the tax tables for the filing status of *Married Filing Jointly* from the IRS.

Table 5. Tax Tables for Married Filing Jointly

Year	If Taxable Income Is Over	But Not Over	Tax Is	Plus This Percentage	of the Excess
2017	0	$18,650	0	10%	0
	$18,650	$75,900	$1,865	15%	$18,650
	$75,900	$153,100	$10,453	25%	$75,900
	$153,100	$233,350	$29,753	28%	$153,100
2018	0	$19,050	0	10%	0
	$19,050	$77,400	$1,905	12%	$19,050
	$77,400	$165,000	$10,313	22%	$77,400
	$165,000	$315,000	$29,388	24%	$165,000
2019	0	$19,400	0	10%	0
	$19,400	$78,950	$1,940	15%	$19,400
	$78,950	$168,400	$9,086	25%	$78,950
	$168,400	$321,450	$28,765	28%	$168,400

The government has also set up a system to ensure that all income-earners pay some tax. There is an alternative minimum tax (AMT) that is aimed at preventing the wealthy from avoiding income taxes. For most people, this minimum tax has no effect; however, it may be significant for the wealthy. Note that this tax is becoming more and more prevalent.

Step 5: Subtract Credits to Calculate Total Tax Owed

Credits are different from deductions. Credits are more valuable because they are dollar-for-dollar reductions in your tax liability, whereas deductions only reduce taxable income. Credits are either refundable (paid to the taxpayer even if the amount of the credits exceeds the tax liability) or non-refundable. Refundable credits include reductions for earned income, taxes withheld on wages, and estimated income tax payments. Non-refundable credits include child tax, child and dependent care, elderly and disabled, adoption, and education. Many of these credits are phased out for taxpayers in higher income brackets. Following are credits for 2019.

The Child Tax Credit of $2,000 ($1,400 refundable) is given for each child of the household under 18 years old at the end of the year. A qualifying child is one whom the taxpayer can claim as a dependent. This credit is given and it can even become a tax refund for low-income families or a refundable credit. However, the Child Tax Credit begins to phase out after the taxpayer's income exceeds a specific amount. The amount phased out is based on the number of credits—it is not a percentage phase-out.

Education tax credits include the *American Opportunity Tax Credit* and the *Lifetime Learning Credit*. The American Opportunity Tax Credit gives parents or students a 100-percent tax credit for the first $2,000 paid and a 25-percent tax credit on the next $2,000 for the first four years of college, with 40% refundable. The result is a credit of up to $2,500 per year for the first four years of college. Qualifying expenses include tuition and books—but not room and board—at an accredited vocational school, college, or university.

After your fourth year of college, the *Lifetime Learning Credit* can be applied to offset 20 percent of the first $10,000 for tuition and related expenses for all eligible students in the family (up to $2,000), even for part-time students.

Taxpayers may be eligible for additional credits if they earn below a specific limit, adopt, are disabled, over 65 and have a low income, pay taxes in other countries, or overpay Social Security taxes because they work more than one job.

Step 6: Subtract Taxes Paid to Get Total Taxes Owed or Amount of Refund

Once you have calculated the total tax you owe, subtract the amount of taxes you have already paid. The result will either be the amount of taxes you owe or the amount you will have refunded to you.

Understand the Major Tax Features and Strategies to Minimize Tax Payments (for a Given Level of Income)

The United States tax system is structured as a progressive, or graduated, tax system. This means that increased income is taxed at increased rates. The logic behind this system is that people who earn more can afford to pay a higher percentage of their earnings in taxes. There are four major types of taxes: income, capital gains, income based, and non-income based.

Income Taxes

The tax system is complicated by the fact that different types of earnings are taxed differently—a policy consistent with the government's view that tax policy should encourage specific earning behaviors. To understand tax policies, there are three terms you should know: marginal tax rate, average tax rate, and effective marginal tax rate.

Your marginal tax rate is the percentage of the last dollar you earn that will go toward federal income taxes. This rate is important to know when you are calculating returns on various assets. Any new income will be taxed at this rate, and any additional deductions will save taxes at this rate. This rate refers to what tax bracket you are in.

Your average tax rate is the average amount out of every dollar you earn that goes toward federal income taxes. This is your overall tax rate on income earned. This rate is calculated by dividing your tax liability by your taxable income.

Finally, your effective marginal tax rate is the average amount out of every dollar you earn that is paid to all local, state, and federal income taxes. This rate is calculated by dividing your tax liability by your total income.

Capital Gains Taxes

Capital gains taxes are taxes on the appreciation of an asset. Capital gains can be either short-term or long-term; these designations refer to how long you owned the asset before you sold it. This tax can also be realized or unrealized, depending on whether or not you have sold the asset. If you owned the asset for less than 12 months and then sold it, appreciation of the asset would be considered realized short-term capital gains, and the gain would be taxed at your marginal tax rate. If you owned the asset longer than 12 months before selling it, any appreciation of the asset would be considered a realized long-term capital gain.

Capital gains taxes do not perfectly match up with the tax brackets; rather, they are applied to maximum taxable income levels (000's). Medicare taxes also change with income

Figure 2. Tax Brackets, Capital Gains and Dividends, and Medicare Tax Rates in 2019

Filing Single	Married Filing Jointly	Head of Household	Ordinary Income	Cap. Gains & Dividends Tax Rate	Medicare Tax Rate Earned Inc.*	Medicare Tax Rate Invest. Inc.	Total Cap Gains & Medicare
-	-	-	10%	0%			
9.70	19.40	13.85	12%	0%	2.9%	0.0%	2.9%
39.48	78.95	52.90	22%	0%	2.9%	0.0%	2.9%
39.38	78.75	52.75		15%	2.9%	0.0%	17.9%
84.20	168.40	84.20	24%	15%	2.9%	0.0%	17.9%
160.73	321.45	160.70	32%	15%	2.9%	0.0%	17.9%
204.10	408.20	204.10	35%	15%	2.9%	0.0%	17.9%
434.55	488.85	461.70		20%	3.8%	3.8%	27.6%
510.30	612.35	510.30	37%	20%	3.8%	3.8%	27.6%

* Combined rate = 1.45% employer contribution.

Unrealized capital gains taxes are postponed until you sell an asset. While you can postpone capital gains taxes, you cannot postpone taxes on distributed earnings from mutual funds or taxes on dividends from stocks and interest from bonds.

Capital gains can also be earned through home ownership. Perhaps you purchased a house years ago for $150,000 and it is worth $400,000 today. Gains of up to $500,000 for couples and $250,000 for individuals are exempt from taxes if the home is your principal residence and if you have lived there and owned the home for two of the five years preceding the sale.

Income-Based Taxes

The third major type of tax is income-based taxes, such FICA (Federal Insurance Contributions

Act). FICA is a mandatory insurance program that is administered by the federal government to provide support to your family in the event of death, disability, health problems, or retirement. To pay for FICA, you and your employer each pay 7.65 percent of your gross salary into the federal system, for a total of 15.3 percent. Of the 7.65 percent, 6.2 percent is paid into Social Security. The amount you pay into Social Security is capped (i.e., income over a certain limit is not taxed) and adjusted annually for inflation. The remaining 1.45 percent is paid into Medicare, a health-care insurance program for the elderly and disabled; this program has no annual cap.

You are responsible for only half of these income-based taxes unless you are self-employed, and then you must pay the entire 15.3 percent yourself.

Starting in 2013, those earning more than $200,000 (Single filing) or $250,000 (Married-Filling-Jointly) will be taxed an additional 0.9 percent on earned income and an additional 3.8 percent on investment income to help fund Medicare (see Figure 2). Note that companies are not responsible for contributing any additional amount to the changes to the Medicare Tax.

In addition to these taxes, there are also state income taxes and local income taxes. Local income taxes are uncommon, but some larger cities, such as New York City, impose such a tax.

Non–Income-Based Taxes

Non-income-based taxes include sin taxes, excise taxes, and state sales tax. These taxes are imposed when goods are purchased. This category also includes real estate and property taxes that are imposed annually or semiannually on assets owned. Finally, there are gift and estate taxes; these taxes may be imposed when assets are transferred from one owner to another. The tax is imposed on the person transferring the assets, not the person receiving the assets.

There are four strategies to minimize your tax payments for a given level of income or to maximize after-tax income:

If your income rises above a certain level, you begin losing a percentage of your deductions. The higher your income gets, the more your allowable itemized deductions are reduced. While these calculations are complicated, be aware that these adjustments may be applicable.

Strategies to Minimize Tax Payments (for a Given Level of Income)

The challenge to the taxpayer is to determine whether his or her calculated deductions are greater than the government's standard deduction. It may be to your advantage to itemize your deductions. If the government's standard deduction is greater than your itemized deduction, then it is to your advantage to take the standard deduction. Once you understand the tax system, you can utilize the deductions that minimize your tax payments and maximize the amount that is left over for your personal goals.

1. Maximize Your Deductions

It is important to understand which deductions the government allows. By maximizing your deductions, you are reducing your taxable income—the amount on which your taxes are based. Suggestions for maximizing your deductions include the following:

- Use your home as a tax shelter. Interest payments on the mortgage you took out to purchase your home can be deducted from your AGI to reduce your taxable income.
- Shift and bunch your deductions to get the maximum benefit in a specified year.
- Continue to give to your church with tithes and offerings. While you do not give solely for a tax deduction, because you are already giving, you might as well get the tax deduction.
- Keep good records of all charitable contributions, including mileage and any in-kind donations to charities.
- Keep good records of health-related and moving-related expenses.

2. Maximize Long-Term Capital Gains and Stock Dividend Income

A long-term capital gain is a gain on an investment asset that you hold for more than one year before selling. For example, if you bought a mutual fund for $10 two years ago, and you sold it for $15 this year, you have a gain of $5. Since you held the fund for more than one year, the gain is considered a long-term capital gain. Long-term capital gains income is taxed at a lower rate than ordinary income. Try to earn as much capital gains income as possible each year (versus ordinary income).

All income is not taxed equally. Stock dividends are taxed at a preferential tax rate compared to bond interest, whereas bond and savings interest is taxed at ordinary tax rates. Qualified stock dividends are taxed at the dividend preferential rate (20, 15, or zero percent preferential rate, depending on your marginal tax rate). To see if dividends are qualified or not, see Taxes on Security Earnings – Qualified Dividends (LT32).

Here are some key suggestions:

- Focus on long-term capital gains. These are not taxed until the asset is sold.
- Maintain a long-term buy-and-hold strategy on mutual funds and stocks to defer taxes until the assets are actually sold.
- Manage your portfolio on a tax-efficient basis—it's not what you *make*, but what you *keep* after taxes and inflation that makes you wealthy.
- If your risk tolerance allows, increase your allocation to stocks, stock mutual funds, stock index funds, and ETFs since stock dividends are taxed at a lower tax rate.

3. Earn Tax-Exempt Income

Tax-exempt income is excluded from your total income, meaning you do not have to pay taxes

on it. Some key suggestions for using the strategy of earning tax-exempt income include the following:

- Look for tax-free investments. Municipal bond interest is free from federal tax and may be free from state and local tax as well. By investing in municipal bonds, you pay an implicit tax—the rate of return is lower than a comparable taxable bond. Depending on your marginal tax rate, it may or may not make sense to do this. Remember, the goal is to maximize your after-tax profits.

- Use medical savings accounts, also called flexible spending accounts, to pay medical bills. This way you are reducing income by paying medical bills with before-tax dollars.

- Contribute to charity by donating appreciated long-term capital assets. If you donate your appreciated assets to charity, not only do you get the full value of the donation, but you also do not have to pay the capital gains on the appreciated assets. For example, suppose you have a stock you bought for $10 per share and it is now worth $20 per share. If you sold it and used the income to pay your tithes and offerings, you would receive $20 but would have to pay capital gains taxes on your $10 gain. At a 15 percent tax rate, you would only have $18.50 after taxes. However, if you donated the stock to your church or any qualified charity, i.e., a donation-in-kind, the church or charity receives the stock, you receive a receipt for $20, and you do not have to pay capital gains tax on that stock. For help with this process, see Tithing Share Transfer (LT08) Example.

4. Defer Taxes to the Future or Eliminate Future Taxes

Deferring taxes to the future means that you put off paying taxes on your current income now and then pay taxes on the money when you withdraw it at retirement. The following are key recommendations:

- Invest as much as your budget will allow in your 401(k) and your other tax-deferred retirement plans, especially if they are matched accounts. Individual retirement accounts, 401(k) plans, and SEP IRA plans defer taxes to the future.

- Invest in specific-purpose investment vehicles that eliminate all future taxes. You invest in these vehicles with after-tax dollars, and if the assets are used for the purpose that you specified, you never pay taxes on the earnings again. The following are key recommendations:

    - Save for retirement using a Roth IRA or Roth 401(k) investment vehicle. Earnings on Roth investment vehicles are tax eliminated, i.e., you invest with after-tax money, and then you are not taxed on those assets ever again, as long as you take them out after age 59½.

    - Save for your children's educations using a Coverdell Education Savings Account

(Education IRA) or a state 529 savings plan. You invest in these vehicles with after-tax dollars and earnings are never taxed, assuming they are used for qualified educational expenses.

- Save for your children's college-tuition expenses using government Series EE or Series I savings bonds. If the principal and interest are used to pay for college tuition, the interest is tax-free (subject to specific income limits). Focus on your rate of return and your tax rate. If your after-tax return on these vehicles is higher than you could make other places, it may be a good place to invest for your children's education.

Learn to Be More Efficient with Your Taxes

Below are some ideas that may be helpful as you work toward better organization and preparation of your taxes:

1. **Be organized with your record-keeping**. One of the difficult things about preparing your tax return is knowing where all your useful receipts are. Keep a folder that is dedicated to holding all your tax receipts over the year. Make this folder readily available. Any time you do anything that may have a tax consequence, put the receipts in that folder. An electronic system, such as Quicken or Mint.com, makes it easy to record and remember details about charitable contributions or payments toward taxes for future use.

2. **Keep copies of the previous year's tax returns**. When preparing your taxes, review your tax returns from last year. Review your exclusions, tax deferrals, deductions, exemptions, and other areas to make sure you are not missing out on any legal tax reductions. Keep copies of all your lists of deductions and receipts so you will have the necessary backup if you are audited. You should keep copies of the last seven years of your tax returns.

3. **Keep good records for itemizing deductions**. Keep records of things you donate to Deseret Industries, the Salvation Army, United Way, and other charitable organizations: these donations can increase your tax deductions. You should also keep good records showing what non-cash charitable contributions you make, such as miles you travel for church-related or Boy and Girl Scouts activities.

4. **Spend time in December calculating potential investment gains and losses**. Remember, you can offset gains from your investment portfolio with your investment losses and costs, and you can deduct up to $3,000 per year in net portfolio losses. While this may not seem like much, if you know you have $2,000 in investment gains for the year, you could look to assets you want to sell that have investment losses; you could then sell those assets with a corresponding $2,000 loss—thereby canceling out any increase in income from your investments and reducing your tax bill.

5. **Make charitable contributions with appreciated long-term capital assets**. Donate to your church or charity using appreciated assets and avoid the capital gains taxes.

Understand and Create Your Tax Plan

As you work on your taxes, you can see the importance of following the principles. Paying the government everything you owe, and not a penny more is critical. The following are ideas as you put your Tax Plan together, including some strategies that you will not learn until later in the course for thought purposes.

Vision

- This will likely be from your "Plan for Life." It may include:
    - Financial difficulties will not be a concern. We will have sufficient financial resources to meet the needs of our family.
    - I will live with integrity in all I do, including with my God, my family and the government.

Goals

- Pay the government every penny we owe, but not a penny more.
- Show by my actions that integrity is more important than money.
- Be honest in all my dealings, including with the government.
- Use taxes strategically in developing my life and retirement plans.
- Maximize all after-tax cash flows.
- Pay all bills when due.

Plans and Strategies

Before Retirement

- Keep good records for tax and other purposes.
- Every third year get help preparing your federal and state taxes to ensure you are minimizing your tax payments.
- Pay tithes and offerings with appreciated securities.
- Use appreciated securities as a strategy to rebalance your investment portfolio.
- Diversify your retirement assets into 40% tax-deferred (401k, 403b, IRA plans), 30% tax-eliminated (Roth 401k/403b/IRA), and 30% tax-now assets (brokerage accounts and banks). That way you can target your tax rate in retirement at a low rate.
- Be tax-efficient in my investment strategy.
- Do tax harvesting in December to reduce investment income.

During Retirement

- Every third year get help preparing your federal and state taxes to ensure you are minimizing your tax payments.
- Pay tithes and offerings with appreciated securities.
- Use appreciated securities as a strategy to rebalance your investment portfolio.
- While on your mission, change tax-deferred retirement accounts (401k, 403b) into Roth accounts (Roth IRA, Roth 401K) at a lower tax rate.

- Diversify your retirement assets into 40% tax-deferred, 30% tax-eliminated (Roth), and 30% tax-now assets. That way you can target your tax rate in retirement at a lower rate.

Constraints

- Laziness will keep you from good record keeping.
- Not living on a budget will make it difficult to save.
- Getting caught up in the things of the world will make it difficult to save.

Accountability

- You will share your vision and goals with your spouse and children.
- You will remember these things in prayer with Heavenly Father each week.

Summary

Tax planning is a critical part of financial planning because it influences so many different areas of your personal financial life. The average American worked over 100 days last year just to pay his or her federal, state, and local taxes.

Preparing your income tax is a six-step process:

1. Determine your total or gross income from all sources, subtract your exclusions.
2. Subtract adjustments to total income; the result is your adjusted gross income .
3. Subtract the greater of your standard deduction or itemized deductions.
4. Refer to the IRS tax table and calculate your tentative tax.
5. Subtract your credits; the result is your total tax owed.
6. Subtract any taxes already paid; this leaves either the amount of your balance due or the amount of your refund.

Each of these steps is critical to correctly calculating your federal income tax.

The United States tax system is a progressive, or graduated, tax system. Increased income is taxed at higher rates. The four major taxes are income taxes, capital gains taxes, income-based taxes, and non-income-based taxes.

Tax strategies to minimize your tax payments include:

1. Maximize your deductions.
2. Maximize capital gains income.
3. Earn tax-exempt income.
4. Defer taxes to the future or eliminate future taxes.

By using these strategies effectively, you can reduce your tax liability and the amount of taxes

you are legally required to pay at a given level of income.

We concluded with some ideas that may be helpful as you work toward better organization and preparation of your taxes:

1. Be organized with your record-keeping.
2. Keep copies of the previous year's tax returns.
3. Keep good records for itemizing deductions.
4. Spend time in December calculating potential investment gains and losses.
5. Understand the major features of the U.S. tax system.

Taxes are a required part of living in the United States. However, there is no law that requires us to pay more than is legally due. By utilizing the recommendations and ideas in this chapter, you can fulfill your responsibility as a wise financial steward and legally minimize your tax payments to the government.

Assignments

Financial Plan Assignments

Your assignment is to put together your Tax Plan. To do this, start with your PFP Tax Planning Template (LT01-05). You must understand both the taxes you paid last year and the taxes you will pay this year. Get a copy of last year's income tax form. What form did you use (e.g., 1040A, 1040EZ, etc.)? Why did you use that form?

Think about what you are going to do differently this year in regard to your taxes. What forms are you going to use this year? What additional plans and strategies can you use to legally reduce your tax payments for a given level of income? What plans and strategies will you use going forward to pay every dollar you owe in taxes, and not a penny more?

Learning Tools

The following Learning Tool may be helpful for tax planning..

Federal Tax Liability Worksheet (LT39)
: This spreadsheet divides the process of tax planning into each of its component areas. You can choose your year of data, and it brings in the relevant tax tables. It can also help with your education credits and determining the amount owed or refund.

Tithing Share Transfer Example (LT08)
: This document is an example of a form you can use to pay your tithes and other offerings with appreciated stock or mutual funds. You get the benefit of not paying capital gains on your appreciation, and you can deduct the full value of the donations on your taxes.

Review Materials

Terminology Review

Bankruptcy Chapter 13. This process prepares a repayment plan in which the court binds both the debtor and the creditors to terms of repayment. The debtor retains property and makes regular payments to a trustee out of future income to pay creditors over the life of the bankruptcy plan.

Bankruptcy Chapter 7. This process liquidates assets and uses them to pay creditors according to precedence in the bankruptcy code. It is the quickest, simplest and the most frequently selected (75%) kind of bankruptcy filing. Certain debts cannot be waived by Chapter 7 bankruptcy such as child support, student loans, drunk driving fines, etc.

Carelessness. A reason for debt. We understand its costs, but we become lazy.

Compulsiveness. A reason for going into debt. We lack the self-control to discipline our purchases.

Counseling: For-profit credit counseling agencies. These are companies whose goal is to make money through helping people get out of debt. They often consolidate debt into a single loan with a lower rate, or get homeowners into a interest-only home loan and use the excess cash to pay down debt.

Counseling: non-profit credit counseling agencies. These are agencies set up specifically to help people reduce the credit-card debt load in their lives. The non-profit companies have arrangements with many of the credit companies. Working with them, they can reduce or even eliminate your interest payments with specific creditors.

Credit Counseling Agencies (CCAs). These may be either non-profit or for-profit agencies to help you get out of debt. You should use these with caution.

Debt. It is the process of borrowing something with the expectation to pay it back in the future with interest.

Debt Cycle. It is the process of why and how we go into debt.

Debt Elimination: Expensive Debt First. This is one of the personal strategies. The logic is to pay off your most expensive debts first.

Debt Elimination: Smallest Debt First. This is one of the personal strategies. The logic is to pay of the smallest debts first. Then take the money saved to pay off all your other debts. You have success early on as you pay off the smallest debts first.

Debt Reduction Strategies. These are strategies for reducing debt. It is a six-step process: 1. Remember perspective, the "why's" and "what's." Accept that you have a debt problem; 2. Write down your goals so you know where you want to be. Stop incurring new debt; 3. See where you are by making a list of all your bills and debts. Admit the need to change your habits and lifestyle if being debt free is important; 4. Look for one-shot ways of reducing debt; 5. Organize a debt repayment Plan; and 6. Follow through on the Plan until total debt elimination.

Home Equity Loans. This is a personal debt strategy. You take our a home equity loan, which is a loan against the equity in your home (the difference between what the home is worth and how much you owe on it) to pay off your debts.

Ignorance. A reason for going into debt. We don't understand interest and its costs.

Interest. The cost of using borrowed money. Interest must always be paid,
Necessity. One of the reasons for going into debt. It is we truly cannot feed our families.
Pride. A reason for going into debt. How we look to others is more important than how we look to God.

Review Questions

1. In regard to taxes, what is our obligation as citizens?
2. Why is tax planning important?
3. What are the seven steps to calculating your income taxes?
4. What are the four strategies to minimizing your tax payments?
5. Give five ways to help better organize and prepare your income taxes.

Case Studies

Case Study #1

Data

Matt and Janina, ages 42 and 40, are married and filling out their 2019 taxes. They have 4 children, 3 under 17 and one a dependent in college. They contributed $5,000 to a traditional 401k in 2019, $2,500 to a flexible spending plan, and state and local taxes were $11,000. They can only deduct medical bills above 10% of AGI, job related expenses above 2% of your AGI, and state and local taxes less than or equal to $10,000. The standard deduction for married filing jointly is $24,400, and the child tax credit is $2,000 per child under 18. Tax rates for 2019 for married filing jointly are:

$0 to	$19,400	10%
$19,400 to	$78,950	$1,940 plus 12% of the amount over $19,400
$78,950 to	$168,400	$9,086 plus 22% of the amount over $78,950

Income:	Earned Income	$80,000
	Interest Income	10,000
Expenses:	Home mortgage interest	6,800
	Un-reimbursed medical bills	9,063
	Tithes and offerings	9,600

Calculations

Using the married filing jointly status and the information above, calculate their 2019 taxes first using the standard deduction and then using itemized deductions. Calculate their marginal tax rate and average tax rate on gross income.

Recommendations

Which way should they calculate their taxes? What could they do to reduce their taxes?

Case Study #1 Answers

Calculations: Standard Deduction Method

1. Income from all Sources $90,000

Less 401k exclusion	-5,000	
= Gross Income	85,000	
2. Less Flexible Spending	-2,500	
= Adjusted Gross Income (AGI)	82,500	
3. Minus Standard Deduction	-24,400	
4. Minus Exemptions (6)	0	(6 * $0)
Equals Taxable income	58,100	
5. Look up tax in tax table:		
Tax:	1,940	10% on first $19,400
	4,644	12% on remainder
Tentative tax	$6,584	
6. Child tax credit	-6,500	(3 * $2,000) + $500 family credit
7. Total Tax Due	$84	

Calculations: Itemized Deduction Method

1. Gross Income	$85,000	(Earned + Interest – 401k exclusion)
less Flexible Spending	-2,500	
2. Adjusted Gross Income	82,500	
3. Deductions		
Home Mortgage Interest	6,800	
Medical Expenses	813	($9,063-(82,500*.10)
State and local taxes	10,000	($10,000 max)
Tithing	9,600	
Total Deductions	27,213	
4. Minus Income Exemptions	0	(6 ex. *0)
Equals Taxable income	55,287	
5. Look up Tax in Table	1,940	10% on first $19,050
$55,287-19,400 *.12	4,306	2% on remainder
Calculated tentative tax	$6,246	
6. Child tax credit	-6,500	(2,000 * 3 kids under 18)
= Total Taxes Due	-$254	

Since $1,400 per child is refundable, he will get a refund of the $254.

Calculations: Calculate their marginal and average tax rate on gross income.

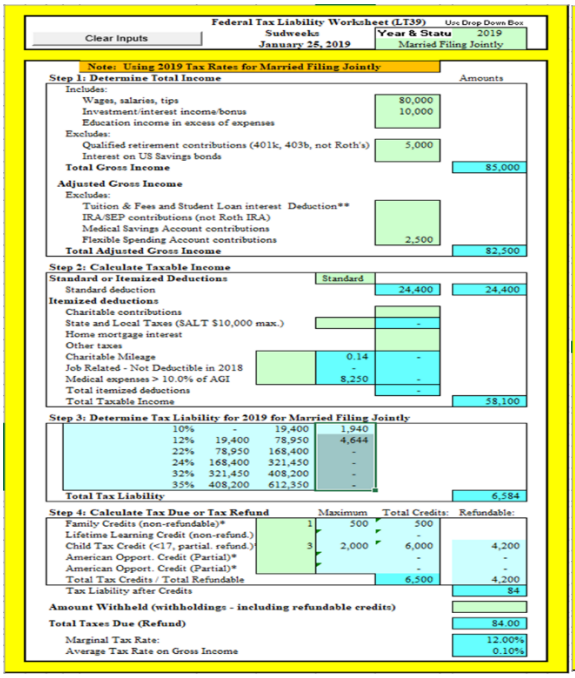
Their marginal tax rate, the tax rate they would pay on each new dollar of income is 15% for both the standard and itemized deduction calculation.

Their average tax rate, the rate they actually pay in taxes is their taxes divided by their gross income.

Standard deduction = $84/85,000 = 0.1%

Itemized deduction = $0/$85,000 = 0%

As a check, Federal Tax Worksheet (LT39) may be helpful.



Federal Tax Liability Worksheet (LT39) Use Drop Down Box
Clear Inputs | Sudweeks January 25, 2019 | Year & Statu 2019 Married Filing Jointly

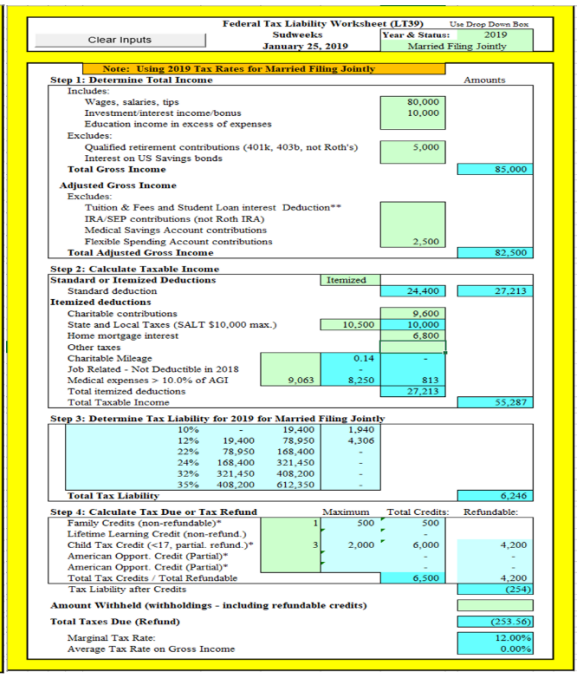
Note: Using 2019 Tax Rates for Married Filing Jointly

Step 1: Determine Total Income		Amounts
Includes:		
Wages, salaries, tips	80,000	
Investment/interest income/bonus	10,000	
Education income in excess of expenses		
Excludes:		
Qualified retirement contributions (401k, 403b, not Roth's)	5,000	
Interest on US Savings bonds		
Total Gross Income		85,000
Adjusted Gross Income		
Excludes:		
Tuition & Fees and Student Loan interest Deduction**		
IRA/SEP contributions (not Roth IRA)		
Medical Savings Account contributions		
Flexible Spending Account contributions	2,500	
Total Adjusted Gross Income		82,500

Step 2: Calculate Taxable Income			
Standard or Itemized Deductions	Standard		
Standard deduction		24,400	24,400
Itemized deductions			
Charitable contributions			
State and Local Taxes ($ALT $10,000 max.)		-	
Home mortgage interest			
Other taxes			
Charitable Mileage	0.14	-	
Job Related - Not Deductible in 2018	-		
Medical expenses > 10.0% of AGI	8,250	-	
Total itemized deductions		-	
Total Taxable Income			58,100

Step 3: Determine Tax Liability for 2019 for Married Filing Jointly				
10%	-	19,400	1,940	
12%	19,400	78,950	4,644	
22%	78,950	168,400	-	
24%	168,400	321,450	-	
32%	321,450	408,200	-	
35%	408,200	612,350	-	
Total Tax Liability				6,584

Step 4: Calculate Tax Due or Tax Refund		Maximum	Total Credits:	Refundable:
Family Credits (non-refundable)*	1	500	500	
Lifetime Learning Credit (non-refund.)			-	
Child Tax Credit (<17, partial. refund.)	3	2,000	6,000	4,200
American Opport. Credit (Partial)*			-	-
American Opport. Credit (Partial)*			-	-
Total Tax Credits / Total Refundable			6,500	4,200
Tax Liability after Credits				84
Amount Withheld (withholdings - including refundable credits)				
Total Taxes Due (Refund)				84.00
Marginal Tax Rate:				12.00%
Average Tax Rate on Gross Income				0.10%



Federal Tax Liability Worksheet (LT39) Use Drop Down Box
Clear Inputs | Sudweeks January 25, 2019 | Year & Status: 2019 Married Filing Jointly

Note: Using 2019 Tax Rates for Married Filing Jointly

Step 1: Determine Total Income		Amounts
Includes:		
Wages, salaries, tips	80,000	
Investment/interest income/bonus	10,000	
Education income in excess of expenses		
Excludes:		
Qualified retirement contributions (401k, 403b, not Roth's)	5,000	
Interest on US Savings bonds		
Total Gross Income		85,000
Adjusted Gross Income		
Excludes:		
Tuition & Fees and Student Loan interest Deduction**		
IRA/SEP contributions (not Roth IRA)		
Medical Savings Account contributions		
Flexible Spending Account contributions	2,500	
Total Adjusted Gross Income		82,500

Step 2: Calculate Taxable Income				
Standard or Itemized Deductions		Itemized		
Standard deduction			24,400	27,213
Itemized deductions				
Charitable contributions			9,600	
State and Local Taxes ($ALT $10,000 max.)		10,500	10,000	
Home mortgage interest			6,800	
Other taxes				
Charitable Mileage		0.14	-	
Job Related - Not Deductible in 2018		-		
Medical expenses > 10.0% of AGI	9,063	8,250	813	
Total itemized deductions			27,213	
Total Taxable Income				55,287

Step 3: Determine Tax Liability for 2019 for Married Filing Jointly				
10%	-	19,400	1,940	
12%	19,400	78,950	4,306	
22%	78,950	168,400	-	
24%	168,400	321,450	-	
32%	321,450	408,200	-	
35%	408,200	612,350	-	
Total Tax Liability				6,246

Step 4: Calculate Tax Due or Tax Refund		Maximum	Total Credits:	Refundable:
Family Credits (non-refundable)*	1	500	500	
Lifetime Learning Credit (non-refund.)			-	
Child Tax Credit (<17, partial. refund.)*	3	2,000	6,000	4,200
American Opport. Credit (Partial)*			-	-
American Opport. Credit (Partial)*			-	-
Total Tax Credits / Total Refundable			6,500	4,200
Tax Liability after Credits				(254)
Amount Withheld (withholdings - including refundable credits)				
Total Taxes Due (Refund)				(253.56)
Marginal Tax Rate:				12.00%
Average Tax Rate on Gross Income				0.00%

Recommendations

Method:

Using the Itemized versus the standard deduction nets a savings of $338 over the standard deduction. Matt and Janina should use the itemized method as they have more money for their goals

What could they do to reduce their taxes?

There are lots of different answers you could give; however, you do not have specific data in the case that leads to any specific recommendation. Following are a few assumptions and ideas:

1. Maximize Deductions
   - They should keep records of their home interest payments, state and local taxes(up to $10,000) and property taxes which are deductible. Property taxes were not in the case.
   - If they are involved in charity, they could deduct the miles they drive to and from the charity.
   - If they have non-cash contributions such as donations to Deseret Industries or Goodwill, they could keep good records of these donations.
   - If they have appreciated financial assets they could contribute these to charity instead of cash, reducing taxes paid, increasing deductions and eliminating capital gains taxes.
   - They could keep having kids.
2. Minimize Taxes Owed

- If they have investments, they could use a passive strategy and purchase low-turnover mutual funds to minimize their mutual fund distributions (and taxes), increase long-term capital gains (rate depends on their taxable and AGI income).
- If they invest in stocks or stock mutual funds, stock dividends are taxed at a preferential rate versus bond interest at their marginal tax rate.

3. Receive tax-exempt income
   - It their work has a flexible spending plan (FSP), they could contribute to their FSP to pay medical bills with pre-tax dollars and reduce their AGI. In this case, they should have a larger FSP.
   - If they have investments, they could invest in municipal bonds which are federal tax-free for interest, or Treasury securities which are state tax-free.
4. Defer taxes to the future or eliminate future taxes altogether
   - If they have qualified plans at work, they could contribute to a 401k/403b/457 plan. This plan would reduce their AGI and may have a match.
   - They have kids so they could contribute to 529 and Education IRA plans which would have no tax advantages now but eliminate taxes on their earnings in the future.
   - If available, they could use a Roth 401k or Roth 403b, which may have a match, and never pay taxes on these earnings again.

Case Study #2

Data

Your friend Brian, a financial analyst, comes to you with this sure-fire method of reducing taxes. He says that if you buy into this product (this product can be many different types of tax-schemes), you will not have to pay taxes on the earnings and it will save you taxes as well. It doesn't sound right, so Brian comes and asks:

Application

To what lengths should you go to avoid taxes?
Where should your best tax advice come from?

Case Study #2 Answer

Any legal method. However, if it seems too good to be true, it probably is, so get another opinion. It's not worth losing your integrity or going to prison over bad tax advice.
You are ultimately responsible for your choices and for paying taxes. Where you get your tax advice, and how and what you pay for your taxes and other obligations is your choice and responsibility.
Your best tax advice should come from those who make it a business of giving tax advice. In addition, the IRS has many publications which can help you as you determine the taxes you should pay.

Case Study #3[3]

Data

David and Jenny have four children: Aaron (20), Brittany (18), Camden (16), and Dannie (14). David earned $110,000, and a $10,000 bonus, and had $12,000 withheld for federal income taxes, $6,000 for Utah State income taxes, and $9,180 for payroll taxes. They earned $100 interest. They saved $12,000 in a Roth 401k and $5,000 in a traditional IRA. They $13,000 in tithes and offerings, $6,000 in Utah state taxes, $4,500 in property taxes, and $4,200 in qualified home mortgage interest. They paid $4,000 in unreimbursed medical costs when Dannie broke her arm. Aaron is a missionary in Peru, and they contributed $400 each month to the Church for his expenses. Brittany just completed a semester at BYU Idaho, with expenses of $4,700 ($2,000 tuition, $300 books, and $1,600 housing and $800 food). (Sorry but a mission does not count for a family credit)

Recommendations

Based on the facts below, help the Petersons determine if they should itemize or use the standard deduction? Will they have to pay more taxes or will they get a refund? How much?

Case Study #3 Answers

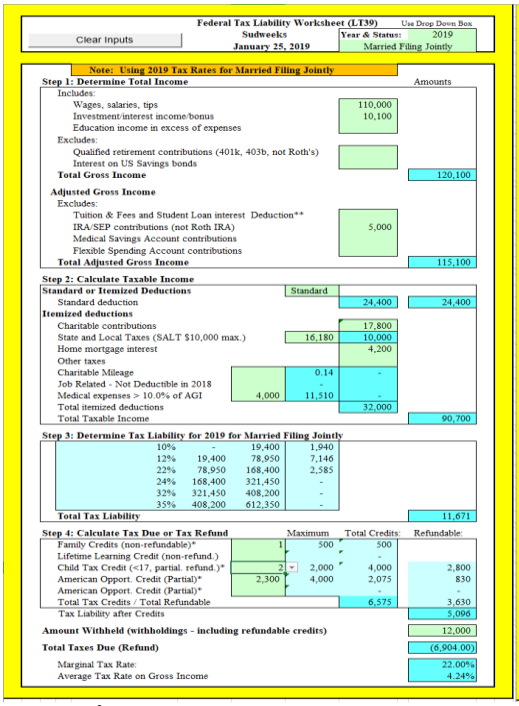
Calculations: Standard Deduction Method

1. Gross Income	$120,100	
2. Less IRA contribution	-5,000	
= Adjusted Gross Income (AGI)	115,100	
3. Minus Standard Deduction	-24,400	
4. Minus Exemptions (6)	0	(6 * $0)
Equals Taxable income	90,700	
5. Look up tax in tax table:		
Tax:	1,940	10% on first $19,400
	7,146	12% on the next bracket
	2,858	22% on remainder
Tentative tax	$11,671	
6. Child tax credit	-4,500	(2 * $2,000) + $500 family credit
AO Credit	-2,075	(100% of $2k + 25% up to $4k)
7. Total Tax Due	$5,096	
Taxes Paid	12,000	
Refund	-$6,904	

Calculations: Itemized Deduction Method

1. Gross Income	$120,100
2. Less IRA contribution	-5,000
= Adjusted Gross Income (AGI)	115,100
3. Deductions	
Home Mortgage Interest	4,200

Medical Expenses	0	($4,000-(115,100*.075)
State and local taxes	10,000	($10,000 max)
Tithing	17,800	(13,000 + $400*12)
Total Deductions	$32,000	
4. Equals Taxable income	83,100	
5. Look up Tax in Table	1,940	10% on first $19,050
	7,146	12% on $58,350
	913	22% on $5,700
Calculated tentative tax	$9,999	
6. Child tax credit	-6,575	(2,000 * 3 kids under 18)
7. Total Taxes Due	$3,424	
Amount withheld	12,000	
Refund is	-$8,576	



Federal Tax Liability Worksheet (LT39) Use Drop Down Box
Clear Inputs | Sudweeks | January 25, 2019 | Year & Status: 2019 | Married Filing Jointly

Note: Using 2019 Tax Rates for Married Filing Jointly

Step 1: Determine Total Income — Amounts
Includes:
Wages, salaries, tips: 110,000
Investment/interest income/bonus: 10,100
Education income in excess of expenses
Excludes:
Qualified retirement contributions (401k, 403b, not Roth's)
Interest on US Savings bonds
Total Gross Income: 120,100

Adjusted Gross Income
Excludes:
Tuition & Fees and Student Loan interest Deduction**
IRA/SEP contributions (not Roth IRA): 5,000
Medical Savings Account contributions
Flexible Spending Account contributions
Total Adjusted Gross Income: 115,100

Step 2: Calculate Taxable Income
Standard or Itemized Deductions: Standard
Standard deduction: 24,400 — 24,400
Itemized deductions
Charitable contributions: 17,800
State and Local Taxes (SALT $10,000 max.): 16,180 — 10,000
Home mortgage interest: 4,200
Other taxes
Charitable Mileage: 0.14 — -
Job Related - Not Deductible in 2018: -
Medical expenses > 10.0% of AGI: 4,000 — 11,510 — -
Total itemized deductions: 32,000
Total Taxable Income: 90,700

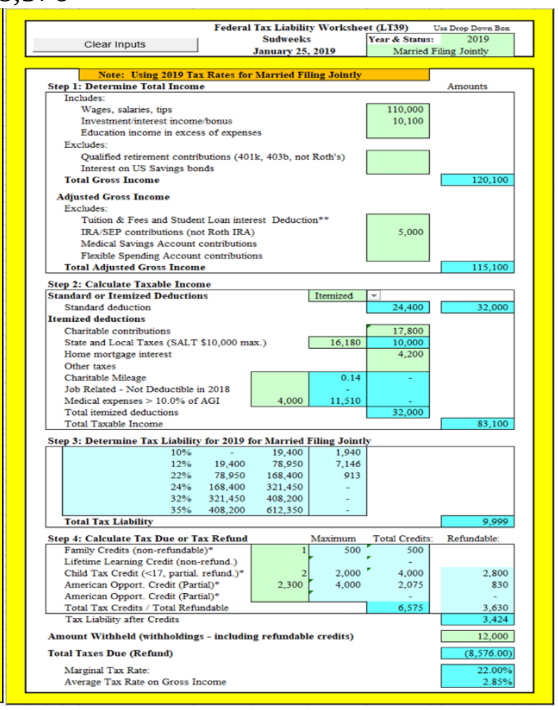
Step 3: Determine Tax Liability for 2019 for Married Filing Jointly

10%	-	19,400	1,940
12%	19,400	78,950	7,146
22%	78,950	168,400	2,585
24%	168,400	321,450	-
32%	321,450	408,200	-
35%	408,200	612,350	-

Total Tax Liability: 11,671

Step 4: Calculate Tax Due or Tax Refund — Maximum — Total Credits: — Refundable:
Family Credits (non-refundable)*: 1 — 500 — 500
Lifetime Learning Credit (non-refund.): -
Child Tax Credit (<17, partial. refund.)*: 2 — 2,000 — 4,000 — 2,800
American Opport. Credit (Partial)*: 2,300 — 4,000 — 2,075 — 830
American Opport. Credit (Partial)*: -
Total Tax Credits / Total Refundable: 6,575 — 3,630
Tax Liability after Credits: 5,096

Amount Withheld (withholdings - including refundable credits): 12,000
Total Taxes Due (Refund): (6,904.00)
Marginal Tax Rate: 22.00%
Average Tax Rate on Gross Income: 4.24%



Federal Tax Liability Worksheet (LT39) Use Drop Down Box
Clear Inputs | Sudweeks | January 25, 2019 | Year & Status: 2019 | Married Filing Jointly

Note: Using 2019 Tax Rates for Married Filing Jointly

Step 1: Determine Total Income — Amounts
Includes:
Wages, salaries, tips: 110,000
Investment/interest income/bonus: 10,100
Education income in excess of expenses
Excludes:
Qualified retirement contributions (401k, 403b, not Roth's)
Interest on US Savings bonds
Total Gross Income: 120,100

Adjusted Gross Income
Excludes:
Tuition & Fees and Student Loan interest Deduction**
IRA/SEP contributions (not Roth IRA): 5,000
Medical Savings Account contributions
Flexible Spending Account contributions
Total Adjusted Gross Income: 115,100

Step 2: Calculate Taxable Income
Standard or Itemized Deductions: Itemized
Standard deduction: 24,400 — 32,000
Itemized deductions
Charitable contributions: 17,800
State and Local Taxes (SALT $10,000 max.): 16,180 — 10,000
Home mortgage interest: 4,200
Other taxes
Charitable Mileage: 0.14 — -
Job Related - Not Deductible in 2018: -
Medical expenses > 10.0% of AGI: 4,000 — 11,510 — -
Total itemized deductions: 32,000
Total Taxable Income: 83,100

Step 3: Determine Tax Liability for 2019 for Married Filing Jointly

10%	-	19,400	1,940
12%	19,400	78,950	7,146
22%	78,950	168,400	913
24%	168,400	321,450	-
32%	321,450	408,200	-
35%	408,200	612,350	-

Total Tax Liability: 9,999

Step 4: Calculate Tax Due or Tax Refund — Maximum — Total Credits: — Refundable:
Family Credits (non-refundable)*: 1 — 500 — 500
Lifetime Learning Credit (non-refund.): -
Child Tax Credit (<17, partial. refund.)*: 2 — 2,000 — 4,000 — 2,800
American Opport. Credit (Partial)*: 2,300 — 4,000 — 2,075 — 830
American Opport. Credit (Partial)*: -
Total Tax Credits / Total Refundable: 6,575 — 3,630
Tax Liability after Credits: 3,424

Amount Withheld (withholdings - including refundable credits): 12,000
Total Taxes Due (Refund): (8,576.00)
Marginal Tax Rate: 22.00%
Average Tax Rate on Gross Income: 2.85%

Case Study #4[4]

Data

Steve and Stella are a young married couple with a baby. Steve earned $6,000 and Stella $10,000. $2,000 was withheld from their paychecks for federal income taxes, and they will take the standard deduction for MFJ. They learned about IRAs in Fin418, so they set up and contributed $200 to a Roth IRA. They had tuition costs of $10,400 and books of $600, equally split. They received federal Pell grants worth $6,000 in 2019 equally split.

Calculate their:

- AGI (Step 1)
- Taxable Income (Step 2)

- Tax Liability (Step 3)
- Taxes Due/(Refund)* (Step 4)

Case Study #4 Answers

Calculate their AGI:

- Their AGI is compose of their gross income less any adjustments. Their gross and adjusted gross income is: $16,000

Calculate their Taxable Income:

- Since they took the standard deduction ($24,400) and only made $16,000, their taxable income is: 0

Calculate their tax liability:

- Since their taxable income is $0, their tax liability is: 0

Calculate their refund:

- The child tax credit is $2,000, of which $1,400 is refundable
- They have a Pell grant of $6,000, equally split, with books and tuition also equally split.
- Their total education expenses for tuition and books was $11,000, less the Pell grant of $6,000, would result in tuition and book expenses, in excess of the Pell grant, of $5,000 each.
- Since it was equally split and both are going to school, we do two American Opportunity Credits using $2,500 of expenses for each. This results in two credits of $2,125 of which 40% ($850) is refundable.
- Their total credits were $6,250, of which $3,100 is refundable
- Their total refund would be the $3,100 of refundable credit, plus the $2,000 they paid, for a total refund of $5,100

From the Vita (volunteer income tax assistance) Lab, a tax lab for students, they would recommend that since the credits are more important and you have no taxable income

- Take $3,000 and put it in gross income. Your taxable income is still 0
- Recognizing the $3,000 in income allows you to put $4,000 each in the AOC credit, which brings up your total refundable credit to $3,400
- Your refund is $5,400, $300 more than calculated earlier

For BYU students, we recommend when you are doing your taxes that you go to the VITA Lab for help. You can sign up at http://www.vita.byu.edu and set up an appointment

[1] Tax freedom day is the day the average tax payer has covered all their federal and state taxes for the year. See Tax Foundation, Washington, D.C., https://taxfoundation.org/tax-freedom-day-2018, June 30, 2019).
[2] Doctrine and Covenants 58:21–22.

[3] Used with permission of E. Jeffrey Hill and Craig Israelson, Fundamentals of Family finance: Living Joyfully within your Means Workbook, BYU Press, 2016, updated with new tax data.
Tax Foundation, Washington, D.C., https://taxfoundation.org/tax-freedom-day-2018, June 30, 2018).
[4] Used with permission of E. Jeffrey Hill and Craig Israelson, Fundamentals of Family finance: Living Joyfully within your Means Workbook, BYU Press, 2016, updated with new tax data.

5. Cash Management: Making the Little Things Count

Introduction

The term "cash management" is the process of collecting and managing and investing cash for the short-term. It 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 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.

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:

A. Understand the importance and principles of cash management.
B. Know the different types of financial institutions the need to spend time each week to effectively manage your finances.
C. Understand the different cash-management alternatives and how to compare them.
D. Understand and create your Cash Management Plan.

Understand the Importance and 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.

Trade-offs of Cash Management

There are three main trade-offs regarding cash management. The first is the risk-return trade-off: higher liquidity means less risk and 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 . . . 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 [spouse] and children and peace in your hearts.[1]

Being able to provide for one's family and to feel secure financially are great goals for cash management.

Principles of Cash Management

The principles of effective cash management are:

1. Know yourself, your vision, goals, plans and budget. It is critical to know what is important to you as you work to make the little things count.

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand your key areas of cash management. Cash management funds are "emergency funds" where liquidity, the ability to convert funds to cash quickly, is necessary.

4. Seek for the highest return in terms of after-tax and equivalent taxable yield. Make this consistent with your financial safety, interest rate, risk tolerance and liquidity requirements.

5. Monitor and revise your cash management strategy as necessary. This will help you to meet your changing personal and market environments.

Finding Balance

As you work on managing your short-term finances, finding balance among doctrines, principles and application is important in helping you become better. We have shared some ideas for principles, although I am sure you can find others that are important to you. Below are a few ideas for doctrines on which the principles are based. As you strive to increase your ability and effectiveness in managing your cash, I recommend you study and ponder the doctrines and principles supporting cash management.

Principles	Doctrines
Know yourself, your vision, goals, and plans	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Understand the key areas of cash management	Agency
Seek the highest return and safety	Agency
Monitor and revise your plan as needed	Accountability

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with our liquid assets, which is an application. From a higher perspective, or increased vision,

We are children of Heavenly Parents (identity), striving to live worthy of the Spirit (obedience), using the talents and skills we have been blessed (stewardship), with a Plan to be wise stewards and agents over our short-term finances (agency). This is important as the small things can add up over time (accountability), helping us so that we can accomplish our personal missions and family vision and goals.

Know Types of Financial Institutions and the Importance of Spending Time on your Finances

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 funds in 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.

Making the Time Commitment

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:

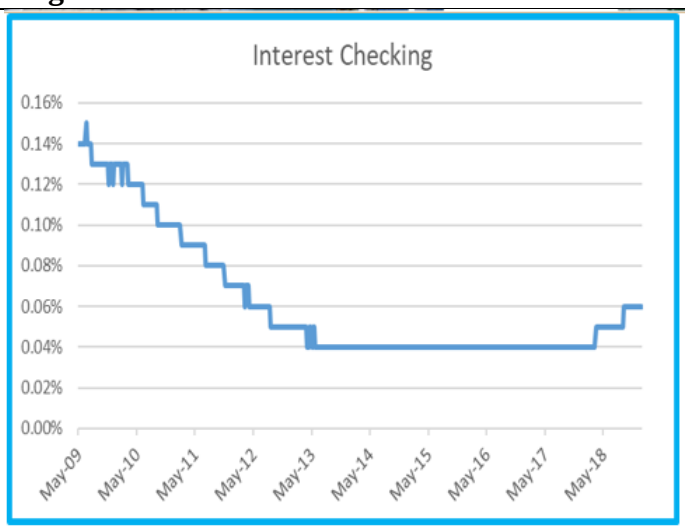
> Board of Governors of the Federal Reserve System
> Division of Consumer and Community Affairs
> 20th Street and Constitution Avenue, N.W., Stop 801
> Washington, D.C. 20551

Understand Cash-Management Alternatives 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, short-term bond 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 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.

Chart 1. Checking Account Rates over Time



Source: St. Louis Federal Reserve at Fred.org

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.

A 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 (see Chart 2). Such accounts are also known as money market demand or deposit accounts.

Chart 2. Money Market Account Rates over Time

Source: Bankrate.com 2019/01/25

Money Market Accounts (MMA)

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 (see Chart 3).

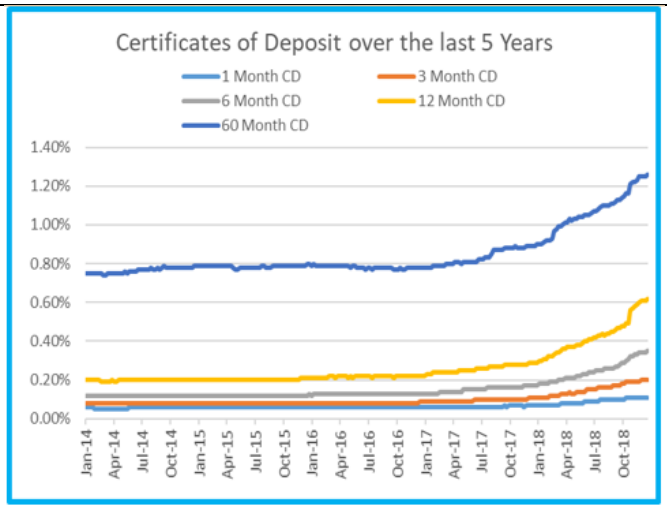
CDs are less liquid than other cash-management alternatives because the money must be deposited for a certain amount of time; however, with that reduction in liquidity comes a higher interest rate. The required minimum balance for a CD account is generally higher than it is for a savings or checking 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 https://www.bankrate.com/.

Chart 3. CD Rates over time



Source: Fred.org 2019/01/25

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.

Short-term Bond Mutual Funds (STBMFs)

Short-term bond mutual funds pool money from many investors to buy higher yielding debt securities, less than 1 year maturity. 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. We recommend you purchase no-load short-term mutual funds, which means they do not have a sales charge. You can review the structure and performance of these mutual funds on websites such as www.morningstar.com.

These STBMFs are generally very liquid. Because they are no-load funds, you can buy and sell easily. As mutual funds, they may have a required minimum balances. We will discuss where to find this information in a later section of this course. Interest rates are generally slightly higher than MMMFs, as the duration or maturity of these assets are a bit longer. These are not FDIC insured, and may be all taxable or tax free, depending on what the fund is invested in. To invest, contact a mutual fund company to set up an account and purchase a fund.

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 to their face value, and when the bill matures, investors receive the full face value (see Chart 4).

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, and various brokerage institutions.

Chart 1. Cash Management Alternatives 2019

2019 Cash Management Asset Comparisons MBA 620/Fin418/Fin200 Financial Planning (1/26/19)									
	Traditional				Short-term Mutual Funds		Government Bills and Savings Bonds		
Assets:	Checking	Savings	Money Market (or MMDA)	Certificate of Deposit	Money Market Mutual Fund	Short-term Bond Funds	US Treasury Bills	EE Bonds	I bonds
Description:	Deposits help at a financial institution that allows withdrawals by checks and deposits on demand; hence, it is also called a demand account.	Deposits held at a financial institution that earn interest. Internet savings rates generally higher	A savings account that typically earns rates and that pays interest based on current money market interest rates. These have higher minimum balances.	Savings certificates with fixed maturity and interest rate, and can be issued in any denomination. Access to the funds is restricted until maturity date	An open-end mutual fund that invests in very short-term debt securities such as US treasury bills, municipal bonds, or commercial paper.	An open-end mutual fund that invests in short-term corporate bonds, municipal bonds, or Treasury securities with maturities less than one year.	Short-term US government debt obligations sold with different maturities and issued at a discount from par. Investors receive interest at maturity.	US government savings bonds where the interest rate is set every 6 months and tied to current market interest rates.	US government savings bonds with interest rates linked to US inflation and in which rates are set every 6 months
Liquidity:	Very liquid, daily	Very liquid, daily	Very liquid, daily	Fixed maturity on CDs	Somewhat liquid, get money in 3 days	Somewhat liquid, get money in 3 days	Somewhat liquid depending on maturity	After 12 months redeem at any bank	After 12 months redeem at any bank
Required Minimum Balances:	None	Low to none	Higher required minimum balances	Higher required minimum balances	Depends on mutual fund requirements	Depends on mutual fund requirements	Higher minimum balances	May purchase in denominations from $25 to $10,000	May purchase in denominations from $25 to $10,000
Interest Rates:	.05% - 2.5%	.05% - 2.0%, Internet .3% - 2.5%	.2% - 2.0%	1M: .11%, 3M: .20%, 6M: .35%, 1Yr: .62%, 5 Yr: 1.26%	Higher than MMA, .25-.5% depending on market conditions	Higher than MMMF, .35-.8% depending on market conditions	1M: 2.41%, 3M: 2.43%, 6M: 2.51%; 1Y: 2.58%, 5Y: 2.56, 10Y: 2.74%	Rates are reset every 6 months and are 0.1% through Apr. 30, 2019	Rates are reset every 6 months and are 2.83% through Apr. 30, 2019
Taxes:	Federal and State	Federal and State	Federal and State	Federal and State	Bonds - all taxable; Muni bonds - Fed. tax-free, if from your state - all tax free; US Treasuries - State tax free	Bonds - all taxable; Muni bonds - Fed. tax-free, if from your state - all tax free; US Treasuries - State tax free	State tax free	State tax free. If principle and interest used to pay for college tuition, then both Federal and State tax free	State tax free. If principle and interest used to pay for college tuition, then both Federal and State tax free
Safety:	FDIC insured	FDIC insured	FDIC insured	FDIC insured	Not FDIC insured but very short-term (<30 days)	Not FDIC insured but very short-term (< 1 year)	Not FDIC insured but a US debt obligation	Not FDIC insured but a US debt obligation	Not FDIC insured but a US debt obligation
Early Withdrawal Penalties:	None	None	None	Yes	None	None	Yes	Must hold 12 months then 3 months interest penalty before 5 years	Must hold 12 months then 3 months interest penalty before 5 years
Other features:	None	None	May have limited check writing	None	May have limited check writing	None	None	If proceeds used for tuition, then state and federal tax free	If proceeds used for tuition, then state and federal tax free
How to invest:	Contact a bank or other financial institution	Contact a bank or other financial institution	Contact a bank or other financial institution	Contact a bank or other financial institution	Contact a no-load mutual fund company to invest	Contact a no-load mutual fund company to invest	Purchase from www.treasurydirect.gov, banks and brokers	Purchase from www.treasurydirect.gov, $10,000 per year plus $5,000 from tax refund. Income limits apply	Purchase from www.treasurydirect.gov, $10,000 per year plus $5,000 from tax refund. Income limits apply

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 (see Chart 5).

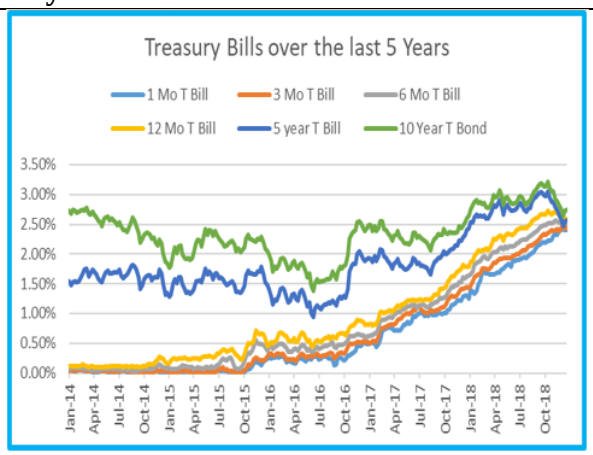
Series EE bonds are liquid in the sense that they can be cashed at any time after one year. Ideally, you should hold them for at least five years to ensure there will not be an interest penalty; after five years, these bonds can be cashed at any bank. Interest rates are competitive. Required minimum 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).

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 (see Chart 6).

Chart 4. Treasury Bill Rates over Time



Source: Fred.org 2019/01/25

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.

Table 1. US Government Series EE/I Savings Bonds MAGI Income Limits

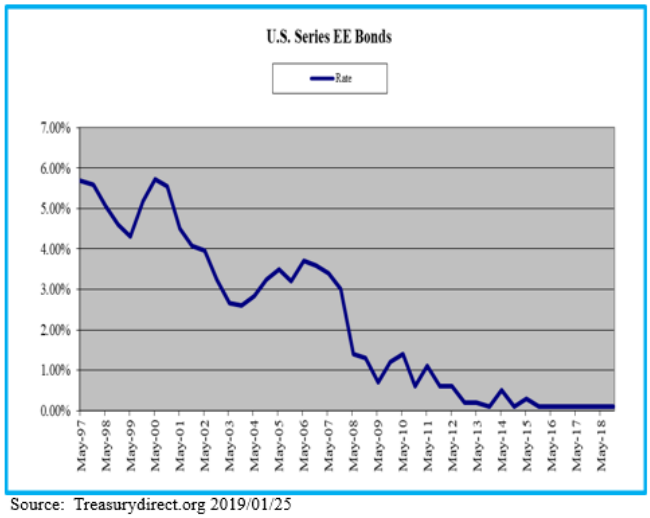
Year	Filing Single	Married Filing Jointly
2014	$76,000–91,950	$113,950–143,900
2015	$77,200-92,199	$115,751-145,749
2016	$77,550–92,550	$116,300–146,300
2017	$78,150–93,150	$117,250–147,250
2018	$79,700–94,700	$119,550–149,550*

*Note: As of June 18, 2019, income limits were not yet available.

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.savingsbonds.gov. Series I bonds have the same MAGI limits as Series EE bonds above (see Table 1).

Chart 5. US Series EE Bond Rates over Time



Source: Treasurydirect.org 2019/01/25

Comparing Cash-Management Alternatives

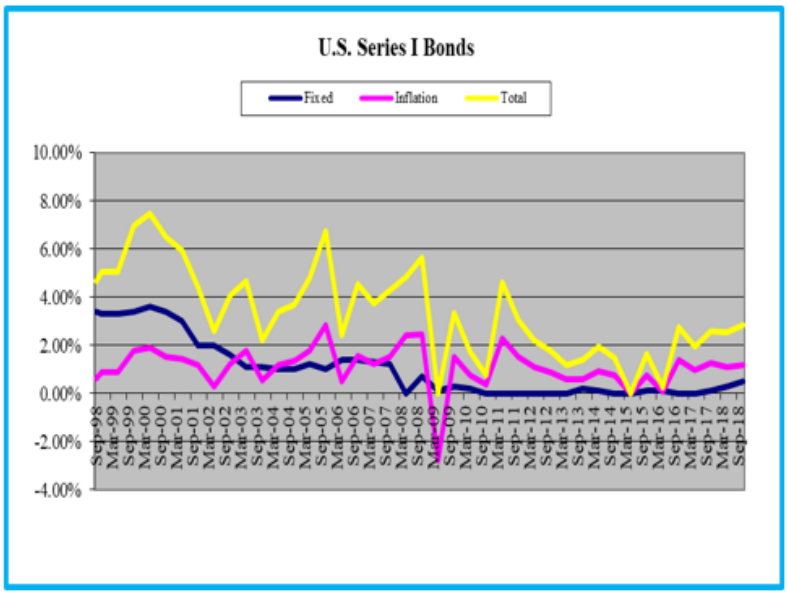
When comparing cash-management alternatives, it is critical to understand and accurately compare the following five areas:

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). The Annual Percentage Yield is the effective rate of return taking into account the effect of compounding interest. Look for this APY yield when comparing alternatives. It includes the impact of different compounding periods. The formula for APY = $(1 + [APR/Periods])^{Periods} – 1$.

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). The formula for After-Tax Return = Before-Tax Return * (1 – 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).

Chart 6: US Series I Bond Rates over Time



Source: Treasurydirect.org 2019/01/25

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). The formula for ETY = After-Tax Return / (1 – Marginal Tax Rate).

To gain a better understanding of after-tax returns and equivalent taxable yields, see After-Tax, ETY, and Other After-Inflation Returns (LT26).

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 as Real Return = [(1 + nominal return) / (1 + inflation)] – 1 where nominal return is the return including inflation.

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?

Understand and Create Your Cash Management Plan

You need to develop a cash management plan for your finances. Following is one idea as to how you could do this.

1. Decide how many months of expenses you want in your emergency fund. Generally, 3 to 6 months is recommended. This is usually considered the time it takes to get another job.

2. Decide how you will divide your investments between the various cash management assets. I like to use a month's expenses as a good guide.

3. Diversify your cash management assets based on risk and return. Try to get the highest return at your level of liquidity, safety, and risk. Using additional assets discussed can help, and I try to diversify my assets over a number of different cash management alternatives.

Now that you have a few ideas, following are some ideas to help you with your Plan.

Vision

- Likely from your Plan for Life. Other ideas include:
    - Financial difficulties are not a concern.
    - I will always have sufficient to meet by short-term liquidity needs.
    - To be prepared for all emergencies in life.

Goals

- Have adequate liquidity for short-term needs, and keep additional funds invested for better returns.
- Keep a 4 month Emergency Fund at all times.
- When Emergency Fund is drawn down, replenish it immediately to bring it back to its target level.
- Pay off all credit cards monthly and not pay any interest.
- Strive for the highest interest rate consistent with my level of risk.
- Seek to try to keep up with inflation.

Plans and Strategies

- Auto pay a specific amount monthly into savings/investing accounts.
- Diversify my short-term instruments in checking, saving, CDs, US Savings Bonds, MMMFs, and short-term bond funds.
- I will have 3 months expenses in my Emergency fund, 1 month of expenses in checking, 1 month savings/CD (for higher interest), and 1 month in a no-load short-term bond fund (for better than MMMF interest rates).
- I will have 4 months expenses in my Emergency fund, 1 month expenses in checking, 1 month in savings/CD, 1 month in a short-term bond fund, and 1 month in I bonds (which you have held for one year and which can be used for educational expenses for your children as well).
- Since my income is so volatile, I will have 6 months expenses in my Emergency fund, 1 month in checking, 1 month in a MMMF, 2 months in a short-term bond fund, and 2 months in I bonds.
- Reevaluate my cash management holdings annually to make sure I am getting the best tax-adjusted return.
- Watch requirements of high-yield and other savings accounts carefully so I do not lose return from additional fees.

Constraints

- Laziness will keep you from good record keeping.
- Not living on a budget will make it difficult to save.
- Getting caught up in the things of the world will make it difficult to save.

Accountability

- I will share my vision and goals with my spouse and children.

- I will remember these things in prayer with Heavenly Father each night and morning.

Realize that these are just ideas, but may give some thought as to what you can and should include in your Cash Management Plan.

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. It is the challenge of making every dollar count.

Cash management is part of your overall plan to be a better and wiser steward over your resources to accomplish your personal and family vision and goals. Do it well.

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. 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. 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).

Finally, you should develop a Cash Management Plan. This Plan will help you know how much you should put into the various cash management alternatives and why.

Assignments

Financial Plan Assignments

Your assignment is to put together your Cash Management Plan. I recommend you use the PFP Cash Management Plan Template (LT01-06) as a starting point. With this template, create your Plan. Include:

Vision. What is your vision for Cash Management. For most it is to have the cash available as needed so you do not need to dip into long-term savings for short-term needs.

Goals. Where would you like to be with your Cash Management Plan?

Plans and Strategies. You Action Plan should be the cash-management vehicles 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, (Internet banks) that can give you a higher return with the same amount of liquidity and safety?

Start by reviewing 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)? Which of these current vehicles, if any, do you use? What rates are you earning on your checking and saving accounts? What monthly and other fees are you paying.

Constraints. What will keep you from accomplishing this Plan? What can you do to minimize that chance?

Accountability. Who will you be accountable to?

Learning Tools

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

After-Tax, ETY, and Other After-Inflation Returns (LT26)
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

Terminology Review

After-Tax Return: This is your return after the impact of taxes has been taken into account. It is your before-tax return times 1 minus your marginal tax rate, or $R_{\text{Before tax}}$ * (1 – Marginal Tax Rate)

Annual Percentage Yield: The Annual Percentage Yield is the effective rate of return taking into account the effect of compounding interest and includes the impact of different compounding periods.

Cash Management: Cash management is the process of collecting and managing and investing cash for the short-term.

CD Laddering: the process of getting a higher interest rate by buying longer term CDs and purchasing them more often. For example, 1 month CD rates are too low, but you like 6 month rates. Take the amount of money you want to invest, divide it by 6 (or any number), then invest 1/6 of your money every month in a 6 month rate. You are creating a ladder of CDs, and every month you have money coming in. You would then reinvest that in another 6 month CD.

CDs: Certificates of Deposit are savings certificates with a fixed maturity date, a specific interest rate and can be issued in any denomination. A CD restricts access to the funds until the maturity date, and are generally issued by a commercial bank.

Checking Accounts: Checking accounts are deposits help at a financial institution that allows withdrawals and deposits on demand; hence, it is also called a demand account.

Commercial Banks. These financial institutions 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.

Corporate bonds: Debt instruments issued by corporations to fund the requirements of the companies.

Credit unions. These institutions 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.

EE Bonds: US government savings bonds where the interest rate is set every 6 months and tied to current market interest rates.

Equivalent Taxable Yield: This is the yield you would need to earn on a fully taxable security to give the same after-tax return that you receive on a tax advantaged security, i.e., a security that has specific tax advantages (i.e., tax free for Federal or State or both).

I Bonds: Inflation linked US government savings bonds, where the rates on the bonds are tied to inflation.

Inflation: This is the rate of general level of prices are changing

Interest Rates: This is the amount charged by a lender to allow a borrower the use of the

funds. It is expressed as a percentage of principal; and typically noted as the APR or annual percentage rate.

Interest Rate Adjustments: With certain cash management instruments, the interest rates can change over time, depending on a specific index and a spread.

Internet Banks: These financial institutions 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.

Maturity: Maturity is the amount time certain financial instruments require the investment to be held, i.e., 3 months, 5 years, or 10 years.

Money Market Account or Money Market Deposit Account: A non-financial account that pays interest based on current interest rates in the money markets. They typically require a higher minimum balance to avoid monthly fees and typically have a higher rate of interest.

Real Interest Rate: The real rate is the interest rate that has been adjust to eliminate the effects of inflation.

Safety: Safety refers to the ability to invest without losing principle. Banks and credit unions have FDIC and NCUA insurance are available for up to $250,000 per depositor (not per account).

Savings and loan associations. These institutions 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.

Savings Bonds: Bonds issued by the US government with tax advantages to encourage savings.

US Treasury Bills: These are short-term debt obligations of the US Government with a maturity of generally less than one year, are sold in different maturities, and are issued at a discount from par. Investors do not receive regular payments as with a coupon bond, but do receive interest at maturity.

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%

<u>Case Study 3</u>

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

After-tax return = before-tax return * (1 – (federal + state marginal tax rate))

4.5% * (1 – (.35 + .07)) = The after-tax return is 2.61%

Real Return = [(1+ after-tax return) / (1 + inflation)] - 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

[1] "To the Boys and to the Men," *Ensign*, Nov. 1998, 51
[2] Thomas J. Stanley and William D. Danko, *The Millionaire Next Door*, Pocket Books, New York, 1996, 71.

6. Credit: Understanding and Using It Wisely

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."[1]

Objectives

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

A. Understand credit bureaus, credit reports, credit scoring and the principles of using credit wisely
B. Understand the correct uses of credit cards
C. Learn how credit cards work and how to manage credit
D. Understand and create your Credit Plan.

Learn About Credit Bureaus, Credit Reports, Credit Scores and the Principles of Using Credit Wisely

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 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 (Equifax, Trans Union, and Experian) 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 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 evaluation is the process potential creditors use to determine whether or not an individual deserves to be given credit. This is based on an analysis of specific financial information from various sources which results in a credit score. 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[2]

Credit scores above 760 paid 3.27 percent.
Credit scores from 700 to 759 paid 3.49 percent.
Credit scores from 680 to 699 paid 3.67 percent.
Credit scores from 660 to 679 paid 3.88 percent.
Credit scores from 640 to 659 paid 4.31 percent.
Credit scores from 620 to 639 paid 4.86 percent.

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. There are two main FICO scores, including FICO Score 8 (which is the most widely used) and the FICO Score 2, which is used for mortgage lending.

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. You may also be able to get it free from your credit card company or other agency. I generally recommend getting your FICO credit score as these are most used in the industry.. 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, Nordstrom's, and 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.

Which Credit Score Should You Get and How Do You Get It

There are a number of credit score providers including FICO, VantageScore, PLUS Score, etc. The most used credit score is from FICO. Most loans are sorted based on FICO scores, and there are different FICO scores. While I recommend a FICO score, any score will fulfill the requirements for your PFP.

You can go four routes for your credit score. I would recommend you do it for free if you can.

1. FICO Scores. Discover offers your FICO score for free, you can check it often as it is updated monthly. Go to https://www.discover.com/free-credit-score/ and you can get a free FICO score. You can also go to Google.com, and search for "Myfico promotional code" (generally 10-30%), then go to www.MyFico.com and order a standard credit report and FICO score for $19.95 less discount.

2. Other Credit Scores. You can use free sites to get your Vantage or other scores and to monitor it regularly. While not FICO scores, it can help you if you see your trending score. Sites include www.CreditKarma.com (with an app) and www.Creditsesame.com.

3. You may be able to get a copy of your credit score from your bank or credit card provider (it may or may not be a FICO score). Contact them and see what they have available.

4. If you go to Mint.com, you can also get a free copy of your credit score from them. You need to have already done your budget to get it.

Regardless of how you get your credit score, you will view and print off your credit report and credit score and put it in your PFP.

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.

Principles of Using Credit Wisely

Proper understand of the principles of using credit wisely can help us to be wiser consumers of credit. Following are a few principles of using credit wisely which may be helpful as to try to minimize the use of credit.

1. Know what you want out of life. Know yourself, your vision, goals, plans and values. It is important that you have an idea of what you are trying to accomplish so that you can slowly become that vision of yourself. Make sure that everything you do is consistent with the things you are trying to accomplish and the values you hold dear.

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of credit and credit reports. It is critical that you understand how our financial system works in regards to credit. Learn how things work and how you can improve your standing with lenders.

4. Know where you are financially. This is especially important in regards to your budget, assets and liabilities. Hide no bills from your spouse and make sure you understand all assets and liabilities.

5. Keep current on all bills. Pay off all credit cards and other debt monthly—you do not need a balance to build credit. Set a goal to not go into debt except for those things that the prophets and apostles have counseled. Work hard to not spend money you don't have.

6. Make only planned purchases from your budget. Only make purchases that are in your budget and that are planned for, particularly large purchases. Use this planning time each quarter or month to wisely determine your needs and wants, and then to plan accordingly.

7. Be wise in your use of credit and debt. Don't go into debt except for a modest home and modest education. Do not fall for the monthly payments trap that says you can pay a certain amount each month.

8. Review your credit score and credit reports annually. This is to ensure correctness and no identity theft which is becoming more prevalent. Work to improve your credit reports and raise your credit score to above 750 if possible.

Finding Balance

As you work on managing credit, finding balance among doctrines, principles and application is important in helping you become better. We have shared some ideas for principles, although I am sure you can find others that are important to you. Below are a few ideas for doctrines on which the principles are based.

Principles	Doctrines
Know yourself, your vision, goals and budget	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Understand the key areas of credit and reporting	Agency
Know where you are financially	Stewardship
Keep current on all bills, don't go into new debt	Accountability
Make only planned purchases	Stewardship
Be wise in your use of credit	Accountability
Review your score and credit reports quarterly	Stewardship

From Obedience to Consecration

From the principles and doctrines, you can see that you are not just working on being wise with your use of credit, which is an application; rather, from a higher perspective, or increased vision,

> We are children of God (identity), striving to live worthy of the Spirit (obedience), acting on our ability to choose (agency), who understands the benefits and dangers of credit (stewardship) and who uses credit only for those items recommended (accountability). We understand the credit industry (stewardship), use it to our advantage by keeping your

credit score high (accountability), so we can get the lowest cost on needed credit products (stewardship), so we can eliminate our interest costs and save money to accomplish our individual missions and personal and family vision and goals.

Identify Appropriate Uses for Credit Cards

Credit cards are essentially open lines of credit. Credit cards can be either 1. the single most destructive financial instrument in the history of the world, or 2. a tool to help us reach our personal and family goals. It depends on us! If we use them to borrow money and get further into debt, they are destructive. If we use them to achieve our personal and family goals, they can be helpful.

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 vision and goals.** What do you want to accomplish individually and as a family? What do you want to accomplish financially? If you can develop good habits, instead of paying interest you can earn it.

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 How to Manage Credit

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. 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.

Understand and Create Your Credit Plan

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

Managing Open 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:	888-766-0008
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, do plastic surgery, i.e., 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.

Creating Your Credit Plan

How you use credit can have a major impact on how you accomplish your personal and family vision and goals. Not living on a budget, not understanding your needs versus wants, and buying on credit are significant constraints that have derailed many wonderful family visions and goals.

As such, it is important that you develop a Credit Plan for how you will manage credit. It need not be long, but it needs to be thought out. Following are a few ideas.

Vision

- From your " Plan for Life." Other ideas may include."
- We will have the necessary financial resources to be able to accomplish my personal mission and my individual and family vision and goals.
- We will use credit wisely in that we will not pay a dollar of interest for non-mortgage, non-student loan debt.

Goals

- We will watch our Credit Reports and Scores quarterly to ensure no major changes and no fraud.
- We will not go into debt except for those things specified by the prophets: a modest education and home, and perhaps a first car.
- We will use credit wisely and to our advantage, and will not pay interest.
- We will not buy cars on debt after the first car.
- We will pay off all credit cards monthly.
- We will not pay any credit card or auto interest.

Plans and Strategies –

Overall

- We will live on a budget and save 20% (or your amount) and save 15% for retirement.
- We will not buy anything with credit cards unless we have the money to pay it off at the end of the month.
- If we have spending problems, we will perform "plastic surgery" and cut up our credit cards.
- We will save for all auto and toy purchases, and will pay cash for all vehicles and toys.

Credit Cards

- We will maintain our Emergency Fund of 4 (your amount) month's income.
- We will use credit cards, but use them wisely and only for planned items in our budget.
- We will use debit cards carefully as the risk of loss is higher.
- We will pay cash for all our vehicles. We will save $300 each month (your amount) for new vehicles.

Credit Reports

- We will Opt Out of all mailing lists for credit cards.
- We will pull one credit report every four months to make sure there are no changes.
- We will check our Credit Report each time to make sure there are no mistakes or fraud.

Credit Scores

- We will Opt Out of all mailing lists for credit cards.

- We will keep our credit score above 760 so we can get the lowest rates for a mortgage and insurance.
- We will pull our free FICO Credit Score annually to make sure there are no major changes.
- We will watch our VantageScore monthly via the CreditKarma or CreditSesame app to ensure no major changes.

Constraints

- Our biggest hurdles to accomplishing this will be:
    - bot living on a budget and not saving money.
    - being impatient and not saving for our vehicles, toys, and other large purchases.
    - Losing the Spirit and not keeping an eternal perspective by having scripture study each day, FHE each week, and attending the temple regularly.
    - Not watching our spending on the little things so we can do the big things.

Accountability

- From your "Plan for Life." Other ideas may include:
    - I will share my vision, goals and plans with God each morning in prayers.
    - I will share these vision and goals with my spouse and kids so they can keep me accountable.

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.

We shared the key principles and doctrines of using credit wisely. As we follow the principles and understand the doctrines, it changes our perspective for the better.

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.

We shared how to manage your open credit and the importance of having a Credit Plan on how you will use credit during your life. 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, and having a Credit Plan are important parts of the modern financial world. We shared concrete ideas on how to put together your credit plan.

Assignments

Financial Plan Assignments

Your assignment is to put together your Credit Plan. I recommend you use PFP Credit Use Template (LT01-07). This will help you evaluate how you are doing in managing credit wisely. 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.

Vision. What is your vision for Credit? Again, this need not be long.

Goals. What are your goals for using and managing credit wisely?

Plans and Strategies. For Credit Cards, answer the following for each credit card you have (bold items are required--see Chart 1: Credit Card Rates). If you have no credit cards, state that you have no credit cards and complete your action plan on views of future debt and perhaps your plan to obtain a credit card.

Credit Report. 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.

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.

Credit Score. Finally, go and obtain your credit score. This score is used by many industries to determine the type of credit risk you are. While we prefer a FICO score, which is used by 85% of the industry, you are welcome to go to free locations, such as www.creditkarma.com review your credit score (they actually use VantageScore 3.0). it can give you an idea of how others see your credit usage. They generally will use either the TransUnion or Equity credit data to calculate your 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 as part of your Plans and strategies. Under your Action Plan, what are the things you are going to do to improve your credit usage and to be better at wisely managing credit?

Finish by writing your constraints and accountability.

Chart 1: Credit Card Rates

Annual Percentage Rate for Purchases (fixed or variable)	%
Cash Advance APR (fixed or variable)	%
Balance Transfer APR (fixed or variable)	%
Overdraft Advance APR (fixed or variable)	%
Variable Rate Information (Index is _____)	
Purchase And Balance Transfer APR (Index + ___.__%)	%
Cash Advance APR (Index + ___.__%)	%
Default APR (Index + ___.__%)	%
Grace Period (in days)	
Method of Computing Balance for Purchase	
Annual Fee	
Minimum Finance Charge	
Transaction Fee for Balance Transfers	
Transaction Fee for Cash Advances	
Late Payment Fee	
Over-the-Credit-Limit Fee	
International Fee	
Credit Limit	
Date Opened (if available)	

Learning Tools

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

Credit Card Repayment Spreadsheet (LT18)

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.

Debt Amortization and Prepayment Spreadsheet (LT09)
This Excel spreadsheet is a debt amortization and prepayment schedule to help you reduce and eliminate your debt.

Debt Elimination Schedule with Accelerator (LT20)
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. You can choose pay highest interest rates first, consistent with Marvin J. Ashton's plan in the article "One for the Money," or smallest payoff first, consistent with Dave Ramsey. 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:

	10%	16%	18%	24%
Average daily balance	$5.00	____	____	____

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.

	10%	16%	18%	24%
Average daily balance	$5.00	$8.00	$9.00	$12.00

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.

<u>Case Study 4</u>

Data

Bethany, a BYU student, was reading about the importance of having a high credit score. She went to 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 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, 2 May 2012

7. Loans: Avoiding Consumer and Minimizing Student/Mortgage Loans

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:

A. Understand consumer loans, principles, characteristics and costs.
B. Understand mortgage loan types, characteristics, and costs.
C. Understand the key relationships for borrowing.
D. Understand and create your Consumer Loans and Debt Plan.

Understand Consumer Loans, Principles, Characteristics and Costs

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.

Dangers of Consumer Loans

When should you obtain a consumer loan? The following are a few questions to ask yourself if you are thinking of borrowing suing a consumer loan:

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.

The principles of effective consumer loan use are the same as the principles of effective loan use:

> **1. Know yourself, your vision, goals, and plans**. What is important to you, not just now, but in the future? What do you want to accomplish with your life? What is the vision of what you want you and your family to become? The key is to have the vision of your bigger "yes" in the future so you can say no to the current temptations to spend. "Where there is no vision, the people perish."[2]
>
> **2. Seek, receive and act on the Spirit's guidance**. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.
>
> **3. Understand the key areas of debt and know where you are financially**. This including your assets, liabilities, spending and income. If married, do not hide any liabilities or assets from each other. How much do you owe, and what are your assets? In

order to be able to get where you want to go, you must know where you are now. Have a realistic idea of your income, spending, debt and investment progress. Get on your budget and plan for the things you want to accomplish.

4. Resolve not to go into debt except for a modest home or education. Decide now the things you will do and what you will not do with debt? Make those decisions now, so you won't have to re-decide time after time. Strive to learn from your experiences, the experiences of your family, and others. Thankfully, we have the teachings of leaders and scriptures who have given us counsel. Resolve to not go into debt except for a modest home and modest education. Be wise in your expenditures.

5. Finally, pay as you go. You cannot spend yourself into financial security. Live within your means, and do not spend that which you do not have, and follow your goals and decisions.

If you are in debt add, let me add a few points which will be discussed in the next chapter.

6. Prioritize your debts. Which are the most important? If you cannot pay them all, give priority to secured debts for house or car. If the time comes that you cannot pay all your debts, determine which are most important, such as a roof over your head and food and transportation.

7. Develop a debt repayment plan. Automate it and follow it closely. A debt repayment plan is how you will pay back your debts. You must be able to continue to meet your current needs for yourself and your family, and have sufficient to repay the debt when it comes due.

8. Do not take on any new debt. Debt stops growth, both physically and spiritually. Do not add to your debt burden as you strive to pay off your debts.

9. Once out of debt, continue paying yourself. This will help to catch up with your savings.

Finding Balance

As you work on managing consumer loans, finding balance among doctrines, principles and application is important in helping you become better. Below are a few ideas.

Principles	Doctrines
Know yourself , your vision, goals and budget	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Know where you are financially	Accountability
Use debt only for a modest home and education	Agency
Live within your means and avoid debt	Stewardship

If you are in debt, add:

Develop a debt repayment plan	Stewardship
Do not take on any new debt	Accountability
Once out of debt, continue paying yourself	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with consumer loans, which is an application. Rather, from a higher perspective, or with increased vision,

> We are children of a King (identity), striving to live worthy of the Spirit (obedience), using our agency wisely (stewardship) as we follow the prophet and scriptures in deferring our wants (agency). We can wait to pay cash for specific consumer items (stewardship) so that we are wiser stewards over the things that we have been blessed with, so we have the resources to accomplish our personal missions and our individual and family vision and goals.

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. These 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:

APR = [(Interest payments + fees) / number of years] / 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. Notice how the imposition of fees raises your APR.

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

APR = [($240 in interest + $40 in fees) / 2 years] / 1,000 = 14 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. These 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.

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. The Credit Card Repayment Spreadsheet (LT18) 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. The Debt Amortization and Prepayment Spreadsheet (LT09) 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. These 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. These 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. These 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. These 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.

Chart 1. Secured Versus Unsecured Loans

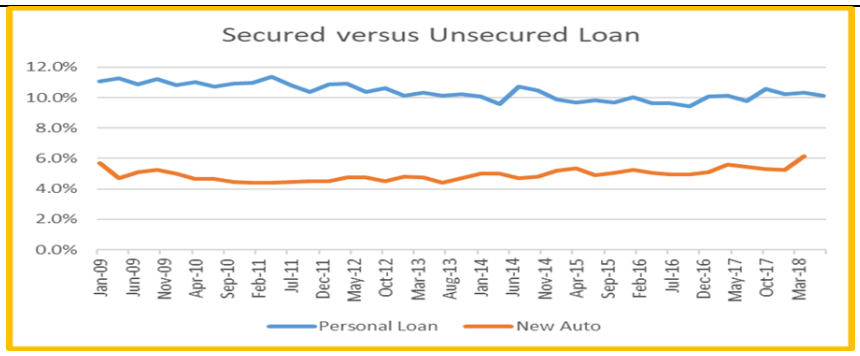


Table 1.Simple Interest Method

	Amount	**$**1,000	**Stated Interest**		12%
	P/Y	12	**PMT Using Excel Function**		
	Years	1	**Payment**	$88.85	
	Amount	**Payment**	**Interest**	**Principal**	**Remaining Principal**
1	$1,000.00	$88.85	10.00	$78.85	$921.15
2	$921.15	$88.85	9.21	$79.64	$841.51
3	$841.51	$88.85	8.42	$80.43	$761.08
4	$761.08	$88.85	7.61	$81.24	$679.84
5	$679.84	$88.85	6.80	$82.05	$597.79
6	$597.79	$88.85	5.98	$82.87	$514.92
7	$514.92	$88.85	5.15	$83.70	$431.22
8	$431.22	$88.85	4.31	$84.54	$346.68
9	$346.68	$88.85	3.47	$85.38	$261.30
10	$261.30	$88.85	2.61	$86.24	$175.07
11	$175.07	$88.85	1.75	$87.10	$87.97
12	$87.97	$88.85	0.88	$87.97	$0.00
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.

Convertible loans. These 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. These 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). This line of credit is also a second mortgage 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.

Chart 2. Home Equity and HELOC Loans

Current home equity interest rates

3-month trends	Home equity loan	30K HELOC
1/30/2019	5.91%	6.78%
1/23/2019	5.92%	6.73%
1/16/2019	5.89%	6.73%
1/9/2019	5.94%	6.73%
1/2/2019	5.88%	6.52%
12/19/2018	5.91%	6.26%
12/12/2018	5.92%	6.27%
12/5/2018	5.87%	6.28%
11/28/2018	5.91%	6.23%
11/21/2018	5.91%	6.21%
11/14/2018	5.92%	6.21%
11/6/2018	5.90%	6.23%
10/31/2018	5.96%	6.23%
10/24/2018	5.95%	6.20%

Student loans. 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. These 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. These loans are scary. They 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.

Chart 3. Auto Loan

Current auto loan interest rates

Dates	60-month new car	48-month new car	36-month used car
1/30/2019	4.77%	4.71%	5.34%
1/23/2019	4.77%	4.71%	5.35%
1/16/2019	4.74%	4.69%	5.33%
1/9/2019	4.77%	4.71%	5.35%
1/2/2019	4.95%	4.90%	5.48%
12/19/2018	4.96%	4.90%	5.53%
12/12/2018	4.93%	4.86%	5.54%
12/5/2018	4.90%	4.84%	5.54%
11/28/2018	4.93%	4.87%	5.58%
11/21/2018	4.94%	4.88%	5.57%
11/14/2018	4.95%	4.89%	5.60%
11/6/2018	4.93%	4.87%	5.57%
10/31/2018	4.93%	4.87%	5.57%
10/24/2018	4.90%	4.83%	5.51%

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!

Chart 4. Consumer Loan Types 2019

Consumer Loan Comparisons 2019
MBA 620/Fin418/Fin200 Financial Planning (2/14/19)

	Type:		Security:		Rate Type:			Home Related:		Specialty:		
Loan:	**Single Payment**	**Installment**	**Secured**	**Unsecured**	**Fixed Rate**	**Variable Rate**	**Convertible**	**Home Equity**	**HELOC**	**Student**	**Auto**	**Payday**
Description:	Loan paid off in one payment. It may also be a balloon or other loan used to finance a purchase until more permanent financing is available.	Loans that are repaid at regular intervals, i.e., each month. Payment includes interest for the period plus some principal, which increases each period	Loans that are secured by a tangible asset, such as a car or boat, that will be sold if the loan is not repaid. Because it is secured by the asset, interest rates are less.	Loans that are not secured by any asset and are based on the credit worthiness of the borrower.	Loans that maintain a constant interest rate for the entire term of the loan.	Loans that have an interest rate that is tied to an index and that can change depending on market conditions and a spread.	Loans in which the interest rate structure can change, from a fixed or variable rate loan to the opposite.	Second mortgages which use the equity in your home to secure the loan. Borrowers use these for consumer purchases	Loans secured by the equity in a home for a specific amount and term. Generally used like a credit card with a revolving line of credit.	Loans by students to pay for higher education costs and may have Federally subsidized interest rates. **AVOID PRIVATE EDUCATION LOANS**	Loans secured by the vehicle the consumer is purchasing. Because it is secured, interest rates are lower.	Short-term loans of 1-2 weeks secured by a post-dated check, and the worst kind of borrowing. **AVOID THESE LOANS LIKE THE PLAGUE**
Annual Percentage Rate (APR):	5-20% depending on where you borrow, your income and your credit	4-20% depending on where you borrow, your income and your credit	4-12% depending on the secured asset, your income and credit	12-25+% depending on who you borrow from, your income, loan use and your credit	4-20% depending on where you borrow, use of the proceeds and your credit	4-20% depending on where you borrow, use of the proceeds and your credit	4-20% depending on where you borrow, use of the proceeds and your credit	3-6% depending on equity in the home, your income and the your credit	3-6% depending on equity in the home, your income and the your credit	6.8% for subsidized loans, and 10-24% for unsubsidized private loans depending on where you borrow	5-14% depending on the type of auto, who you borrow from, how long, and your income and credit	500-700% APR depending on your credit, income, where you borrow and for how long
Amount owed doubles every "x" Years (at highest rate):	Doubles every 3.5 years	Doubles every 3.5 years	Doubles every 6 years	Doubles every 3 years	Doubles every 3.5 years	Doubles every 3.5 years	Doubles every 3.5 years	Doubles every 12 years	Doubles every 12 years	At 6.8% doubles every 10 years, at 24%, every 3 years	Doubles every 7 years	Doubles every 1 month
Rate Type:	Variable or Fixed	Generally Fixed	Variable or Fixed, generally installment	Variable or Fixed, generally installment	Fixed Rate, can be either installment or single payment	Variable Rate, can be either installment or single payment	Variable or Fixed, generally installment	Variable or Fixed, generally installment	Variable or Fixed, generally installment	Fixed for subsidized and fixed or variable for unsubsidized, installment	Variable or Fixed, generally installment	Fixed, single payment
Cost Calculations:	[(Interest + fees)/years]/avg. borrowed	Amortization table	Amortization table	Amortization table	Can be either installment or single payment	Can be either installment or single payment	Can be either installment or single payment	Amortization table	Amortization table	Amortization table	Amortization table	[(Interest + fees)/years] / avg. borrowed

Understand the Types, 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. These 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.

Jumbo loans. 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.

Table 2. Conventional Loan Limits for Fannie Mae and Freddie Mac (Single Family)

Year	Loan Limits
2015	$417,000
2016	$417,000
2017	$424,100
2018	$424,100
2019	$484,350

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

Piggyback loans. These 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). 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.

Chart 5. Fixed Rate Loans

Today's Mortgage Interest Rate

3-month trend	30-year fixed rate	15-year fixed rate
1/30/2019	4.62%	3.96%
1/23/2019	4.62%	3.99%
1/16/2019	4.59%	3.98%
1/9/2019	4.63%	4.07%
1/2/2019	4.68%	4.11%
12/19/2018	4.75%	4.13%
12/12/2018	4.83%	4.21%
12/5/2018	4.90%	4.33%
11/28/2018	5.01%	4.40%
11/21/2018	5.01%	4.41%
11/14/2018	5.10%	4.47%
11/6/2018	5.10%	4.46%

Variable- or adjustable-rate mortgages (ARMs). 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.

Interest-only options on FRM or ARM loans. These 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.

Chart 6. Adjustable Rate Mortgages (ARMs)

Bankrate Current Home Mortgage Rates

PRODUCT	INTEREST RATE
30-year fixed mortgage rate	4.41%
15-year fixed mortgage rate	3.72%
5/1 ARM mortgage rate	4.05%
7/1 ARM mortgage rate	4.15%
30-year fixed jumbo mortgage rate	4.44%
30 Year FHA mortgage rate	4.02%
10/1 ARM	4.42%
20-year fixed mortgage rate	4.31%
30-year VA mortgage rate	4.05%

Last update: 02/05/2019 at 6:30 AM

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). 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 and interest payments.

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). 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. Balloons 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. 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. These 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. While the required down payment is very low, the maximum amount that can be borrowed is also low.

Guaranteed Loans. 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.

Chart 7. FHA and VA Loans

30-year fixed jumbo mortgage rate	4.44%
30 Year FHA mortgage rate	4.02%
10/1 ARM	4.42%
20-year fixed mortgage rate	4.31%
30-year VA mortgage rate	4.05%

Last update: 02/05/2019 at 6:00 AM

Understand the Key Relationships to Reduce Borrowing Costs

If you have consumer loans, the key is keeping your costs low. The least expensive types of consumer loans are obtained from parents or family (generally), 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. [3]

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:

> After-tax lost return = nominal interest rate * (1 – tax rate)
> Tax rate = 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 from your savings account *(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.

Understand and Create your Consumer Loan and Debt Plan

Following are a few ideas as you put together your Consumer Loans and Debt Plan. Be aware that we have yet to discuss some of these areas, so we will have more suggestions in specific areas later in the course.

Vision

- From your Plan for Life. Other ideas may include:
    - We will not pay any interest ever on consumer loans and non-mortgage or non-student loan debt.
    - We will defer our wants and always pay cash for our wants.
    - Debt will not be an option or a concern.

Goals

- We will always live on a budget and save 20%.
- We will shop around for best rates on necessary debt and avoid unnecessary debt like the plague.
- Consumer loans. We will never go into debt for consumer products, including autos.
- Student loans. We will only use subsidized Student loans and will repay them quickly.
- Mortgage loans. We will pay off our home by age 45, and we will not go into retirement with mortgage or other debt.

Plans and Strategies

Consumer Loans

- We will separate needs from wants.
- We pay cash for all consumer purchases.
- We will pay off all credit cards monthly.
- We avoid debt like the plague.
- We keep our emergency fund at 4 months and rebuild it quickly once it is drawn down.
- We defer all wants until we can pay cash for them.

- We may have to borrow for our first car, but after that, we will pay cash for all transportation needs.
- We will never buy toys with debt.

Student Loans

- We will spend loan money only on education.
- We will seek scholarships as much as possible.
- We defer all wants until we can pay cash for them and after we have paid off our student loans.
- We will not buy toys until our student loans are all paid off.
- We will understand our employment options to help pay off our student loan debt.
- We build our emergency fund to 3 months and then use the 20%+ to pay down non-subsidized and then subsidized loans.

Mortgage Loans

- We strive to have a 20% down payment to reduce the need for PMI.
- We ensure all housing payments are within the front- and back-end ratios recommended.
- We avoid debt like the plague.
- We keep our emergency fund at 4 months and rebuild it quickly when it is drawn down.
- We defer all wants until we can pay cash for them, except for student and mortgage loans.
- We will not borrow against the equity in our home.

Debt Reduction

- Once school is out, put enough in the company 401k for the match, then save 20% minimum to build our emergency fund.
- After that, I will use 20-30% to pay of debt as quickly as possible paying the highest interest rate first (LT20). Once debt is paid off, continue to pay 20% into savings.
- Continue to live like a student after college, build my emergency fund, then pay 30% each month against my debt using the debt snowball method until debt is all gone. I will then keep paying myself 20% into saving and investing.

Constraints

- Key is living on a budget and saving 20%.
- One half of all unexpected money (bonuses, tax refunds, etc.) will be put toward paying down principal (after our emergency fund).
- Do all required maintenance and plan on replacing key housing machinery as needed. We will also not skimp on required maintenance.
- Do most of the household work ourselves as a family, and will learn as we go, we will bring in experts in areas outside of our proficiency.
- We will stay strong in the gospel, keeping our covenants, attending the temple and serving.

Accountability

- We will share our vision and goals with our children.
- Children will have daily and weekly indoor jobs, as well as weekly yardwork.
- Home is where we teach our children to work. They will learn to use all landscaping and woodworking tools as we work together on our modest and model home.
- We will rotate the jobs weekly so all children will have the opportunities to work throughout the home and will become proficient on all tools.

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: time horizon and how certain are you of that time horizon, preferences (if any) for required payments, and tolerance for interest-rate risk.

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

Your assignment is to put together your Consumer Loan and Debt Plan. I recommend you use the PFP Loans Template (LT01-08) as a starting point. Think through the purpose of any consumer, student and other loans you may have. Are they necessary? Could you have gotten by without them? What is your view on loans and debt?

Develop your vision and goals for loans and debt? It need not be long.

Begin working on your plans and strategies as part of your action plan. Start with where you are. 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.

If you are in debt, 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. What is your debt reduction strategy? How long will it take for you to get out of debt (I recommend you use Debt Elimination Schedule with Accelerator (LT20) as a possible tool). Most importantly, what are your views and goals on future debt?

Learning Tools

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

Credit Card Repayment Spreadsheet (LT18)
: 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.

Debt Amortization and Prepayment Spreadsheet (LT09)
: This Excel spreadsheet is a debt amortization and prepayment schedule to help you reduce and eliminate your debt.

Debt Elimination Schedule with Accelerator (LT20)
: 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

Terminology Review

Auto Loans. Auto loans are consumer loans that are secured with an automobile. Because they are secured, they have a lower interest rate than an unsecured loan or credit card. They normally have a maturity length of 2 to 6 years. The risk is that you will often be left with a vehicle that is worth less than what you owe on it.

Balloon Loans. These are loans which payments including interest and principle are not sufficient to pay off the loan at the end of the loan period, but require a large "balloon" payment at some point in the future to fully pay off. This type of loan is not recommended.

Consumer Loans. 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. 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.

Convertible Loans. These loans begin as a variable-rate loan and can be locked into a fixed-rate loan at the then current interest rate at some predetermined time in the future (for a specific cost).

Fixed-rate Loans. Have the same interest rate for the duration of the loan. Normally have a higher initial interest rate as the lender could lose money if overall interest rates increase. The lender assumes the interest rate risk, so they generally add an interest premium to a variable rate loan

Home Equity Lines of Credit (HELOC). Home equity lines of credit are basically second mortgages which 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. Interest rates are variable and are generally interest only in the first few years. They have lower rates of interest than other consumer loans.

Home Equity Loans. Home equity loans are basically second mortgages which use the equity in your home to secure your loan. Normally can borrow up to 80% of your equity in your home

Installment Loans. Installment loans are loans which are repaid at regular intervals and where payment includes both principal and interest. These are normally used to finance houses, cars, appliances, and other expensive items. These loans are amortized, which is the process of the payment going more toward principal and less toward interest each subsequent month. These may be secured or unsecured loans, variable-rate or fixed-rate loans.

Payday Loans. These are short-term loans of 1-2 weeks secured with a post-dated check which is "held" by the lender and then cashed later. These have very high interest rates

and fees, APR > 720%. Typical users are those with jobs and checking accounts but who have been unable to manage their finances effectively.

Secured Loans. Secured loans are guaranteed by a specific asset, i.e. a home or a car, and typically have lower interest rates.

Single Payment (or balloon) Loans. These are loans that are repaid in only one payment, including interest. These are generally short-term lending of one year or less, sometimes called bridge or interim loans, often used until permanent financing can be arranged. These may be secured or unsecured.

Student Loans. These are loans with low, federally subsidized interest rates used for higher education. Examples include Federal Direct (S) and PLUS Direct (P) available through the school; Stafford (S) and PLUS loans (P) available through lenders. Some are tax-advantaged and have lower than market rates. Payment on Federal Direct and Stafford loans deferred for 6 months after graduation.

Unsecured Loans. Unsecured loans require no collateral, are generally offered to only borrowers with excellent credit histories, and have higher rates of interest – 12% to 28% (and higher) annually.

Variable-rate Loans. Have an interest rate that is tied to a specific index (e.g., prime rate, 6-month Treasury bill rate) plus some margin or spread, i.e. 5%). Can adjust on different intervals such as monthly, semi-annually, or annually, with a lifetime adjustment cap. Normally have a lower initial interest rate because the borrower assumes the interest rate risk and the lender won't lose money if overall interest rates increase

Mortgage Terminology

Balloon Mortgages. These are mortgage loans whose interest and principal payment won't result in the loan being paid in full at the end of the term. The final payment, or balloon, can be significantly large. These loans are often used when the debtor expects to refinance the loan closer to maturity.

Conventional loans. These are loans that are neither insured or guaranteed. They are below the maximum amount set by Fannie Mae and Freddy Mac. They require Private Mortgage Insurance (PMI) if the down payment is less than 20%.

FHA Loans. These are Federal Housing Administration (FHA) Insured Loans. The FHA does not originate any loans, but insures the loans issued by others based on income and other qualifications. There is lower PMI insurance, but it is required for the entire life of the loan (1.5% of the loan). While the required down payment is very low, the maximum amount that can be borrowed is also low.

Fixed rate mortgages (FRMs). These are mortgage loans with a fixed rate of interest for the life of the loan. These are the least risky from the borrower's point of view, as the lender assumes the major interest rate risk above the loan rate. These are the most-recommended option for new home buyers.

Interest Only Option Loans. These are FRMs or ARMs with an option that allows interest only payments for a certain number of years, and then payments are reset to amortize the entire loan over the remaining years. Some will take out an interest only loan to free up principal to pay down other more expensive debt. Once the interest-only period has passed, the payment amount resets, and the increase in payment can be

substantial. These are generally not recommended.

Jumbo Loans. These are loans in excess of the conventional loan limits and the maximum eligible for purchase by the two Federal Agencies, Fannie Mae and Freddy Mac, of $424,000 in 2018 (some areas have higher amounts). Some lenders also use the term to refer to programs for even larger loans, e.g., loans in excess of $500,000.

Negative Amortization Mortgages (NegAm). These are mortgage loans in which scheduled monthly payments are insufficient to amortize, or pay off the loan. Interest expense that has been incurred, but not paid is added to the principal amount, which increases the amount of the debt. Some NegAm loans have a maximum negative amortization that is allowed. Once that limit is hit, rates adjust to make sure interest is sufficient to not exceed the maximum limit.

Option Adjustable Rate Mortgages (Option ARMs). This is an ARM where interest rate adjusts monthly, and payments annually, with "options" on the payment amount, and a minimum payment which may be less than the interest-only payment. The minimum payment option often results in a growing loan balance, termed negative amortization, which has a specific maximum for the loan. Once this maximum is reached, payments are automatically increased and the loan becomes fully amortizing after 5 or 10 years, regardless of increase in payment and must be repaid within the 30 year limit. These are not recommended.

Piggyback Loans. These are two separate loans, one for 80% of the value of the home and one for 20%. The second loan has a higher interest rate due to its higher risk. The second loan is used to eliminate the need for PM Insurance. With a piggyback loan, PMI is not needed, but these are much harder to get now.

Reverse Mortgages. These are mortgage loans whose proceeds are made available against the homeowner's equity. Financial institutions in essence purchase the home and allow the seller the option to stay in the home until they die. Once they die, the home is sold and the loan repaid, generally with the proceeds. These 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.

VA Loans. These are Veterans Administration (VA) Guaranteed Loans. These loans are issued by others and guaranteed by the Veterans Administration. They are only for ex-servicemen and women as well as those on active duty. Loans may be for 100% of the home value.

Variable or Adjustable Rate Mortgages (ARMs). These are mortgage loans with a rate of interest that is pegged to a specific index that changes periodically, plus a margin that is set for the life of the loan. Generally the interest rate is lower compared to a fixed rate loan, as the borrower assumes more of the interest rate risk. The may have a fixed rate for a certain period of time, then afterwards adjust on a periodic basis.

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
[(240 + 100) / 2] / 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:

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%.

<u>Case Study 3</u>

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 interes

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)?

Table 3. APR Calculation

Calculated rate using Excel "Rate" Function:				12.000%
Amount	1,000	**Stated Interest**	12%	
P/Y	12	**Payment**	$47.07	
Years	2	PMT = from loan calculator		
Amount Received:		1,000		**Remaining**
Amount	**Payment**	**Interest**	**Principle**	**Principle**
1,000.00	$47.07	10.00	$37.07	$962.93
$962.93	$47.07	9.63	$37.44	$925.48
$925.48	$47.07	9.25	$37.82	$887.66
$887.66	$47.07	8.88	$38.20	$849.47
$849.47	$47.07	8.49	$38.58	$810.89
$810.89	$47.07	8.11	$38.96	$771.92
$771.92	$47.07	7.72	$39.35	$732.57
$732.57	$47.07	7.33	$39.75	$692.82
$692.82	$47.07	6.93	$40.15	$652.68
$652.68	$47.07	6.53	$40.55	$612.13
$612.13	$47.07	6.12	$40.95	$571.18
$571.18	$47.07	5.71	$41.36	$529.82
$529.82	$47.07	5.30	$41.78	$488.04
$488.04	$47.07	4.88	$42.19	$445.85
$445.85	$47.07	4.46	$42.62	$403.23
$403.23	$47.07	4.03	$43.04	$360.19
$360.19	$47.07	3.60	$43.47	$316.72
$316.72	$47.07	3.17	$43.91	$272.81
$272.81	$47.07	2.73	$44.35	$228.47
$228.47	$47.07	2.28	$44.79	$183.68
$183.68	$47.07	1.84	$45.24	$138.44
$138.44	$47.07	1.38	$45.69	$92.75
$92.75	$47.07	0.93	$46.15	$46.61
$46.61	$47.07	0.47	$46.61	$0.00
$540.68	**Total Int.=**	**129.76**	**Actual APR =**	**12.0%**

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 = $[(1 + \text{APR} / \text{periods})^{\text{periods}}] - 1$.

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%

This is a very expensive loan.

D. 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

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
[2] Proverbs 29:18.
[3] J. Reuben Clark Jr., *Improvement Era*, Jun. 1938, 328

8. Debt: Avoiding Debt Like the Plague

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 now. In the late nineties in particular, the stock market's upward trend encouraged consumers to acquire significant additional 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. Someone said "we borrow money we don't have, to buy things we don't need, to impress people who don't care."[1] Will Rogers summarized the current condition of our nation by saying, "We'll show the world we are prosperous, even if we have to go broke to do it."[2]

People comment on how difficult it is to pay back loans. What they don't realize is for every dollar borrowed, they must earn more than a dollar to pay it back. We are not consistent in our thinking. With debt, we are borrowing an after-tax amount. However, to pay it back, we must earn a before-tax amount. That difference can be significant depending on your taxes, contributions and savings.

Objectives

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

A. Understand our leader's counsel on debt.
B. Understand the principles of using debt wisely.
C. Understand how to develop and use debt-reduction strategies.
D. Understand plans and strategies for debt reduction.

Understand our Leader's Counsel on Debt

We have been counseled for 6,000 years to "Pay thy debt and live."[3] Debt is a form of bondage, limiting both temporal and spiritual freedom. J. Reuben Clark reminded us:

> It is a rule of our financial and economic life in all the world that interest is to be paid on borrowed money. . . Interest never sleeps nor sickens nor dies; it never goes to the

> hospital; . . it never visits nor travels; it is never laid off work; it never works on reduced hours; it never pays taxes; it buys no food, it wears no clothes. . . Once in debt, interest is your constant companion every minute of the day and night; you cannot shun it or slip away from it; you cannot dismiss it;. . .and whenever you get in its way or cross its course or fail to meet its demands it crushes you. So much for the interest we pay. Whoever borrows should understand what interest is, it is with them every minute of the day and night.[4]

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."[5]

More recently, 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."[6]

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. He said:

> 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.[7]

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 as well.

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."[8]

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.[9]

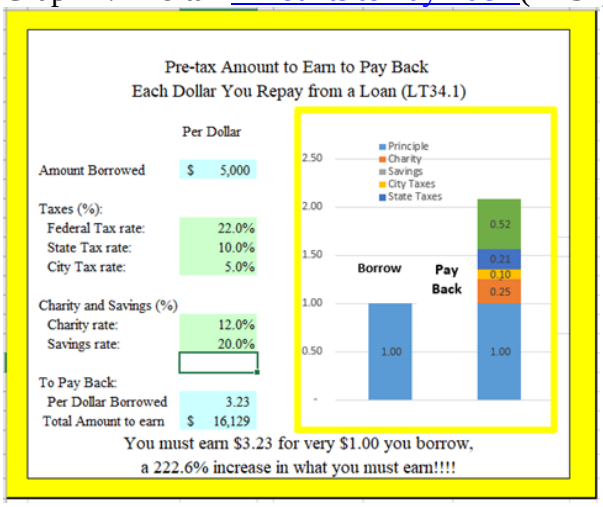
It may be acceptable to incur debt to undertake a business endeavor if (1) the debt does not jeopardize the personal or family finances of the business owners or managers, (2) the debt is used for a valid business purpose or investment opportunity, (3) speculative ventures and consumption under the guise of investment should be avoided. Using debt to finance a speculative venture magnifies the risk of the investment. And (4) 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.

Why is Repaying Debt So Hard

Most in debt find it difficult to pay it back. That is because when we borrow money, we are borrowing an after-tax amount, and to pay the debt back, we must earn a before-tax amount. The difference is significant.

For example, let's say you borrowed $1. In order to pay that dollar back, you must not just earn $1, but you must earn enough to pay your taxes, charitable contributions, and any savings you plan. Assuming your federal tax rate was 22%, your state tax of 5%, a city tax of 5%, charity of 12% and you are saving 20%, you would need to earn $3.23 for every dollar you will pay back, and this does not include interest (see Graph 1). For a tool to help you calculate how much you will need to earn, see Amounts to Pay Back (LT34).

Graph 1. Pre-tax Amounts to Pay Back (LT34)



For a $5,000 loan, you must earn $16,129 before tax to pay off the $5,000 debt assuming the percentages above. Borrowing is not cheap.

Understand the Principles of Using Debt Wisely

There are a few important principles of effective loan use. These include:

1. Know yourself. This includes your vision, goals and plans. What is important to you, not just now, but in the future? What do you want to accomplish with your life? What is the vision of what you want you and your family to become? The key is to have the vision of your bigger "yes" in the future so you can say no to the current temptations to spend. "Where there is no vision, the people perish."[10]

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of debt, and know where you are in your spending and your income. If married, do not hide any liabilities or assets from each other. How much do you owe, and what are your assets? In order to be able to get where you want to go, you must know where you are now. Have a realistic idea of your income, spending, debt and investment progress. Get on your budget and plan for the things you want to accomplish.

4. Set your priorities. Decide now the things you will do and what you will not do? Make those decisions now, so you won't have to re-decide time after time. Strive to learn from your experiences, the experiences of your family, and others. Thankfully, we have the teachings of leaders and scriptures who have given us counsel. Resolve to not go into debt except for a modest home and modest education. Be wise in your expenditures.

5. Finally, pay as you go. You cannot spend yourself into financial security. Live within your means, and do not spend that which you do not have, and follow your goals and decisions.

If you are in debt add, let me add a few points which will be discussed in the next chapter.

6. Prioritize your debts. Which are the most important? Give priority to secured debts for house or car. If the time comes that you cannot pay all your debts, determine which are most important, such as a roof over your head and food and transportation.

7. Develop a debt repayment plan. Automate it and follow it closely. A debt repayment plan is how you will pay back your debts. You must be able to continue to meet your current needs for yourself and your family, and have sufficient to repay the debt when it comes due.

8. Do not take on any new debt. Debt stops growth, both physically and spiritually. Do not add to your debt burden as you strive to pay off your debts.

Finding Balance

As you work on avoiding and eliminating debt, finding balance among doctrines, principles and application is important in helping you become better. Below are a few ideas.

Principles	Doctrines
Know yourself , your vision, goals and budget	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Know where you are financially	Accountability
Use debt only for a modest home and education	Agency
Live within your means	Stewardship
If you are in debt, add:	
Develop a debt repayment plan	Stewardship
Do not take on any new debt	Accountability
Once out of debt, continue paying yourself	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with our finances and avoiding debt, which is an application. From a higher perspective, or with increased vision,

> We are children of God (identity), striving to live worthy of the Spirit (obedience), showing what we believe by our actions and choosing to delay gratification (accountability). We are taking responsibility for our actions and using our agency (stewardship) to save for things and not borrow, and learning the lessons God would have us learn through distinguishing between our wants and needs (agency) so we can accomplish our individual missions and achieve our individual and family vision and goals.

Understand How to Develop and Use 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."[11]

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.
6. Follow through on the Plan until total debt elimination.

There are three basic types of debt-reduction strategies:

Personal strategies: These are strategies you can use on your own; they include the use spreadsheets and financial management software, such as Quicken, Mint.com, YNAB 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.

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.

Debt-elimination Calendar: Smallest Balance First. Dave Ramsey, in his book The Total Money Makeover (2003), recommends you pay off your smallest balance first. His logic is that as you see your debt decreasing, it will increase your motivation to continue attacking your debt until you get it paid off.

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 sort the columns by the debt with the smallest balance first, and the next smallest next. As you pay off

the smallest balance, you see success quickly and it helps keep you motivated. Once the first 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.

Table 1: Debt-Elimination Calendar

	Credit Card	Consumer Loan	Dentist	Piano Loan	Auto Loan	Student Loan	Total Payments
Interest Rate	16%	13%	10%	8%	6%	5%	
Amount Owed	$215.68	$533.66	$613.61	$1,399.94	$10,006.37	$7,002.64	$ 19,772
Min. Payment	110	70	50	75	235	120	660
March 20xx	110	70	50	75	235	120	660
April	110	70	50	75	235	120	660
May		180	50	75	235	120	660
June		180	50	75	235	120	660
July		52	178	75	235	120	660
August			230	75	235	120	660
September			30	275	235	120	660
October				305	235	120	660
November				305	235	120	660
December				129	411	120	660
January					540	120	660
February					540	120	660
March 20xx					540	120	660
April					540	120	660
May					540	120	660
June					540	120	660
July					540	120	660
August					540	120	660
September					540	120	660
October					540	120	660
November					540	120	660
December					540	120	660
January					540	120	660
February					167	493	660
March 20xx						660	660
April						660	660
May						660	660
June						660	660
July						245	245

Note that with both highest rate and smallest balance, if you have extra money, you can add an accelerator to your payoff. This can allow you to pay off your debt even faster.

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. Debt Elimination Spreadsheet with Accelerator (LT20) on this 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.

Home equity loans: Exchanging for Secured Debt. 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 the 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:

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. These 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. These 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:

- 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.

Legal Strategies—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.

Chapter 7. 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.

Chapter 13. 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 bankruptcies are caused by loss of relationships (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 further developing your relationships, 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.

Understand Plans and Strategies for Debt Reduction

If you are out of debt, we are pleased. It is not an easy thing to get and stay out of debt. But it is important. If so, your Consumer Loans and Debt Plan will be short.

For those in debt, your Debt Reduction Plan and Strategies are part of your Consumer Loan and Debt Plan. For your Plan, continue from what you did with your Credit Plan previously on credit, and add your views on debt. Then add you're your debt reduction plans and strategies that may be helpful. Start with your views on debt. What is the place of debt in your life?

Plans and Strategies – Debt
Overall

- I will keep an emergency fund of 3-6 months at all times. When I use these, I will repay them in 6 months

- I will avoid debt except for a home and education, and will pay off my home by age 45
- I will pay cash for all transportation purchases and toys
- I may need to borrow for my first car. If so, I will pay it off within 3 years and pay cash for all future vehicles
- I will save money for my children's education and missions by saving $20 per child per month so I will not need to go into debt for these things
- I will save 20% of my income and will invest wisely. I will get the company match, save 15% of my income for retirement. And not borrow against my 401k

Debt Reduction

- Once school is out, put enough in the company 401k for the match, then save 20% minimum to build our emergency fund.
- After that, use 20-30% of income to pay off debt as quickly as possible paying the highest interest rate first (LT20). Once debt is paid off, continue to pay 20% into savings
- Continue to live like a student after college, build my emergency fund, then pay 20%+ each month against my debt using the debt snowball method until debt is all gone. After that, I will then keep paying myself 20% into saving and investing.

One-off Debt Reduction Strategies

- Bump up your debt repayment percentage. Pay more than the minimum balance, and use 30-50% of income to get out of debt.
- Negotiate a lower interest rate. Call the credit card company and request a lower interest rate which can reduce your interest costs. If they will not do this, move your balances to another card that has a lower interest rate (but make sure transfer fees are low)
- Use savings to pay down debt after you have your Emergency Fund
- Use any salary increase to pay down debt. Live at your previous salary and use increases to pay debt
- Use your tax refund check entirely to pay down debt.
- If possible, exchange consumer debt for mortgage debt. If you have equity in your home and you have changed your spending habits, use your equity to pay down debt.
- Sell assets. Have a yard sale and sell those things you probably should not have bought in the first place to reduce your debt.

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 and growth. Debt stops growth, both temporal and spiritual.

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.

We concluded with ideas for those in debt, of a Debt Reduction Strategy, which is part of your Consumer Loans and Debt Plan. This Plan can be powerful in helping you stay away from and eventually reducing your debt.

Assignments

Financial Plan Assignments

Your assignment is to finish your Consumer Loan and Debt Plan. You have already worked on consumer loans as part of the PFP Loans Template (LT01-08), and now you will add more to the debt and debt reduction portion. Your Consumer Loan and Debt Plan includes four main areas: Consumer Loans, Student Loans, Mortgage Loans, and Debt and Debt Reduction. You will include each of these four areas as you develop your plans for using debt.

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, auto, mortgage 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.

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?

If you are in debt, create a Debt Reduction Strategy, and include it as part of your Consumer Loan and Debt Plan.

Learning Tools

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

Debt-Elimination Spreadsheet with Accelerator (LT20)
: 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. You can also choose between paying highest interest or smallest balance first.

Debt Amortization and Prepayment Spreadsheet (LT09)

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

Credit Card Repayment Spreadsheet (LT18)
This Excel spreadsheet gives information on how long it will take to pay off credit cards and other debt.

Review Materials

Terminology Review

Average Daily Balance (ADB). A common way of calculating interest to charge. Computed by adding each day's balance for a billing cycle and then dividing by the number of days in the cycle.
Cash Advance. Using a credit card to obtain cash, such as through an ATM or over the counter at a bank. This is an extremely expensive way to borrow, and carries several pricy fees.
Credit Bureau. Private organizations which maintain credit information on individuals, which it allows subscribers to access for a fee. The three major credit bureaus to know are Equifax, Experian, and Trans Union.
Credit Card. A financial instrument that allows the holder to make purchases through an open line of credit.
Credit Limit. The maximum amount that one can borrow on a single credit card. This amount is often influenced by one's credit score.
Credit Report. Information collected by credit bureaus from subscribers, creditors, public court records, and the consumer.
Credit Score. A numerical evaluation of your credit based on specific criteria determined by the credit scoring company.
Debit Card. Unlike credit cards, debit cards act like a personal check. When used, money is taken straight from the connected account to pay for the purchased item.
FICO Score. This is the most commonly used credit score. It ranges from 300 to 850.
Grace Period. The amount of time given by a credit card company to pay a due balance before interest starts to accrue. Normally 20 to 25 days, excluding cash advances. It does not apply if the card already carries a balance.
Secured Credit Card. Similar to a standard credit card, but is tied to a checking or savings account. The card cannot be used once the money in the account is gone, until more funds are added. Useful for building credit.
Smart Card. Similar to a debit card, but rather than being connected to a certain bank account, they magnetically store a certain amount of money linked to the card itself.
Teaser Rates. Very low introductory interest rates used to attract new customers to a certain credit card. They increase soon after the card is in the user's hands.

Review Questions

1. What are two debts that, according to leaders, are okay to incur?
2. What are principles of avoiding debt and why are they important?
3. What key doctrines, if understood better, would help you avoid debt?

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 Debt-Elimination Spreadsheet with Accelerator (LT20), 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 vision of where they want to be.
   - I shared with them the importance of perspective and that personal finance is just part of the gospel of Jesus Christ.
   - I share with them doctrines, principles and application, the "why's", "whats'" and "how's" of personal finance and why the Lord wants us to be financially secure.
   - They recognized that they had a debt problem. They were finally sick and tired of being sick and tired.
2. Help them realize where they are financially, and that their habits were not taking them to their goals.
   - 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 and ratios
   - We worked at finding out where the money was going so we could put it to the best use.
   - We put them on a very strict income and expense plan, and we worked on both areas.
3. 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.).

4. Help them determine a course of action and debt reduction plan, and committed them to that course.

- We worked together to make a debt reduction plan, and then we all worked together to follow that plan.
- I enlisted other people as part of a team approach to help them with talking to creditors and paying off their debts.
- We met together every week and I held them accountable for their plan.

5. Help them follow through with their plan (until total debt elimination*)

- We worked together on their debt reduction plan (not our plan) and held them accountable for it
- We met with them weekly to see how they were doing and to encourage them to stick with the Plan

We continued to offer encouragement and support in a non-judgmental manner
Now, many years later, they are still in debt, but their debts have become much more manageable and they are working to pay them off completely. 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."

Case Study #2

Data

Emilee has been thinking about how much she has to earn to pay back her loans once she leaves school. Assume she will be in the 25% Federal tax bracket after school, living in New York (10% state tax rate) and New York City (5% city tax rate), and she pays 12% gross of her income to charity.

Calculations

How much must she earn to pay back $1.00 in student loans (this assumes 0% interest)?

Case Study #2 Answer

Calculations

To pay back $1.00 in student loans will require:

- Taxes:
- Federal tax rate: 25%
- State tax rate: 10%
- City tax rate: 5%
- Charitable contributions: 12%

The formula is:

- $x - .25x - .10x - .05x - .12x = 1$. Solve for x?

- X = 2.08 (1/(.25+.10+.05+.12)

Emilee must earn $2.08 for every dollar she borrows (and that assumes a 0% interest rate). That's expensive (see Loan Amount to Pay Back (LT34).

Pre-tax Amount to Earn to Pay Back
Each Dollar You Repay from a Loan (LT34.1)

	Per Dollar	Specific Amount
Amount Borrowed	1.00	$ 3,500.00
Taxes (%):		
Federal Tax rate:	25.0%	25.0%
State Tax rate:	10.0%	10.0%
City Tax rate:	5.0%	5.0%
Charity and Savings (%)		
Charity rate:	12.0%	12.0%
Savings rate:		0.0%
Amount Necessary to pay Back	2.08	$ 7,291.67

You must earn $2.08 for very $1.00 you borrow, a 108.3% increase in what you must earn!!!!

Amount Necessary to Pay Back Student Loans
ling Principle, Interest, Taxes and Contributions (LT

	Loan 1		Total
Loan Information:			
Amount Borrowed:	$5,000.00	*Total Amount Borrowed*	$ 5,000.00
Interest Rate (APR):	12.0%	*Weighted Interest Rate*	12.0%
Education Information:			
Months Until Education is done?	24		
Subsidized? (1 = yes, 0 = no)		*Total amount due:*	
Amount due at end of education	$6,348.67	*at end of education:*	$6,348.67
Repayment Information:			
How Many Months to Pay off?	60	*Average months to pay off*	60
Payment per Month	$141.22	*Total Payments per month*	$141.22
Total Amount to Pay off	$8,473.36	*Total Amount to Pay*	$8,473.36
Ratio of Earned (P&I) to Borrowed:	1.69		1.69
Taxes:			
Federal Tax Rate:	25.0%	*Average Federal Tax Rate*	25.0%
State Tax Rate:	10.0%	*Average State Tax Rate*	10.0%
City Tax Rate:	5.0%	*Average City Tax Rate*	5.0%
Charity and Savings:			
Charity rate (%):	12.0%	*Average Charity Rate*	12.0%
Savings rate (%):			
Ratio of Earned (PITSC) to Borrowed:	2.08		2.08
Total Amount Needed to Pay Back	17,652.84	*Total Amount to Pay Back*	$17,652.84
Ratio:	3.53	*Ratio of amount borrowed to amount earned to pay back*	3.53
Annual Percentage Rate	68.0%		

You must earn $3.53 on average to pay back every $1.00 you borrow!!!!!

* APR is calculated from graduation until the time the loan is paid off. I haven't figured out how to calculate the i

Case Study #3

Data

Use the tax and charity information from the previous case. Emilee is in her second to last year in school (24 months till graduation) and is considering a $5,000 alternative loan at 12% and plans to pay it back in 60 months after she graduates.

Calculations

How much must she earn to pay back that alternative loan of $5,000 (which is not subsidized and accrues interest while she is in school) at 12% interest over 60 months and including taxes and charitable contributions?

Case Study #3 Answers

To pay back $5,000 in student loans requires:

- At 12% interest and in her second to last year of school, she will add 24 months of interest or $1,349
  - PV for 60 months will require a payment of $141.22 per month
  - PV=5,000, rate = 12%/12, Periods = 60 months, Solve for her Pmt = ?
  - Payment = $141.22
  - Her total payments will be $141.22 * 60 months or
- Total Payments = $8,474 or 68% more than borrowed

To determine how much she needs to earn to pay back this $8,474, we determine:

- Taxes:
  - Federal tax rate: 25%
  - State tax rate: 10%
  - City tax rate: 5%
  - Charitable contributions: 12%
- The formula is:

- x-.25x-.10x-.05x-.12x = 1. X = 2.08
- To pay back this $8,474, Emilee must earn 2.08 * $8,474 or $17,653
  - Emilee must earn $3.53 for every $1.00 she borrows ($17,653/$5,000=3.53). Again, very expensive.

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[1] Anonymous.
[2] Will Rogers Legacy, California Department of Parks and Recreation at http://www.parks.ca.gov/?page_id=23998.
[3] 2 Kings 4:7.
[4] J. Reuben Clark, Conference Address, April 6, 1938.
[5] Conference Report, Oct. 1903, 5
[6] "Doing the Best Things in the Worst Times," Ensign, August 1984, 41.
[7] "The Celestial Nature of Self-Reliance," *Ensign*, Jun. 1984, 3
[8] "I Believe," *Ensign*, Aug. 1992, 6
[9] "Constancy Amid Change," *Ensign*, Nov. 1979, 80
[10] Proverbs 29:18.
[11] Nina Coleman, "The Manly Wisdom of Will Rogers," in *The Friars Club Bible of Jokes, Pokes, Roasts, and Toasts* (2001), p. 316

9. Time Value of Money 1: Understanding the Language of Finance

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:

A. Understand the term *investment.*
B. Understand the importance of compound interest and time.
C. Understand basic financial terminology (the language of finance).
D. 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 our Excel Financial Calculator (LT12), which is a spreadsheet-based financial calculator available on the website. We also have a Financial Calculator Tutorial (LT3A) which shares how to use 9 different financial calculators.

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."[1]

Understand the Importance of Compound Interest and Time

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.

With simple interest, you only earn interest on your original principal. However, with compound interest, interest is calculated not only on the initial principal but also on the accumulated interest earned in prior periods. The magic of compound interest is that you earn interest on money earned in previous periods, hence the importance of 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.

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.

Understand 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 period 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= [(1+ nominal return) / (1 + inflation)] – 1.

Tax-adjusted (or after-tax) 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:

$$\text{EIR} = [(1 + (\text{nominal return or APR} / \text{periods}))]^{\text{periods}} - 1$$

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:

$$PV = FV / (1 + I)^N$$

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

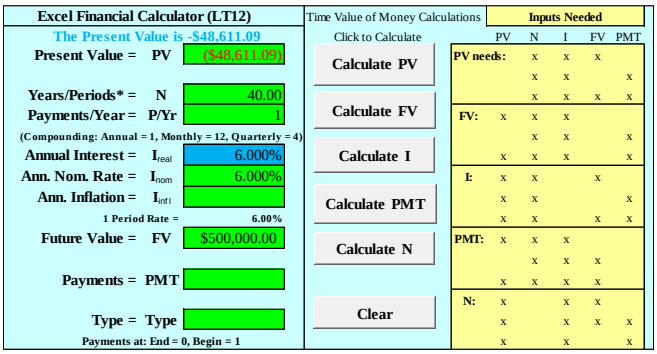
After you find these inputs, you can solve for the present value (PV).

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 (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.

Using our Excel Financial Calculator (LT12), it is:



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:

$$FV_N = PV * (1 + I)^N$$

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 8 percent; assume an

annual compounding period.

B. Calculate the future value (in 15 years) of $5,000 that is earning 8 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), 8 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 $15,861. With a standard calculator, the result is $5,000 * (1 +.08)^{15}$, or the same sum of $15,861.

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 8 percent (5,000 * .10), or $400. Multiply $400 by 15 years; the result should be $6,000. Then add the amount of the original investment of $5,000 to get $11,000.

C. The difference between $15,861 and $11,000 is $4,861, 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

There are no financial plan assignments for this section, although understanding the language of finance is critical to all other sections. As you read through this chapter, think about the purpose of each financial concept. Use either a calculator, your own spreadsheets, or the Excel Financial Calculator (LT12) 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:

Financial Calculator Tutorial (LT03)
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.

Excel Financial Calculator (LT12)
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

Terminology Review

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).
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.
Compound Annuity. An investment that involves depositing the same amount of money at the end of each year for a certain number of years.
Compound Interest. Compound interest is where interest is calculated not only on the initial principal but also on the accumulated interest earned in prior periods. The magic of

compound interest is that you earn interest on money earned in previous periods.
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.
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.
Financial Investments. These are equity or debt investments including stocks (or equities), bonds, mutual funds, cash, treasury bills and notes, options, futures, and so on.
Future Value (FV). The value of an investment at some point in the future.
Inflation. 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.
Interest or Discount Rate. The stated rate you will receive for investing at a specified compounding period for a specified period of time.
Investment. The current commitment of money or other resources with the expectation of reaping future benefits.
Minimum Payment. The minimum amount of payment required by credit card companies each month. The credit card companies purposefully keep these as low as possible, in order to maximize the amount that they earn in interest.
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= [(1+ nominal return) / (1 + inflation)] – 1.
Simple Interest. Interest is paid only on your original principal.
Tax-adjusted (or after-tax) return. The return on your investment after the impact of federal and state taxes has been taken into account.

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:

$PV = FV/ (1 + I)^N$

Case Study 1 Answer

The formula is $PV = FV/ (1 + I)^N$, or $PV = 500{,}000 / (1.06)^{40}$, 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:

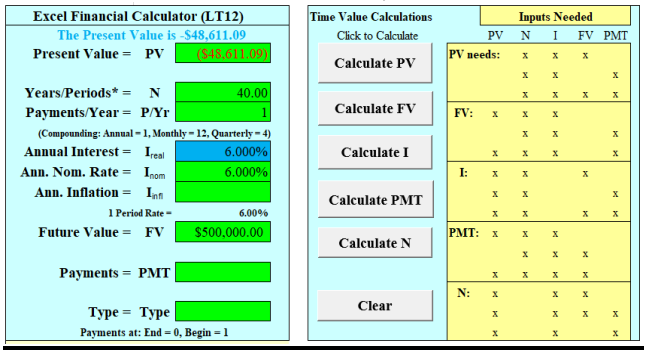
$500,000 = FV

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 = 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 $FV = \$2{,}500 * (1 +.08)^{20}$ or $11,652.39

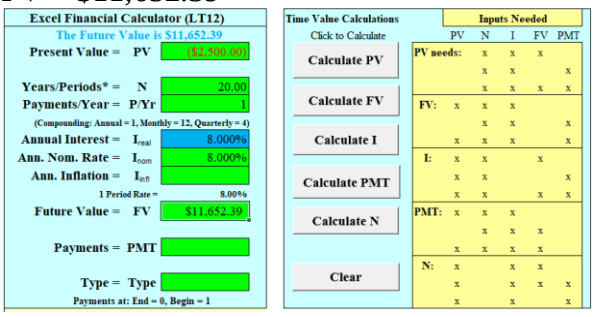
If you were using a financial calculator, you would clear the memories and then enter the following:

$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 = $11,652.39



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10. Time Value of Money 2: Understanding Inflation, 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?

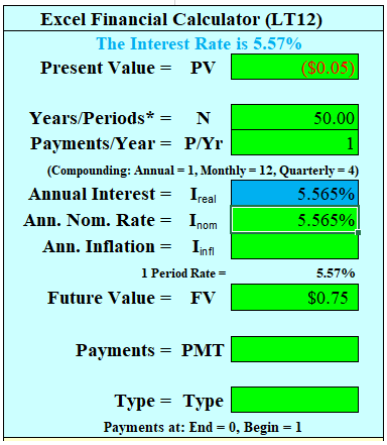
Before solving this problem, clear your calculator's memory, and set your calculator to one annual payment. Then input the following information to solve this problem:

PV = –$0.05 (the price of gum forty years ago)

FV = $0.75 (the price of gum today)
N = 40 (The cost has increased every year for forty years.)
I = ?

The formula is: $((FV/PF)^{(1/N)}))-1$

On average, the inflation rate has been 5.56 percent each year for the last 40 years. So, the average price of gum has increased by 5.56 percent each year for the last 40 years.



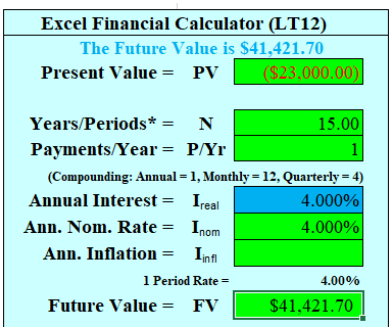
Problem 2: Inflation—The Future Value of a Wedding

I have six daughters and one son. It is estimated that an average wedding cost $23,000. 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 = ?

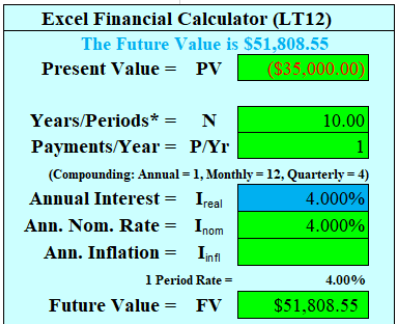
The formula is: $PV*((1+I)^{(N)})$.



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 (π). This method is incorrect. It is preferable to use the following formula:

(1 + nominal return (r_n)) = (1 + real return (r_r)) * (1 + inflation (π))

To solve for the real return, divide both sides of the equation by (1 + inflation (π)). Once you've divided, the equation looks like this:

(1 + nominal return (r_n)) / (1 + inflation (π)) = (1 + real return (r_r))

Then, subtract one from both sides and reverse the equation to get the following:

Real return (r_r) = [(1 + nominal return (r_n)) / (1 + inflation (π))] – 1

<u>Problem 3: Real Return (i.e., the Return after Inflation)</u>

Paul just graduated from college and landed a job that pays $35,000 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: $r_r = ((1 + r_n) / (1 + \pi)) – 1$. Now plug in the values you know: 0.02 = (1 + x) / (1 + 0.0196) –1. Solving for x results in a nominal return of 4.00 percent. Thus, Paul's nominal return must be 4.00 percent in the future to maintain a real return of 2 percent. The formula for the nominal rate of return is NR = (1 + RR)*(1+I) -1.

b. To maintain his current purchasing power 10 years from now, Paul will have to make $51,809 in real terms.

This problem is very similar to the Future Value we have already discussed. Use the following values to solve this problem:

PV = –$35,000 (This is Paul's current salary.)
I = 2 (Interest is replaced by inflation.)

N = 10 (This is the number of years in the future.)
Solve for FV = ?

Excel Financial Calculator (LT12)		
The Future Value is $42,664.80		
Present Value =	PV	($35,000.00)
Years/Periods* =	N	10.00
Payments/Year =	P/Yr	1
(Compounding: Annual = 1, Monthly = 12, Quarterly = 4)		
Annual Interest =	I_{real}	2.000%
Ann. Nom. Rate =	I_{nom}	2.000%
Ann. Inflation =	I_{infl}	
1 Period Rate =		2.00%
Future Value =	FV	$42,664.80

The formula is FV = PV * $(1+I)^{N.}$

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

{XE "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:

$$PMT = PV_{N,I} / ((1 – (1 / (1 + I)^{N})] / I)$$

$$PMT = \$750{,}000 / ((1 – (1 / (1.07)^{30})] / 0.07) = \$60{,}439.80.$$

Excel Financial Calculator (LT12)		
The Payment is $60,439.80		
Present Value =	PV	($750,000.00)
Years/Periods* =	N	30.00
Payments/Year =	P/Yr	1
(Compounding: Annual = 1, Monthly = 12, Quarterly = 4)		
Annual Interest =	I_{real}	7.000%
Ann. Nom. Rate =	I_{nom}	7.000%
Ann. Inflation =	I_{infl}	
1 Period Rate =		7.00%
Future Value =	FV	
Payments =	PMT	$60,439.80

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

{XE "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.

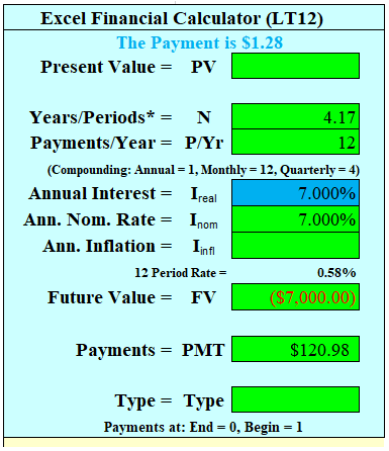
Before solving for the monthly payment, follow these steps: (1) clear your calculator's memory, (2) set your number of payments to 12 so that your calculator will calculate monthly payments instead of annual payments, and (3) make sure your calculator is operating in "end mode," since the payments are received at the end of each period.

To solve the first question, input the following information:

FV = –$7,000
N = 50/12
I = 7
PMT = ?

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:

The formula is $PMT = FV_{N,I} / ((((1 + (I / 12))^{N}) - 1) / (I / 12))$



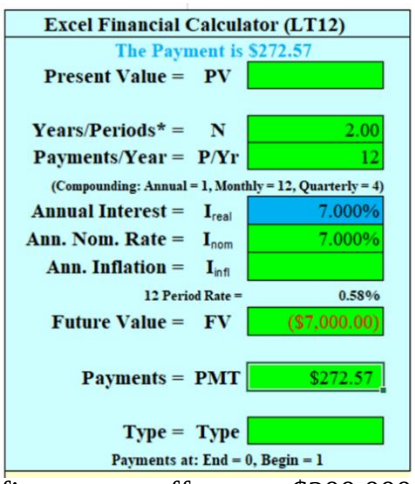
$PMT = \$7{,}000 / ((((1 + (0.07 / 12))^{50}) - 1] / (0.07 / 12)) = \$120.98$

To solve the second question, input the following information:

FV = –$7,000
N = 24
I = 7
PMT = ?

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:

$PMT = \$7{,}000 / ((((1 + (0.07 / 12))^{24}) - 1] / (0.07 / 12)) = \$272.57$



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?

1. First offer: The present value of this offer is $200,000 because the buyer can pay you all of the money today.

2. 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.

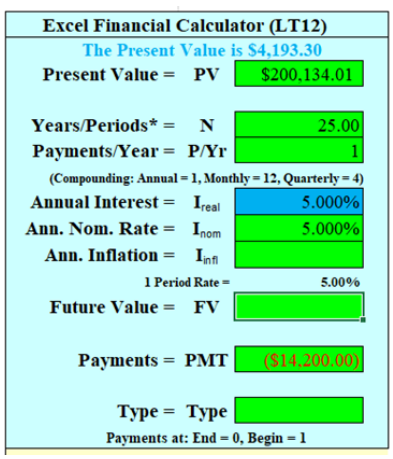
To calculate the present value of the first offer using a financial calculator, clear your calculator's memory, set the number of payments to one annual payment, and make sure your calculator is set to "end mode." Then, input the following information:

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:

$$PV_{N,I} = PMT * (1 – (1 / (1 + I)^N)) / I$$

$$PV_{N,I} = \$14,200 * [1 – (1 / (1.05)^{25}] / 0.05 = \$200,134$$



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 6 and the PMT equal to $3,000. The formula is: $PMT * (((1 + I)^N)-1) / I$.

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 8 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 8 percent interest. Begin by clearing the calculator's memory. Set I equal to 8 and the PMT equal to $3,000.

For 20 years: Set N equal to 20 and solve for FV. FV = $137,286 ($26,929 more than she would earn at the 6 percent interest rate)
For 30 years: Set N equal to 30 and solve for FV. FV = $339,850 ($102,675 more than at the 6 percent rate)
For 40 years: Set N equal to 40 and solve for FV. FV = $777,170 ($312,884 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

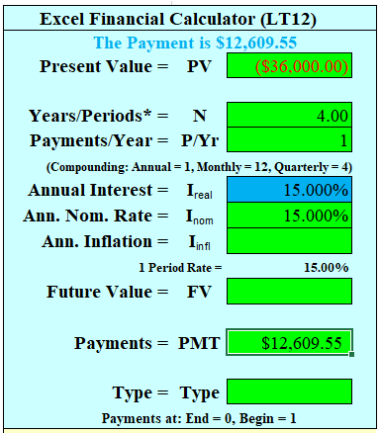
You take out a loan for $36,000 to purchase a new car. If the interest rate on this loan is 15 percent, and you want to repay the loan in four annual payments, how much will each annual payment be? How much interest will you have paid for the car loan at the end of four years?

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:

PV = –$36,000
N = 4
I = 15
Solve for PMT = ? to get $12,609.55.
The formula is: $PMT = PV_{N,I} / ((1 – (1 / (1 + I)^N)] / I)$

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 $1,550 per month? What is the total amount that will be paid for each loan? Assume each mortgage is $250,000.

Loan A: 30-year loan with a fixed interest rate of 4.5 percent

Loan B: 15-year loan with a fixed interest rate of 5.75 percent
Loan C: 20-year loan with a fixed interest rate of 4.125 percent

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:

PV = –$250,000
N = 360 (Calculate the number of monthly periods by multiplying the length of the loan by the number of months in a year: 30 * 12 = 360.)
I = 8.5/12
Solve for PMT = ?

Your monthly payment for this loan would be $1,266.71, and the total amount of all payments would be $1,266.71 * 360, or $456,017. Interest is $206,017.

The formula is: PV/((1-(1/(1+(I/P))^(N*P)))/(I/P))

Loan B. For a 15-year loan at 3.75 percent interest, follow the same steps explained above. This time, input the information listed below:

PV = –$250,000
N = 15 * 12 = 180
I = 3.75

PMT = ?

The monthly payment for this loan would be $1,818.06, the total amount of all payments would be $327,250 and the interest would be $77,250.10.

Loan C. For a 20-year loan at 4.125 percent interest, the calculations are still the same. Input the following in your financial calculator:

PV = –$250,000
N = 20 * 12 = 240
I = 4.125
Solve for PMT = ?

The monthly payment for this loan would be $1,531.47, the total amount of all payments would be $367,552 and the interest paid will be $117,552.

Considering the mortgage payment the homeowner can afford, the best financial option is Loan C—the 20-year fixed-rate mortgage at 4.125 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 $77,250 less.

<u>Problem 10: Becoming a Millionaire</u>

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?

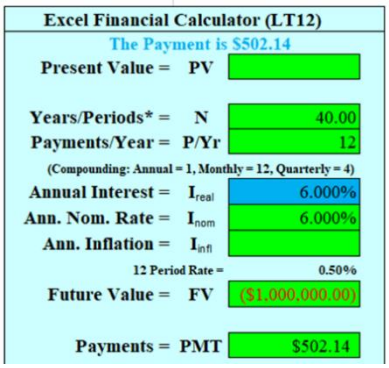
Clear your memory and set payments to monthly. FV = 1,000,000 N = (40 * 12) I = 6%, Solve for Payment (PMT).

PMT = $502.14. She will need to save $502 per month.

The formula is: $FV/(((1+(I/P))^{(N*P)} -1)/(I/P))$

At 89 percent interest:

Clear your memory and set payments to monthly. FV = 1,000,000, N = (40 * 12), I = 89%, Solve for Payment (PMT)
PMT = $286.4513.62. She will need to save only $28614 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 + nominal return (r_n)) = (1 + real return (r_r)) * (1 + inflation (π)) = (1 + nominal return (r_n)) / (1 + inflation (π)) – 1.

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

There is no specific part of your PFP on the Language of Finance. However, it is an integral part

of your work and analysis. 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:

Financial Calculator Tutorial (LT03)
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.

Excel Financial Calculator (LT12)
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

Terminology Review

Amortized Loan. An amortized loan is a loan 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.

Annuity. An annuity is a series of equal payments that a financial institution makes to an investor; these payments can be made at either the beginning or end of each period (usually a month or a year) for an individual's lifetime or 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.

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.

Future Value of an Annuity. The future value of an annuity is the value of a set of

recurring payments at specific dates in the future. It measures how much you will have in the future given a specific return or interest rate.

Inflation. 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.

Present Value of Annuity. The present value of an annuity is the current value of a set of recurring payments at specific dates in the future, given a specified rate of return or interest rate.

Real Returns. A real return is the rate of return you receive after the impact of inflation. 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 (π). This method is incorrect. It is preferable to use the following formula: (1 + nominal return (r_n)) = (1 + real return (r_r)) * (1 + inflation (π)). To solve for the real return, divide both sides of the equation by (1 + inflation (π)). Once you've divided, the equation looks like this: (1 + nominal return (r_n)) / (1 + inflation (π)) = (1 + real return (r_r)). Then, subtract one from both sides and reverse the equation to get the following: Real return (r_r) = [(1 + nominal return (r_n)) / (1 + inflation (π))] – 1.

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

<u>Case Study 1</u>

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 = Payment * $(((1 + I)^N) – 1)/I$ (This is the future value of an annuity factor $_{N,I}$)

Case Study 1 Answer

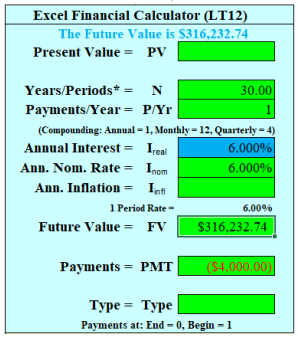
There are two ways for Lee to solve the problem. Using the formula, the problem is solved this way:

$FV_{N,I}$ = Payment * $(((1 + I)^N) – 1) / I$ = FV = $4,000 * $[(1.06)^{30} – 1] / .06$ =

$316,232.74

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 = $316,232.74



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:

$PV_{N,I}$ = Payment * $[1 – (1 / (1 + I)^N)] / I$ (the present value of an annuity factor $_{N,I}$)

Case Study 2 Answer

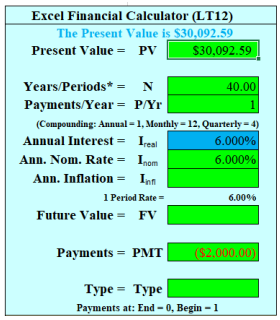
Using the formula, the calculation is:

$PV_{N,I}$ = Payment * $[1 – (1 / (1 + I)^N)] / I$ = PV = 2,000 * $[1 – (1 / (1.06)^{40})] / .06$ = $30,092.59

Using the financial calculator:

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:

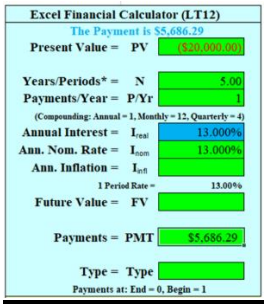
PV_N = Payment * ($PVIFA_{I,N}$)

Case Study 3 Answer

Using the formula, put Brady's borrowed amount into the equation and solve for your payment. $PV_{N,I}$ = Payment * $[1 – (1 / (1 + I)^N)] / I$ = PV = 20,000 = Payment * $[1 – (1 / (1.13)^5)] / .13$ = $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

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?

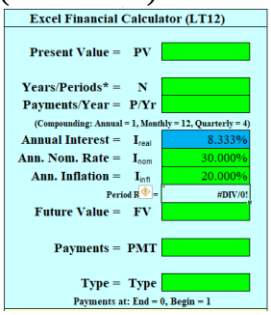
Case Study 4 Answers

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 (1 + nominal return) / (1 + inflation) – 1 = real return

(1.30 / 1.20) – 1 = 8.33%.



In this example, the traditional method overstates return by 20 percent ((10% / 8.33%) – 1). Be very careful of inflation, especially high inflation!

11. Insurance 1: The Basics of Insurance Protection

Introduction

The purpose of insurance—and financial planning in general—is to make our lives more predictable from a financial standpoint. All people face the risk of certain types of loss every day: these risks pertain to our health, automobiles, homes, and many other aspects of our lives. Through the appropriate use of insurance products, you can make the risks of loss more manageable and predictable; managing your risks can bring you more peace of mind as you go about your daily activities and as you seek to achieve your personal and family goals.

Objectives

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

A. Recognize the importance of insurance.
B. Understand what leaders have said regarding insurance and the key principles of insurance.
C. Understand and create your Insurance Plan.

Recognize the Importance of Insurance

Insurance is a legal contract between you and an insurance firm. The insurance firm agrees that if you pay a specified amount, known as a premium, the firm will compensate you for certain kinds of losses or events, such as death, sickness, accident, loss of ability to work, and legal expenses.

There are many types of insurance, and because of the different natures of various types of risk, we have divided our discussion of insurance into sections about life insurance, health insurance, auto insurance, homeowner's/renter's insurance, and liability insurance.

The Importance of Insurance

The concept of insurance was sparked by the idea of pooling risk. People with families and valuable property have always faced the possibility of loss; the possibility of such loss has caused individuals so much concern that they have pursued options for the replacement of their loss. Thus, the practice of insuring property for its replacement value evolved. Life insurance, the practice of replacing the economic value of a human life, has also grown out of this same thought process.

Insurance allows you to transfer the financial risk of certain types of losses to another entity, usually an insurance company, which is organized according to stringent federal and state

regulations specifically for the purpose of protecting you against losses. By transferring the financial risk to such an entity and paying the required premiums, you can receive compensation for loss in the form of either a lump sum or an annual amount of money. This compensation can maintain or replace your income stream. In this way, insurance helps you and/or your family maintain financial stability if you get sick or become unable to work because of disability, injury, or death.

If you have insurance but do not incur a loss for which you had coverage, you lose only the premium you paid, although some insurance policies do have a return-of-premium feature. Even though a particular loss may not occur, you still receive value from the premium paid in the form of peace of mind and the knowledge that you are taking care of your family. If you do not have insurance and you are sued, get sick, or die, you and your family may suffer serious consequences: your family may have to rely on only one income or a reduced income to get by, and your children may not be able to achieve important goals. Insurance allows you to transfer the financial responsibility for risks like illness, disability, and death to an institution capable of handling these risks.

Managing Risk

An important part of determining the right level of insurance you should have is understanding risk. Risk, in terms of insurance, is uncertainty concerning the occurrence of a specified loss.

There is risk in all areas of life, including your lifestyle, your career, your environment, and so on. You can manage risk in four ways: you can avoid it, reduce it, assume it, or transfer it.

> You can **avoid** some risks. For example, you can avoid some health risks by taking care of yourself, eating well, exercising, and avoiding high-risk activities where you might be hurt, such as skydiving. You can avoid some financial risks by diversifying your investments.
>
> You can **reduce** some risks by adding fire extinguishers and burglar alarms to your home, adding airbags to your car, using seat belts, and getting regular medical checkups. By taking these precautions, you can reduce the potential damage of some risks.
>
> You can **assume** some types of risk through self-insurance. For example, I used to own a 1973 Ford Pinto. Instead of carrying full-coverage insurance, which would have allowed me to get the car fixed if it were in an accident, I carried only liability insurance. If I had been in an accident, I would have had to pay to have the car fixed myself (in other words, I assumed the risk of repair and collision costs). If the costs are not too high, you can assume some risks by assuming the potential for additional costs, i.e., a higher deductible, and keeping a slightly larger emergency fund.
>
> You can **transfer** risk to others by purchasing insurance and thus transfer financial responsibility for a specific risk—death, disability, liability, and so on—from yourself to

an insurance company.

Once you understand how to manage risk, you can determine which risks you can avoid, reduce, or assume, and which risks you should transfer to an insurance company or other entity.

The Key to Insurance

The key to insurance is balancing the cost of reducing risk with the potential severity of a loss. Should you insure against all losses? While this may be possible for some people, it is not possible for most—the costs would be too high.

The key is to realize that some losses are not as critical as others. You should insure yourself against high-severity losses that rarely occur—those that would have a major impact on the financial condition of you and your family—such as death, illness, auto or home accidents, and accompanying liability issues. And you should avoid, reduce, or assume the other risks.

You can analyze and classify risk by looking at two important areas. The first area is the frequency of the potential loss: how often could the loss happen? Could it happen every month, every year, or just once in a lifetime? The second area is the severity of the loss: how severe would the implications be for you and your family if the loss occurred? These factors can be charted in Table 1.

Understand What Leaders Have Said Regarding Insurance and Key Principles

Acquiring insurance is an important step toward becoming financially self-reliant. We have been counseled by our leaders to live within our means, to put our lives in order, to provide for our future, and to obtain adequate insurance to meet our responsibilities as parents. We have also been commanded by the Lord to take care of our families.[1] Marvin J. Ashton offered the following counsel on insurance:

> It is most important to have sufficient medical, automobile, and homeowner's insurance and an adequate life insurance program. Costs associated with illness, accident, and death may be so large that uninsured families can be financially burdened for many years.[2]

N. Eldon Tanner also commented on this topic, saying "Every family should make provision for proper health and life insurance."[3]

Understand the Key Principles of Insurance Planning

Insurance should be an important part of your Personal Financial Plan. There are several different approaches to building an effective insurance plan. One approach is to focus on specific products; however, insurance products will and do change over time as new products are developed. A better method is a principles-based approach. While products may change over time, the principles regarding effective insurance planning do not change.

Table 1. Risk Matrix for Understanding Insurance

		Frequency of Loss	
		High	Low
Severity of Loss	High	Avoid Reduce	Transfer
	Low	Reduce Assume	Reduce Assume

The key to insurance is to balance the cost of reducing risk with the severity of the potential loss. Insure against high-severity losses that rarely occur—those events that could have a major impact on your financial situation. Reduce and avoid other risks to the extent that you can. Finally, self-insure against smaller risks that will have limited impact on your financial situation. Use insurance for what insurance does best. Be careful in using insurance products as an investment, or investment products as insurance.

So what are the key principles of insurance planning that we can apply to help us manage our various insurance products wisely? The following are a few ideas to help you understand the key principles of insurance planning:

1. Know Yourself, Your Vision, Goals, and Plans. Insurance is a tool that can help you plan for the future while living in the present. However, before you can develop an insurance plan, you must know what is important to you and what you want from life. Insurance is not an end in itself: it is a tool to help you achieve your vision and personal goals. What are your goals? One goal may include replacing your salary should you die.

Once you determine your goals, the challenge becomes figuring out which insurance products can help you reach your goals the fastest. You should understand each insurance product well. While it will take a significant amount of time to understand insurance products individually, your understanding of the main insurance products will increase with a general overview. Recognize that your insurance needs will change over time. Plan for the future, but live in the present.

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of insurance, and know your budget and how much you can afford. Before you can determine which insurance products you need, you must set a budget. How much can you afford to spend on insurance needs? It is important to be cost-effective in your insurance planning. Insurance is a long-term product, and certain insurance products have higher premiums than others; it makes no sense to begin an insurance program you cannot continue. As you think about your goals and insurance needs, recognize the potential for change in your income—or even loss of income—and the possible impact of such changes on your budget.

However, you need insurance to help you face risks that are beyond your control. You will face financial responsibility if certain adverse events occur. In making insurance decisions it is important to purchase all insurance that is necessary to allow you to survive the foreseeable adverse events of life. If your current consumption does not leave enough money in your budget to purchase necessary insurance, then you may need to reevaluate your priorities.

4. Understand in Detail the Costs and Benefits of Each Insurance Product. Knowledge is power. If you are to make wise decisions in your insurance planning, it is critical for you to understand in detail the costs, benefits, and risks of insurance products and their providers. Do your homework early and you will better understand what various insurance products can and cannot do. Weigh the costs and benefits carefully before you purchase a particular insurance product. Many insurance products have high beginning or up-front expenses and are very expensive to modify or change after the policy is in force.

Also, compare products across companies, and make sure you understand the differences between competing products. Ask for help from your insurance agent or potential insurance agent if you don’t understand the differences.

5. Insure Against High-Cost, High-Severity Losses Only. Insure yourself against events that would have a major economic impact on you or your family. Self-insure against events that would have a smaller economic impact. Balance your need for insurance with the cost of the insurance. The goal is to use insurance to provide funds in those most adverse circumstances where your personal resources would not be sufficient.

6. Work Only with High-Quality Individuals and Institutions. Trust is a critical component of your insurance relationship. Since insurance is a long-term commitment, you want a relationship with an institution that will be willing and able to help you now and in the future. Work with individuals and institutions that make you comfortable. If you feel pressure in any way to purchase a product, find another insurance agent; you do not want an insurance agent who is there just for the sale. The key is to find an agent who will work in your best interests and help you achieve your goals, while at the same time finding an insurance agency that pays up when agreed so you don’t have to dispute every charge.

Know how insurance agents are paid. Minimize the potential for conflicts of interest by understanding the costs of insurance products and how insurance agents are paid for selling these products. For example, the commission paid on cash-value life insurance policies to insurance agents can be *10 to 20 times higher* than commissions paid on term life insurance policies with the same face or policy amount. While the former are much more complex products and may have additional benefits over the alternatives, it is important to understand the potential for conflicts of interest.

Evaluate the insurance company carefully. You want to make sure that your insurance agent and the company will be around for a long time. Make sure the company is financially sound before you purchase their products. Getting your insurance products from the firm with the lowest prices will do you little good if the insurance company goes out of business. You can also evaluate the insurance company by checking the company's rating with various insurance-rating firms.

7. Review Your Insurance Needs Annually. Remember, your insurance needs may change over time as your family situation, investment portfolio, and work situation change. Use wisdom in planning your insurance coverage and in making changes to your policies. Be especially careful of the costs of making changes—many insurance products have higher up-front or beginning costs. Be an informed consumer of insurance products.

Finding Balance

As you work on managing consumer loans, finding balance among doctrines, principles and application is important in helping you become better at managing insurance. Below are a few ideas.

Principles	Doctrines
Know yourself, your vision, goals and plans	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Know your budget and what you can afford	Accountability
Understand the tools of insurance and use carefully	Stewardship
Insure against high-cost high-severity events	Agency
Work with good people and institutions	Stewardship
Review your insurance needs annually	Stewardship

From Obedience to Consecration

As we work on understanding and managing our insurance needs, finding balance among doctrines, principles and application is important. We are not just insurance consumers,

> We are children of a King (identity), striving to live worthy of the Spirit (obedience), learning the critical areas of insurance (stewardship), so we can make wise choices in our use of insurance products (agency). Our goal is to maximize our protection and minimize

costs in each of the five key areas of insurance (stewardship), so we can get the protection we need at a cost that we can afford (stewardship), so that we can accomplish our individual missions and our individual and family vision and goals.

Understand and Create Your Insurance Plan

As you work on making insurance work, you can see the importance of following the principles. Becoming a wise insurance consumer is important to helping you achieve your personal and family vision and goals. Following are ideas as you put your Insurance Plan together. Being a knowledgeable and wise consumer of insurance products will allow you to get the coverage you need at the lowest possible costs.

Vision

- Likely from your Plan for Life. It may also include:
  - Insurance will be used for what it does best; providing security for myself and family.
  - We will not mix insurance and investments.
  - Insurance will help us with financial security.

Goals

- We will always have adequate auto, homeowners/renters, and health insurances.
- We will always have an Emergency Fund large enough to hold us over until government. disability is available. That way we can reduce the need for private disability insurance.
- We will not mix insurance and investments as each do their respective elements well.

Plans and Strategies

Life Insurance: Students and young marrieds

- If married, buy a small $250k - 20 year annual renewable term product with the convertibility option. Once children come, ladder on additional renewable convertible term products.

Married with families

- If term insurance rates have decreased, you can purchase a new product then cancel the old.

Empty nesters

- As your investment assets increase and children leave the home, you can allow some of the policies to terminate without renewing as the need for income replacement is diminished.

Health Strategies: Students and young marrieds

- If married without kids, compare your group plans to a Health Savings Account to see which plan has the best coverage for the costs

Married with families

- Once children come, switch to a traditional group plan to meet your family needs.
- Use a flexible spending plan if offered by your employer to reduce your medical expenses.

Empty nesters

- As children leave home, make adjustments to your health insurance to be cost effective with your coverage.

Disability

- Keep my Emergency Fund at 4 months so if I am disable, I will have sufficient to live on until Social Security or Workers Compensation is available.
- Live health and keep running.

Asset Protection: Students and young marrieds

- Have adequate renters insurance.—it is cheap.
- Have adequate auto insurance, with a minimum 100/300/100 split coverage initially.

Married with families

- Raise your split coverage to 250/500/100 to offer more protection when you have teenage drivers.
- Make sure teenage drivers take "safe-drivers courses" to reduce their insurance costs.

Empty nesters

- Consider an umbrella policy to reduce the risk of future litigation expense as assets increase.

Constraints

- Not living on a budget will make it difficult to save and to have adequate insurance.
- Getting caught up in the things of the world will make it difficult to save.

Accountability

- You will share your vision and goals with your spouse and children.
- You will remember these things in prayer with Heavenly Father each week.

Summary

The insurance industry is always changing, and it can be a challenge to understand the many insurance products available. Each of the many products the insurance industry offers has unique benefits and costs. Understanding what Church leaders have said regarding insurance will help you realize the importance of insurance as part of your Personal Financial Plan and your family's

financial plan. If you understand how insurance can help you, you will be better prepared for the challenges you may encounter in your life. Finally, by understanding and applying the principles of insurance planning as they are outlined in this chapter to create your Insurance Plan, you can make sure the products you choose are the products that will most likely help you achieve your personal goals.

Assignments

Financial Plan Assignments

In this section you will complete your Insurance Plan. I recommend you use the PFP Insurance Template (LT01-09) as a starting point. As you learn about the different types of insurance in this course, think about the different ways to manage risk and the key principles and doctrines of insurance planning. These principles are important because they provide a structure to help you evaluate the different types of insurance and the uses of different insurance products.

Think about these principles as you read through the succeeding chapters on health insurance, life insurance, auto insurance, property insurance, and liability insurance and as you develop vision, goals, and plans and strategies for each of these types of insurance. Think about how you can apply the principles of risk management and insurance planning to the different types of insurance. You will incorporate these principles in the assignments for the succeeding chapters.

Review Materials

Terminology Review

Earnings Multiple Approach. This is one approach for determining the amount of life insurance required. The goal is earnings replacement. The earnings multiple approach seeks to replace the annual salary stream of a bread winner for X years, normally 10 – 15 times gross salary.

Insurance. Insurance is a tool help you achieve your personal and family goals. It is a product that transfers the risk of certain types of losses or events from an individual to another institution. By transferring risk, it can help the individuals achieve specific goals if they die, get sick or become unable to work. But it is a tool that needs to be understood and used wisely.

Investment Risk. This is the risk of who takes responsibility for the investment outcome, the insurance company or the insured.

Life Insurance. This is insurance that provides compensation to your beneficiaries should you die prematurely. It transfers the economic loss of death from an individual to an insurance company by way of a life insurance contract. It can help us take care of our own and extended families should we die.

Mortality Risk. This is the risk that the insured dies outside the contract period and is therefore not covered by insurance.
Needs Approach. This is an approach for determining the amount of life insurance that is required. It determines the total needs of the beneficiaries which includes immediate, debt elimination, transitional, dependency, spousal life income, education, and retirement needs. It is the most detailed of the approaches.
Permanent Insurance. Permanent insurance is an insurance contract that is purchased for the entire life of the policy holder with premiums divided between death protection and savings. Provides insurance that cannot be cancelled, may be used for estate retirement, and savings. It is complex, expensive, and not transparent, and unless premiums are paid, it can expire worthless. Please note that certain permanent products are not permanent, i.e. they can lose money.
Risk Pooling. It is the process where individuals transfer or share their risks with others to reduce catastrophic losses from health problems, accidents, lawsuits, etc.
Term Insurance. Term insurance is insurance protection for the insured over a specific term or time period. They may be renewable or non-renewable policies. It is the least expensive form of insurance and the death benefit coverage is only for a specific term.

Review Questions

1. What is insurance?
2. What is the purpose of insurance?
3. In regard to insurance, what is risk? What are the four ways to manage risk?
4. In Table 1, what are the two ways in which you can analyze risk?
5. What is the key to insurance?

Case Studies

<u>Case Study 1</u>

Data

Bill is 25, married with one child, and does not have any life or health insurance. He has a friend that sells insurance. His friend wants to talk to him about his insurance needs.

Application

What questions should Bill ask as he considers whether to work with this friend for his insurance needs?

Case Study Answers

The answers for these questions are based on information from Arthur J. Keown's *Personal Finance, Turning Money into Wealth Student Workbook*. [4]

1. Are you a full-time insurance agent?

   Work with agents who work full-time as insurance agents. This gives greater assurance that your agent is knowledgeable about the products you need and the products he or she represents.

2. How long have you been a full-time insurance agent?

   Work with someone who is experienced and has been established for a number of years. While a new agent may be competent, an experienced agent will be more likely to be competent.

3. Which life insurance companies do you represent?

   Generally, it is better to work with someone who represents at least one company with a top rating from A.M. Best for 10 consecutive years (see www.ambest.com/ratings for information. You can register for free and view the financial strength and issuer credit ratings on the different insurance companies you are considering). If the agent works with multiple companies, he or she may be able to offer more competitive products than captive agents (agents who only work for a single insurance company).

4. Are you a CLU (a Chartered Life Underwriter)?

   A CLU is preferred, especially if you are seeking advice or considering insurance other than term. Realize that an insurance agent is only able to sell things he or she is licensed to sell.

5. Will I be allowed to keep the insurance proposal you prepare for me?

   You should not consider an agent who won't allow you to keep the insurance proposal. You should be able to take the proposal home and review it on your time.

6. Would you be willing to inform me of the commission you'll receive on any policies you recommend?

   You want to make sure the agent is working on your behalf. Knowing the agent's commission on various policies may help you avoid policies that benefit the agent more than you. If the agent is not willing to share the amount of his or her commission on each product with you, go with another agent who will.

7. Do you have any clients who are willing to recommend you?

   Your agent should either supply you with names of satisfied clients or share testimonial letters from others. You should not consider an agent without recommendations.

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[1] 1 Timothy 5:8
[2] "Guide to Family Finance," *Liahona,* Apr. 2000, 42.
[3] "Constancy Amid Change," *Ensign,* Nov. 1979, 80.
[4] Prentice Hall, New Jersey, 2007, p. W47

12. Insurance 2: Life Planning with Life Insurance

Introduction

Once you understand the basics of insurance, your understanding of the importance of life insurance increases greatly. Much of what is written on the subject of life insurance is confusing and difficult to grasp. The purpose of this chapter is to help you to more clearly understand the benefits and costs of the different types of life insurance.

Objectives

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

A. Understand the benefits of life insurance and the five key questions.
B. Understand the different types of term life insurance.
C. Understand the different types of permanent life insurance.
D. Determine which type of insurance is best for you and know the steps to buying life insurance.
E. Understand plans and strategies for life insurance.

Understand the Benefits of Life Insurance and the Five Key Questions

Life insurance provides your beneficiaries compensation in the event of your death. Death is a low-frequency (you can only die once) but high-severity risk. Life insurance is essentially contingent financing: it will help support your family in the event of your death. The financial loss due to death is significant. Life insurance can help us take care of our nuclear and extended families financially even beyond death.

Life insurance contracts are designed to help consumers achieve a variety of individual and family goals. Life insurance marketing may be confusing, and recommendations and policy language differ from company to company. It is critical to understand the benefits of life insurance so you can make wise choices regarding it.

Benefits of Life Insurance

The greatest benefit of life insurance is insuring your beneficiaries against the economic loss caused by death. While the payments can never replace the person lost, they can replace his or her ability to pay for living expenses, home mortgages and taxes, education expenses, and other costs. At a critical time, the payments may make it possible for the surviving spouse to remain in the home and concentrate on raising the surviving children. However, life insurance offers four

additional benefits that may be of interest to you as you develop your Personal Financial Plan: life insurance can benefit you with estate planning, insurability, retirement planning, and saving.

Life insurance proceeds may be used in estate planning to ensure that sufficient funds are available to pay estate settlement costs after death (debts, taxes, legal costs, burial expenses, etc.). Proceeds may help heirs receive as large a share of inheritance assets as legally possible. In addition, proceeds can be used to ensure that inheritance assets, such as businesses, do not have to be sold at discounted prices to raise funds for estate taxes or other liabilities.

Permanent life insurance products offer guaranteed insurability. Once you have a contract with the insurance company, your insurance contract cannot be canceled unless you fail to make payments. Once you have this contract, regardless of your medical condition, you cannot be denied the life insurance agreed upon.

Life insurance may also be used for retirement planning. When retirement income is taken from the cash value of an insurance policy, it can be received on a tax-favored basis. The cash-value portion of life insurance, after mortality costs and fees, may gain interest or capital gains that are exempt from taxes. This extra interest or capital gains may be saved for retirement. Life insurance also allows you to borrow against the cash-value portion of your policy and, in essence, receive a low-cost loan. Moreover, when you borrow against the cash-value portion of your policy, you don’t have to sell the permanent assets as you would with a normal investment account (resulting in capital gains or losses). Instead, the insurance company actually makes a loan to you against the cash-value portion of the policy.

Finally, life insurance can be a type of forced savings account. For those without the discipline to make monthly payments into a savings or investment program, life insurance can be a part of an overall savings strategy. The individual can purchase certain types of permanent life insurance products with low fees and mortality expenses, and can direct, to a degree, where the investment portion of the monthly premiums are invested. When needed, the individual can borrow against the cash value of the policy for a tax-free loan.

Remember, insurance is never your best investment, and investment is never your best insurance. The goal is to use insurance for what it does best and investment for what it does best. Be careful when combining the two.

Five Key Questions about Life Insurance

You should understand the following important terms as you learn about life insurance:

> **Beneficiary:** The recipient of benefits in the event of the death of the insured.
>
> **Cash value:** The total account value that is available to the policy owner while he or she is alive. Most policies have both guaranteed and non-guaranteed elements of the cash value. This means that some elements, such as a minimum return each year, may be

guaranteed, and other elements, such as may vary with the instrument in which the cash value is invested, may not be guaranteed. The cash value is reduced by any loans or applicable surrender charges.

Face value: The basic benefit the insurance company is to pay the beneficiaries; the face value is due upon the death of the insured. Total benefits may be higher if there have been policy additions.

Insured: The person whose life is covered by the insurance policy.

Policy owner: The individual or business that pays for and owns the insurance policy.

Premium: The payment for an insurance policy. Premiums can be paid monthly, quarterly, semiannually, or annually. Premiums may build cash value in certain insurance products; this cash value may be used to pay costs.

There are five important questions you should ask yourself about life insurance:

1. Why Should You Have Life Insurance?

Life insurance provides financial compensation to your beneficiaries in the event of your death. This type of insurance can help you prepare for major catastrophes and accidents; life insurance also yields some living benefits, or benefits that are available before death. Paul wrote, "But if any provide not for his own, and especially for those of his own house, he hath denied the faith, and is worse than an infidel."[1] Having adequate life insurance can help us fulfill this commandment even after we die.

2. How Does Life Insurance Work?

Life insurance is an example of risk pooling, which means that individuals transfer or share their financial risks with others to reduce potential catastrophic losses due to death, accidents, or health problems. While everyone pays into this insurance pool, because there are several participants and hopefully few recipients, the cost per participant is small because expenses are shared among the large number of participants.

There are two main risks that life insurance can share or transfer: mortality risk and investment risk. Mortality risk is the risk that the insured dies outside of the contract period and is therefore not covered by insurance. Some insurance contracts must be renewed each year and are therefore very risky because health problems or other concerns may make an individual unable to obtain coverage. Other products cannot be canceled by the insurance company (except in the case of nonpayment by the policy owner) and therefore ensure mortality coverage.

Investment risk has to do with who takes responsibility for the investment outcome; with some policies it is the individual who takes responsibility and with others it is the insurance company.

3. Who Needs Life Insurance?

Any individual whose death would create financial hardship for his or her dependents or business should have life insurance. This includes the following types of individuals:

- Single or married parents with children or other dependents.
- Married, single-income couples where the nonworking spouse has insufficient work skills or savings to survive should the breadwinner die.
- Business owners who want the value of their businesses to be passed on to their heirs or who want to preserve the value of their businesses if a key person is lost.
- Those whose estates exceed the tax-free transfer threshold for estates or who need additional liquidity at the time of death to avoid discount sales of estate assets.

While life insurance may offer benefits for other people in addition to those listed above, those benefits are not necessary for every individual.

4. How Much Life Insurance Is Necessary?

The decision regarding how much life insurance you need should be made individually. An earlier edition of the *Handbook for Families* recommends,

> Insure the family's breadwinner first, then others, if desired, as income permits. At a minimum, get enough life insurance to pay for such things as a funeral, taxes, mortgage on the home, car payments, and other debts. The next priority should be to get enough insurance that, supplemented by any government retirement benefits the surviving spouse may be entitled to, there will be sufficient to provide for the family and to make provisions for the children's education and missions. [2]

I like the framework that recommends minimum insurance first, then additional priorities. There are two different methods of determining how much life insurance you need: the earnings multiple approach and the needs approach.

With the **earnings multiple approach** the goal of having life insurance is earnings replacement. This approach has the goal of replacing the annual salary stream of a breadwinner for a certain number of years, or until the children are raised and the surviving spouse is financially stable and retired. Normally, an amount of 5 to 15 times your gross salary is recommended. Generally, most insurance companies will not insure an individual for more than 20 times his or her annual income. There is a three-step process for using the earnings multiple approach:

> *1. Adjust the pre-incident salary down to compensate for the reduction in household expenses.* Generally, a family's expenses decline in a predictable manner in the event of the death of an adult family member. The larger the family size, the less the percentage of total family expenses will drop (see Table 1).
>
> *2. Choose the appropriate interest rate to match the assumed after-tax and after-inflation*

earnings on a policy settlement. Interest rates affect insurance policies in that the higher the market interest rates, the more can be earned on investments, including money paid by an insurance company. If you think future market interest rates will be higher, your beneficiaries will not need as large an insurance settlement as would be necessary if market interest rates were lower.

Table 1. Percent Reduction in Living Expenses for Families

Family members after death	Reduction in living expenses
1	30%
2	26%
3	22%
4	20%
5	18%

To get an idea of how interest rates and the amount needed each year are related, see Table 2. If you needed $50,000 at the beginning of each year for the next 40 years and market interest rates were five percent, you would need to invest $857,954 in an annuity which would give you that $50,000 each year. If market interest rates were three percent, you would need to invest over $1 million in life insurance proceeds. Clearly, interest rates have an impact on insurance needs.

Table 2. Amount Needed for a $50,000 Annual Annuity

Years in Retirement	3%	4%	5%	6%
40	$1,155,739	$989,639	$857,954	$752,315
30	$980,022	$864,602	$768,623	$688,242
20	$743,874	$679,516	$623,111	$573,496
10	$426,510	$405,545	$386,087	$368,004

This table shows the amounts you need to invest to obtain a $50,000 annual payment or annuity for the following years in retirement at the indicated market interest rates.

Once life insurance proceeds are paid to the beneficiaries, the proceeds should be invested with the goal of providing a specific amount of money each year, or an annuity, to meet the beneficiaries' needs and expenses. Additionally, an annuity could be purchased or an annuity settlement option in the policy elected, which would guarantee a specific payment each period for a specific number of periods. Investing these funds will ensure that funds are available to pay expenses in a timely manner.

3. Determine the income stream replacement and annuity. The income stream replacement is how much money the beneficiaries will need each period or year and how long they will need that income stream. Once you have determined how much you need each period and for how

long, you can calculate the amount of money needed to provide the required income stream.

The **needs approach** for determining the amount of life insurance needed has a different goal from that of the earnings multiple approach. The goal is to meet the total financial needs of the household after the death of a breadwinner, both at the time of death and in the future. To calculate the necessary amount of life insurance according to this approach, add up all of your funding needs to determine the total needs of your beneficiaries. Include immediate needs, debt elimination, transitional funds, dependency funds, spousal life income funds, spousal education funds, children's education funds, and retirement income funds. Subtract current insurance coverage and other available assets from this total. There is a four-step process for calculating the needs approach:

1. *Add up all funding needs.* This inventory of funding needs is a very detailed description of the total needs of the family. The total needs of the beneficiaries include the following: immediate needs, such as needs for a funeral and other expenses; debt elimination needs, such as paying off credit card debts and mortgages; transitional needs, which include helping the spouse gain needed skills for better employment if necessary; dependency needs, such as taking care of and educating children; spousal life income needs, such as taking care of the spouse so he or she does not have to work; and education and retirement needs, such as taking care of the surviving spouse in retirement.

2. *Subtract current insurance coverage and other available assets.* The result gives you the amount of additional coverage you will need.

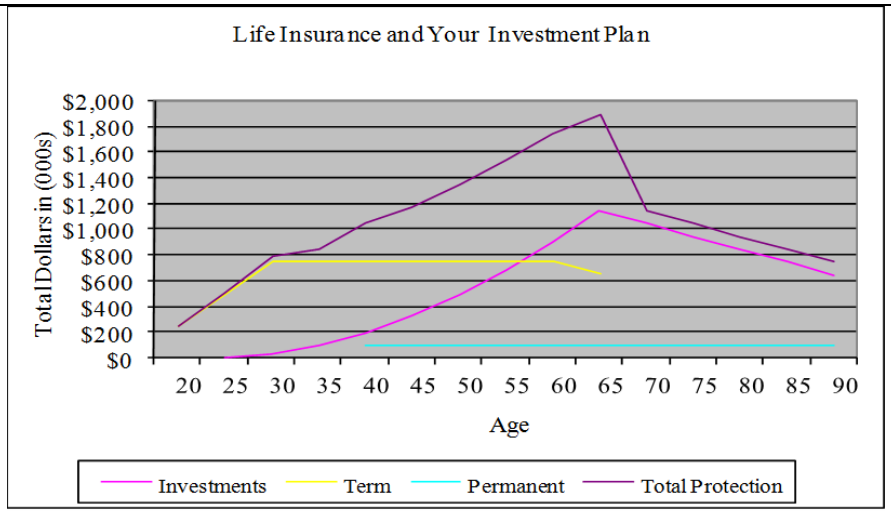
3. *Determine the income stream that would be needed to meet the family needs, and then calculate the amount of money required to provide the needed annuity* (see Figure 2). The difference between your total needs and your current coverage and available assets determines the amount of additional insurance coverage that will be necessary to meet the needs of dependents in the event that the breadwinner dies. Some couples find it essential to have two breadwinners, in which case couples should consider having life insurance for both spouses.

If your goal for having life insurance is income replacement, recognize that your income needs will change over time. Depending on your salary, the size of your family, and the growth of your investment assets, the amount of income that will need to be replaced varies throughout your life: it will increase significantly as children are born and raised and then decline as your children finish college. Therefore, instead of using a single product to meet all of your needs, it may be advantageous for you to utilize multiple products to give you maximum protection at the most cost-effective rate. These products should take into account your goals, budget, and growth in investment assets (see Chart 4).

Finally, you must determine the type of insurance you need. There are two main types of life insurance: term, or insurance for a specific period, and permanent (also known as endowment or cash-value insurance), which is term insurance with a savings component. The type of insurance

you choose will depend on four factors: your priorities and preferences, the amount of insurance needed, your ability and willingness to pay premiums, and the duration of need.

Chart 4. Life Insurance and Your Investment Plan



Permanent: with guaranteed insurability option paid up till age 65. Term: Five-year guaranteed renewable term in $50,000 and $100,000 increments; can add and drop as necessary. Investment: Includes individual and employer sponsored retirement plans [17]

5. What Type of Life Insurance?

Your priorities and preferences refer to your goals and objectives. What do you want the life insurance product to do? What are your personal goals? Your preferences are what you generally like to do. Do you prefer to "own" or "lease"? What are your "biases" for insurance? Are you willing to take the risk of re-insurability or not?

The amount of insurance needed is also an important consideration. Buy term insurance when there is no way to satisfy the financial needs should you die without it. The term protection may be converted to another form of protection at a later date, if available (i.e., convertible term). Buy a combination of term and permanent when you can cover the financial needs should you die and when you are able and willing to allocate additional dollars to appropriate permanent coverage.

Your ability and willingness to pay premiums should also be considered. Pay on installment basis (term, or low-outlay whole life) if your mortality risk is higher than average. Prepay coverage if you expect to live longer than average (vanishing premium or limited-payment whole life) or if you want payments to stop at a specific age. Purchase a yearly renewable term if you want minimal payments initially that increase year to year. Consider permanent coverage if your cash flows are sufficient to cover the higher premiums and you are committed to paying for it for the rest of your life.

The duration of need is your final consideration. Buy a term policy if your need is 10 to 30 years. If the need will last longer than 20 years, buy a permanent policy or a guaranteed renewable term

policy with your required duration (of 10, 20, or even 40 years). Finally, you should buy a permanent policy if the coverage will be continued beyond age 55 or if the policy will be used for estate taxes and charitable giving.

Understand the Types of Term Life Insurance

How Term Insurance Works

Term insurance provides life insurance protection that is valid over a specific term or time period. After the specified period of time is over, the life insurance company is not required to continue coverage. The main advantage of this type of insurance is that it is the least expensive coverage over the short term, since insurance costs rise with age. However, this type of insurance may be disadvantageous because it is valid only if the insured dies during the term of coverage. Another disadvantage is that the cost of the insurance will increase with each new contract period because term insurance is basically the pure cost of mortality insurance at a specific age. Older individuals typically pay more for life insurance because the probability of death increases with age. The insurance contract might not be renewed once the current term expires (at the insurance company's discretion) unless it contains a guaranteed renewable feature.

Figure 4. Term Life Insurance Characteristics

Term Insurance Characteristics					
Type of Policy	Description	Mortality Risk	Policy Cost	Payouts Based on	Biggest Risks
Annual Renewable Term*	Lowest cost term policy with premiums increasing each year aligned with probability of dying; however you must re-qualify and re-apply each year for the policy	Must be renewed each year so risk is high, but policies may be in force well into retirement years	Lowest cost term insurance initially, then costs rise exponentially as probability of dying increases	Payouts based on guarantees	Insured is unable to qualify for renewal and cannot get new insurance. Costs may become prohibitive in later years
Level Term Option*	Lower cost term policy with option for a level price each year of the period	May be renewed for multiple years at the same price so lower risk	Lower cost term insurance	Payouts based on guarantees	Insured is unable to qualify for renewal and cannot get new insurance.
*** Convertible Rider** (included with most policies above)	Insured can convert to a permanent if within a certain number of years or before a certain age	As term, higher risk; but as permanent, risk is lowest as cannot be declined if premiums paid	Most term policies include some form of convertible rider. Check policies for details	Payouts based on guarantees	Insured does not convert within the conversion period and cannot get new insurance

Figure 4 shows term life insurance characteristics for the different types of term policies. Premium payments are made that cover mortality costs and other fees. There is no buildup of cash—all premiums go to pay the costs and fees. As long as you continue making payments, you are covered for the contracted amount of time.

There are many different types of term insurance, the most common being annual term, renewable term, and convertible term.

Annual term. With annual term insurance, the face or death benefit amount is constant throughout the selected term of coverage. Premiums increase each time the contract is renewed,

even though the face amount remains the same. Coverage terminates after the specified time period.

Renewable term. Renewable term insurance policies can be renewed for a specific number of years. Even if health problems become apparent after coverage has begun, you can continue the coverage until the end of the specified period. Premiums will increase considerably at each renewal period, unless you demonstrate to the company that your health and circumstances merit a continued favorable rate.

Convertible term. Convertible term insurance is a policy that can be exchanged for a permanent policy within a specific number of years after issuance, without evidence of insurability. Many term policies contain this specific guarantee. These convertible term insurance policies allow you to convert your term policy to a permanent one at your discretion, regardless of your medical history; you also do not have to get a medical exam to convert your policy.

Premiums on term policies are much lower than on permanent policies with similar death benefits for three main reasons. First, with term policies, you are only paying for insurance for a specific period, which means that the risk is priced one period at a time. Roughly 98 percent of all term policies lapse without payment. Second, term insurance is generally priced for shorter time periods, from one to 20 years. The longer the time period, the higher the fees the insurance companies must charge in the early years to offset the more expensive mortality charges and fees in the later years. Finally, term insurance policies are less complex than permanent products and are cheaper and easier to administer.

There are a number of important questions that should be answered before you purchase term insurance. These questions include the following:

- What is the premium?
- How long can I keep this policy?
- What are the renewal terms of the contract?
- When will my premiums increase?
- Can I convert my term policy to a permanent policy?
- Can I convert it without getting a medical exam? What are the details?
- How strong is the insurance company financially?

Understand the Types of Permanent Life Insurance

Permanent life insurance is a contract in which the premiums are divided between death protection and savings. A portion of the premium pays for the mortality or death benefit component, and a portion goes toward paying the insurance fees. The remainder of the premium is put into an account that earns tax-deferred interest, dividends, or investment gains. Permanent insurance is often called endowment or cash-value insurance. This type of insurance is intended to provide the policy holder benefits over a lifetime. However, the policy will not be permanent if it does not have enough cash value, if the insured is not able to keep paying the premiums, or if

the investment value declines substantially.

Although permanent insurance is permanent under most circumstances, it is still possible to lose money with certain types of these products. The length of time in which payments must be made is sometimes a factor in permanent life insurance policies. You should determine if you can or want to pay premiums for the required length of time before you enter into a contract. If you do not wish to pay premiums throughout your entire life, fewer payment periods with fewer benefits can be arranged, or you may have an option of paying higher premiums over fewer payment periods.

How Permanent Insurance Works

There are three sources of cash that increase the value of a permanent life insurance policy. The first source is the premium payments you make on a regular basis. The second is the investment yield (also known as the dividend or investment earnings) from the cash-value portion of the policy. The third source of cash is available only on policies that allow you the option of receiving tax-free dividends from the insurance company as a legal return of premium. Dividends that exceed the premium are taxable, however. You can typically receive tax-free dividends on your insurance if you own insurance from a mutual company. This is because you own part of the company and receive a dividend as an inflow to your account each year based on your ownership of the company's earnings. However, should insurance company profits decline, these dividends are likely to decline as well. If your insurance policy comes from a stock company, then you have no ownership; however, the credits and costs of your policy will still be affected by the company's performance.

Permanent insurance cannot be canceled and therefore can be maintained for as long as you live. It provides a death benefit similar to that of term insurance as well as an opportunity to accumulate tax-deferred savings, which can be used for retirement and estate planning. Also, as the cash value of the insurance policy accumulates, it becomes a valuable asset that can be borrowed against—enabling you to get a loan that is very inexpensive and possibly tax-free. If you fail to pay back the loan, the face value of your policy is decreased by the value of the loan at payment to your beneficiaries.

Because permanent insurance is designed to maintain a constant premium throughout your life and to build cash value, the premium is naturally higher. To put this concept in perspective, the premium for a permanent policy may be 5 to 10 times higher than the premium on the same amount of term insurance; the premium is much higher because a portion of your premium goes toward creating cash value. Unless you maintain the policy by continuing to pay insurance premiums to cover costs and build cash value, the policy can expire, and you may lose much of what you have already put into the policy. With some of the newer products, like variable life insurance, your investments could *potentially lose money,* which would likely increase the amount of money you would have to contribute each year. Also, depending on the type of permanent insurance you have, there *may not be a guaranteed return* each year.

Expenses are another important aspect of buying a life insurance policy. Expenses can be divided into two categories. The first type of expense is the mortality cost, or the cost of the insurance. The second type of expense is the fees that accompany the purchasing process. These fees include sales commissions (often substantial), state insurance costs, deferred acquisition taxes, administrative fees, and investment fees (if applicable). These costs vary depending on the type of contract you have, so you should ask your agent to disclose these issues to you during the decision-making process. For a representation of the process of understanding permanent insurance, see Figure 5.

After you have paid the premiums on your permanent insurance for many years, the investment yield and dividends on your insurance may be sufficient to fund the policy (after expenses); when this happens, you will no longer need to continue paying the premiums. However, there is a risk that you will have to continue paying the premiums depending on the type of account, the investments chosen, and the economic environment.

Types of Permanent Insurance

There are a number of different types of permanent life insurance products, and these products differ according to five investment criteria: mortality risk, investment risk, policy costs, investment choice (i.e., assets), and investment flexibility. For a comparison of various term and permanent life insurance policies, see Tables 7 and 8.

Mortality risk refers to the risk that the insured dies within the contract period and is covered by insurance.

Investment risk refers to who takes responsibility for the investment outcome.

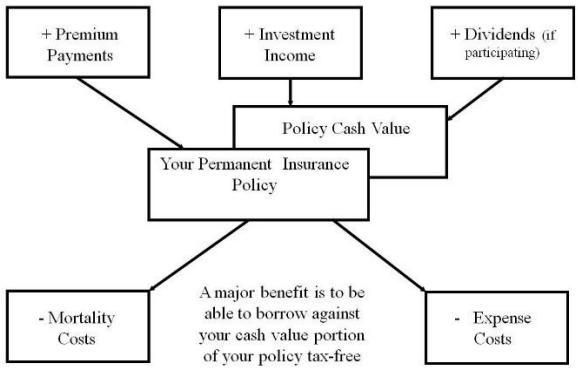
Policy cost compares the costs of the policy to other life insurance products.

Investment choice refers to the types of vehicles or assets the insured chooses to use to build his or her tax-deferred savings.

Policy flexibility refers to the degree of flexibility the insured has regarding insurance products—for example, account options, flexibility to change the face amount or death benefit over time, and flexibility to change premium payments depending on the insured's current situation. In the following chart, account flexibility, premium flexibility, and face value flexibility refer to the flexibility to change the investments, premium payment amounts, and face amount during the life of the contract (see Table 7).

It is important to understand why you want permanent life insurance. Understand your needs. Understand the individual polices of competing life insurance companies, such as the charges and deductions of the insurance company and the fees and expenses of the mutual funds or assets invested in. Finally, select the policy that gives you maximum benefit at the lowest possible cost to you.

Figure 5. Your Permanent Insurance Policy



Whole life. Whole life insurance gives lifelong coverage; this type of insurance has a fixed premium based on your age at the time of purchase. It is also called "straight life" or "ordinary life." Although the risk of death increases with age, most insurance companies keep the premium and face amount of an insurance policy constant by charging more in the early years of your policy and less in the later years of your policy than you would be charged for term insurance. Whole life insurance is ideal for those who want and can afford permanent life insurance protection with a savings element. Mortality risk and investment risk are both eliminated with this product. This type of insurance provides a transition from income replacement goals to goals regarding retirement and estate planning. This type of insurance may also be attractive for those who have low self-discipline or low tolerance for risk in saving and investing.

Other advantages of whole life insurance include a fixed death benefit, a growing cash value, and potential growth from tax-deferred dividends. The disadvantages include the fact that it requires a much higher premium for the same amount of coverage. Moreover, the yield on the cash value portion of whole life insurance may not be competitive with yields on alternative investments because whole-life policies are generally invested in an insurance company's long-term bonds and mortgages.

Universal life. Universal life insurance is a type of permanent life insurance that is a mix between term insurance and savings. Mortality risk is eliminated. This type of insurance earns interest at current money market or bond rates, so when interest rates are high, this type of policy will typically earn a better return. Thus, investment risk, while not eliminated, is low. This type of insurance also has a guaranteed minimum interest rate that is set for the life of the insured. The policy deducts a monthly fee for insurance coverage: the fee includes the mortality cost and the cost of managing the policy. Contributed funds that do not go toward paying for mortality insurance and costs earn tax-deferred interest.

In a universal life policy, the premium and face amounts are flexible. You can pay premiums in excess of costs in order to build cash value that is subject to federal tax limits. You can change the face amount of the policy and the amount and frequency of premium payments. Universal life insurance is ideal for those who want a flexible policy that combines term protection and tax-

deferred savings; this type of insurance is also appropriate for those who have sufficient knowledge of financial matters and are somewhat flexible and self-directed.

An advantage of universal life insurance is that it provides permanent protection that is similar to that of whole life insurance, and it has flexible premiums and death benefits. The cash value earns tax-deferred interest and can be borrowed against if the need should arise. One disadvantage is that universal life insurance typically requires a much higher premium than term life insurance requires for the same amount of coverage. Also, the cash value of the policy fluctuates depending on the amount paid into the policy and the current market interest rates. The cash value can quickly be depleted by insurance charges if sufficient premiums are not paid. The newest form of universal life insurance is similar to whole life insurance in that it guarantees payment for the full face amount of the policy in exchange for a fixed premium.

Variable life. Variable life insurance allows you to direct the investment portion of your premium into one or more separate investment accounts (such as stocks, bonds, or money market accounts). For this reason, investment risk for this type of product is substantial. Depending on company policy, you can change where the investment portion of your premium will go two to five times per year. While this type of policy gives added flexibility of investment, it is also risky because you, rather than the insurance company, decide where your money is invested; therefore, you assume the risk of the cash-value component. Variable life insurance often costs more in the long run than other types of permanent life insurance because of the added expenses and risks. This type of insurance is appropriate for those who want to take risks, manage their own investments, and have an opportunity (but no guarantee) for tax-deferred growth. If you need a tax shelter and are an experienced, risk-tolerant investor, variable life insurance may be a viable option.

Variable life insurance has the advantages of permanent protection and potential for building cash value. Returns are earned on a tax-deferred basis, and variable life insurance allows for either a fixed (straight variable) or flexible (variable universal) premium. Because you determine where the cash value will be invested, there is a potential for higher returns; these returns reflect the performance of the separate investment accounts. However, variable life insurance has the disadvantage of generally having higher costs. Premiums for variable life insurance are much higher than premiums for term life insurance and other permanent products with the same amount of coverage. This type of investment is also riskier than others because your investment can lose money, and, as in all permanent products, policies may lapse if you don’t make payments.

Variable universal life. Variable universal life insurance combines the flexible features of universal life insurance with the investment options (and risks) of variable life insurance. You choose where to invest your premiums, and you assume all the investment risks associated with your choice, as with variable life insurance. Investment risk with this type of permanent insurance is substantial. You can raise or lower your premiums in a single policy, as with universal life insurance. The insurance company makes no guarantee on your cash value.

When you change investment vehicles, no capital gains are acquired, and any investment gains are tax-deferred. You have great flexibility regarding the frequency and amount of premium payments, and you are able to make partial withdrawals in the form of loans. If you furnish proof of insurability, you can increase or reduce the amount of coverage. Variable universal life insurance may be the best life insurance option for you if you need a tax shelter and if you are comfortable with high-risk/high-reward investing.

Table 8. Permanent Insurance Policies

Permanent Insurance Characteristics*								
Type of Policy	Description	Mortality Risk	Policy Cost	Payouts Based on	Biggest Risks	Policy Flexibility (for Permanent Insurance Only): Investment	Premium	Face Amount
Whole Life	Lowest fixed cost permanent policy with premiums and payouts based on guarantees	Low as the policy will remain in force for life based on fixed premiums	Lowest cost permanent, but much higher than term	Payouts based on guarantees	Higher fixed premiums and conservative returns on guaranteed insurance instruments may limit upside	No ability to change, managed by general account of the insurance company	Fixed with no ability to change premiums	Generally no ability to change contract face value
Universal Life	Lower cost flexible permanent policy with cash value invested in short-term and money market investments	Low as the policy will remain in force as long as premiums are paid	Lower cost permanent, but more expensive than Whole Life	Payouts based on assumptions ONLY	Improper funding or very conservative money market returns may require additional contributions	No ability to change, can invest only in shprt-term fixed money market investments	Maximum ability to change premiums	Options to add cash value to the face amount for the total death benefit
Variable Universal Life	Higher cost flexible permanent policy with cash value invested in stocks, bonds, money market, etc. at insured's discretion	Low as the policy will remain in force as long as premiums are paid	Higher costs as there is more flexibility in investments	Payouts based on assumptions ONLY	Expensive and risk remains that low subaccount returns may require additional contributions making it prohibitively expensive	Maximum ability to change, between stocks, bonds, money market etc.	Maximum ability to change premiums	Options to add cash value to the face amount for the total death benefit
Equity Indexed Universal Life	Highest cost flexible permanent policy with cash value appreciation tied to a stock market index with no return downside but capped upside the company can change	Low as the policy will remain in force as long as premiums are paid	Highest costs and expenses which gives limited upside	Payouts based on assumptions ONLY	Very expensive and low stock market caps (which company can change after signing) and high fees offer limited market upside of 3-6% after fees	Choice among a few different invesetment indices with caps	Maximum ability to change premiums	Options to add cash value to the face amount for the total death benefit
Column Descriptions:	Key points of the policy most relevant to consumers	The risk that the insured dies outside the contract period and is not covered by the policy	The cost of the policy in relation to other life policies, both term and permanent	What the payout amounts are based on. If assumptions, the insured's risk is much greater	The insured's key risks of the chosen insurance policy	The insured's ability to change the investments during the life of the contract	The insured's ability to modify the premium payments for certain periods and ranges	The insured's ability to change the face amount of the policy within the contract period
Note: * With permanent products, if insurance company profits are insufficient, they can change the contract after signing to increase profits. ** These are general comments and may not apply in every situation.								

The advantages of variable universal life insurance include permanent protection, returns that are earned on a tax-deferred basis, the choice of either a fixed premium (straight variable) or flexible (variable universal) premium, and the potential for higher returns on your cash value (based on the mutual fund's performance). This type of insurance also gives you the ability to choose different types of investments and to change investment vehicles free of charge a certain number of times per year. The disadvantages include higher costs—variable universal premiums are higher than premiums for term insurance for the same coverage. This type of insurance is also much riskier because your investments can lose money.

Equity indexed universal. Equity indexed universal life insurance combines the flexible features of universal life insurance with the investment options (and risks) of an equity index mutual fund (without dividends) which offers a capped exposure to the major equity markets for the cash value portion of the policy. By using this product, you assume all the investment risks associated with options on the major equity market and index mutual funds. The major selling point of this product is you gain the capped upside of the equity markets should markets advance, and none of the downside risk of a negative equity return.

The advantages are they offer capped upside exposure to the equity markets, without the risk of losing principle should the equity markets decline below zero return which sounds attractive. The downside is the huge commissions on these products—the fee structure is very high. There are caps on returns from the equity markets that limit your upside, usually to 4–8% per year maximum. Finally, because of the high fees on these products, unless they are aggressively funded, the cash value is often insufficient to keep the policy in force later in life due to the very high fees.

Permanent Insurance Cautions

Students who are looking at permanent insurance need to ask themselves several important questions:

> **Can I commit to the premiums over the long-term?** Many students have no prospective job opportunities and will likely be in school for many more years. With permanent insurance, you are committing to make payments, regardless of whether you are in school and whether you have a job. Can you really commit to these payments now?
>
> **Do I need the tax benefits now?** Once you get out of school, purchasing term insurance and investing the remainder (the difference between what you would have paid with a permanent product and what you pay with the term product) in a Roth IRA or 401(k) may be cheaper and better for you in the long run because you will not have to pay high insurance charges and you can therefore invest more for retirement. Qualified savings plans and retirement plans do not provide life insurance, but you may still want to consider putting your investment dollars into these plans before you get the more expensive life insurance products.
>
> **Are the rates of return on these insurance products guaranteed?** Except for whole life, the answer is no. The rates they give on amounts they will pay are assumptions. In addition, be aware that the insurance companies can change the contracts after you have signed them, changing terms, conditions, and amounts paid if they are not making enough profit. Because of this, be careful of people who are selling products they do not understand. Because the commissions on these products are very high, some people may be selling products they don’t understand to clients who don’t need them.
>
> **Do I have a history of medical problems that would preclude my ability to get life insurance?** If this is the case, you might want to look into permanent insurance.

For most students, “buy term and invest the rest” is an appropriate insurance strategy. Most students would do well to buy a term policy that is level term for 10 to 30 years with a convertibility option to permanent insurance and take the additional money they might have spent for permanent insurance and invest that in either a Roth or traditional IRA or a qualified retirement plan.

There is a place for permanent insurance for some individuals. However, think about this:

> Commissions: If permanent insurance is such a good product, why pay such high commissions for sales? First year commissions to agents can be 50-120% of first year sales, often with recurring commissions for each year the policy is in place.
>
> Annual Sub-account fees/expenses: Why must fees be so high on investment sub-accounts? These investments are not complex products, and are often just index funds. Why are the fees on these products so high compared to products not offered by insurance companies?
>
> Assumptions: Why can the company change the insurance contracts even after the product is sold? In addition, payments on cash value products (except whole life) are based on assumptions which the company can change any time even after the contract is sold.
>
> Transparency: Why is anecdotal return evidence so poor, which shows that 20 year returns on permanent products have generally been only slightly above inflation? Why is performance data so very difficult to find for these products?

Typical Expenses for a Permanent Life Insurance Policy

While permanent insurance has many benefits, it also has many more charges and deductions than term life insurance. This is because permanent contracts are designed to meet very specialized goals and needs. Because it would be impossible to describe every possible variation in detail, I will highlight a few of the main expenses of a variable universal life insurance policy (the most complex and flexible policy with the highest premium) as an example. These expenses may include the following:

Investment Account–Level Fees

Sales charges or front-end load: These are deductions for salesman distribution expenses. These charges can consume anywhere from zero to 10 percent of new money or premiums invested in the policy.

State premium taxes: These taxes vary by state and range from zero percent in Oregon to five percent in the Virgin Islands.[3]

Deferred acquisition (DAC) taxes: The DAC tax is a corporate federal income tax that is imposed on insurance companies. Previously, insurance companies wrote off all their acquisition expenses in the first year, thereby reducing taxable income. Now companies must spread out these acquisition expenses over the life of the acquisitions. This means that income is generated in the early years and income taxes are incurred. These taxes on the insurance companies are passed on to the insured.

First-year expenses: First-year administration fees include the cost of setting up the policy.

Monthly administrative fees: These fees enable the insurance company to provide services such as mailing confirmation notices and providing periodic reports.

Mortality and expense charges: These fees compensate the insurance company for certain mortality and expense risks and can range from 0.4 to 1.3 percent annually.

Sub-Account Fees

Sub-account fees are fees paid to the managers of the mutual funds in which the cash value of life insurance policies are invested. These fees include management and 12b-1 fees.

Investment management fees: These are charged for the overall management of the investment accounts, or in other words, the fees paid for professional management. These fees are taken daily from the underlying net assets or value of the sub-accounts.

12b-1 fees: These are used to pay financial advisors and brokerage firms for marketing the account's funds.

Overall expense ratio: This ratio finds the combined cost of all the asset-based charges discussed in this chapter. This is an important number that can be used to compare the costs of managing your money both inside and outside of a life insurance contract.

Figure 6. Charges for Permanent Insurance

Account-level expenses:	**Minimum**	**Average**	**Maximum**
Sales charges	0.0%	8.0%	10.0%
State premium taxes	0.75%	2.0%	5.0%
DAC tax	0.0%	1.5%	2.0%
First-year expense	$200	$350	$700
Administration fees/month	$4	$6	$15
Policy loans as % contract surrender value,			
Interest spread	75%, 4%	90%, 2%	100%, 0%
Asset charges			
Mortality and expense	0.4%	0.7%	1.3%
Sub-account fees			
Investment management	0.4%	0.8%	2.8%
12b-1 fees	0.0%	0.0%	0.5%
Overall expense ratio	1.0%	1.5%	4.4%
Other charges			
Surrender charges (these can be significant)			

Other Fees

Policy loans: A major benefit of permanent insurance is the ability to borrow money against the contract's surrender value (the value the policy would have if you decided to take the cash rather than the death benefit). If you die before the policy loan is paid back, the beneficiary of the loan will receive the face value of the contract minus what is still owed.

Surrender charges: Surrender charges, back-end loads, and contingent deferred sales charges refer to the amount of the policy's account value that you forfeit if you cancel or terminate your policy within a specified period. These fees reimburse the insurance company for expenses that have not yet been recovered. Surrender charges can be significant.

Other fees: There are a number of other fees and expenses that should also be taken into account. These include partial withdrawal processing fees, which are assessed for taking money out of the insurance policy; transfer charges, which are assessed for making asset transfers that are over the limit specified in your policy; and other charges that may be assessed for additional annual reports, increases in principal sums, additional riders, and so on. Not all companies assess all of these charges; be sure that all charges are disclosed when you are in the process of deciding what type of insurance to purchase.

When the charges, fees, and expenses are totaled, it is not uncommon for the total to be between 5 and 15 percent of every dollar you put into permanent insurance. Because of this, the cash-value portion of this type of insurance will grow more slowly than the cash value of a less expensive term policy. However, the term life policy requires you to pay income taxes (capital gains taxes) each year on your investment returns, which can reduce the advantage of a term life policy.

Permanent insurance is not for everyone. It is a very complex financial instrument and will help only those who need the specific benefits of this type of insurance. By understanding your needs and the different aspects of competing life insurance company policies—the charges, deductions, fees, and expenses of the invested assets—you can select a policy that will give you the maximum benefit at the lowest possible cost.

The following are some important questions to ask yourself about permanent insurance before you decide to invest:

- Are the premiums within my budget? Are the costs reasonable?
- Can I commit to these premiums on a long-term basis?
- On a variable life policy, what is the assumed interest rate in the example, or illustration, given you by the insurance agent?
- Is the classification shown in the illustration appropriate for me (i.e., smoker/nonsmoker, male/female)?
- Which figures are guaranteed and which are not?
- Will I be notified if the non-guaranteed amounts change?
- Is the death benefit guaranteed?

- Will the premiums always be the same, even if interest rates are lower than in the illustration?
- Is the illustrated premium sufficient to guarantee protection for my entire life?
- Is the "current rate" illustrated actually the rate paid recently? What was the current rate in each of the last five years?
- What assumptions have been used regarding company expenses, dividends, and policy lapse rates?
- Does all my cash value earn the current rate?
- Is the illustration based on the "cash surrender value" or "cash value"? (The cash surrender value is usually lower and reflects what will be paid if the policy is canceled.)

Understand Which Type of Life Insurance is Best for You

Determining which type of life insurance is right for you can be a challenge. For most people, especially students, convertible renewable term life insurance, which can be converted to a permanent policy without a new medical exam and is renewable for up to 30 years, is the cheapest and best alternative. If your goal is income replacement, term insurance is relatively inexpensive and has the most affordable coverage when life insurance is needed the most; it is possible to carry the coverage only for the amount of time insurance is needed. Although term life insurance becomes more expensive with age, it may become less necessary as your other assets, such as your investment portfolio, grow, so your dependents would need fewer benefits from life insurance in the event of your death. However, if taxes or other liabilities are due at death or if one desires to leave an estate, insurance may still be necessary.

Permanent insurance may be the best choice if you meet very specific criteria. If your goal is medical insurability (that is, if you have a history of medical problems and you already have convertible term insurance), you can't be denied life insurance should you decide to convert policies.

If the value of your assets is very great and you plan to leave an estate, and if you have estate-planning issues (i.e., you need to shield some of your assets), you should consider permanent insurance.

If your goal is retirement savings and you have already invested substantial amounts of money in your tax-deferred retirement accounts and have already invested the maximum in your tax-deferred accounts and annuities, you may want additional tax-deferred savings; consider permanent insurance as an additional investment vehicle.

If you are still unsure about what type of insurance is best for you, consider a renewable convertible term policy. This type of insurance provides the low cost of term insurance while giving you the ability to convert to a cash policy in the future (within a specific number of years).

Steps to Buying Life Insurance

Selecting an insurance agent is your responsibility—choose wisely. You are not just buying insurance: you are building an insurance structure that will shelter you and your dependents for many years. Following are some important tips for buying insurance:

1. Understand what you want. Understand yourself, your goals, and your budget. Consider how much insurance you need versus how much insurance you want. What kind of insurance policy will best meet your needs given your current family situation and cash flow? How much money do you want to spend? Do you have any pre-existing health conditions? Do you need the insurance for your whole life, or only for a specific period? Can you accept the significantly higher costs of permanent policies?

2. Compare the costs of competing policies. Do your homework and shop around, not just based on price but also based on benefits, coverage, and exclusions. Some possible ways of comparing policies are listed as follows:

- What are the annual premiums versus the amount of the coverage?
- Is the policy renewable, and for how many years?
- Do I have to get a new medical to renew the policy?
- Is the policy convertible? Into what type of policy?
- Is the insurance policy participating (offers tax-free dividends) or nonparticipating?
- If participating, what is the five-year dividend history?
- If participating, what is this year's expected dividend?
- What is the total premium cost over the next 10 years (excluding dividends)?
- In 10 years, what will your cash value be?
- What will the total premium cost be over 20 years?
- At what interest rate can you borrow against the policy? Is the spread guaranteed?

3. Select only a high-quality insurance company; base your choice on company ratings. Price is not the only criteria you should look at when selecting an insurance company. You also want the company to be around to pay the benefits years down the road. Remember, you are looking for a long-term insurance relationship. Check with A.M. Best at www.ambest.com or Standard & Poor's at www.standardandpoors.com for ratings of your company.

4. Select an insurance agent with whom you feel comfortable and who does not pressure you. Study the agent's recommendations and ask for a point-by-point explanation if there are items you don't understand. If the agent can't explain all the costs and benefits, go to someone who can. While it is not necessary to have an insurance agent, it can be helpful because an agent can explain the many options and details of the life insurance contract. Remember to ask about the insurance agent's commission on any recommended product.

5. Use wisdom in your decisions. Make sure you check out the insurance company; read your policy when you receive it to ensure it is correct. Consider alternative approaches to finding life insurance: use the Internet or an advisor to help you. Make sure you feel good about the decision

before you sign anything or send any money.

Before you purchase life insurance, consider a few final thoughts:

- Be careful if your only source of life insurance is from your company. Consider having part of your insurance from outside your company's plan. Realize that if you get sick and lose your job, your insurance may terminate with your employment. It will be difficult to get new life insurance if you are very sick.

- Don't rush into a decision just because you are feeling pressured. Wait a few days and then decide. This is not a short-term decision. Take your time and choose wisely—but choose!

- Make your check payable to the insurance company, not the agent. The insurance company will pay the agent. Be sure the insurance agent gives you a receipt for all payments. Make sure there is an adequate paper trail in case there are questions or problems later on.

- Read your policy carefully during your "free-look" period. You are given a specific amount of time in which you have the option to cancel the policy. Make sure you understand your policy completely at the beginning and then review your policy annually. Your life situation may change, so make sure your policy is sufficient to meet your needs as they change.

- If you are changing policies, especially permanent policies, make sure you clearly understand the consequences. Surrendering one permanent insurance policy to buy another insurance policy could be very, very, very (get the hint?) costly. Understand all the costs of making a change before you make it.

- Finally, if you have a complaint, contact your insurance agent first. If you don't get an adequate response from your agent, contact your state insurance department; they can help.

Understand Plans and Strategies for Life Insurance

Following are a few ideas of life insurance plans and strategies over different time periods.

Life Insurance Plans and Strategies

Students and Young Marrieds

- If married, buy a small $250k - 20 year annual renewable term product with the convertibility option. In case things happen to your health, you can convert to a (generally) whole life policy without a medical exam.
- Once children come, ladder on additional renewable convertible term products, extending out the life to the time that children leave home.

- If term insurance rates have decreased, you can purchase a new product then cancel the old.

Married with Families

- Make sure you have sufficient term policies consistent with LT 29 to protect those you love.
- Continue to ladder in additional policies and keeping their maturities longer consistent with the time children leave home.
- If you have filled your Roth/traditional 401k and Roth/traditional IRA investments and are looking for additional tax-deferred investments, you may want to look into permanent products. Be careful.
- If term insurance rates have decreased, you can purchase a new product then cancel the old.

Empty Nesters

- As your investment assets increase and children leave the home, you can allow some of the policies to terminate without renewing as the need for income replacement is diminished.
- If you would like to leave money to your heirs, think to maximize your contribution to Roth products, as these are wonderful assets to leave to heirs (the taxes have already been paid).
- If your desire and plans for estate planning materialize, you can utilize permanent insurance for some of those options. Be careful of costs.

Summary

Getting life insurance is an important step toward becoming financially self-reliant. We would be wise to have an appropriate amount of it.

Life insurance products vary widely, and they can be challenging to understand. It is critical to understand the major principles of life insurance and how life insurance can help you reach your specific personal and family goals.

In this chapter, we answered the five key questions about life insurance: 1. Why should you have life insurance? 2. How does it work? 3. Who needs life insurance? 4. How much should you have? and 5. What kind should you have?

Term insurance provides life insurance protection that is valid over a specific term, or time period. The major advantage of this type of insurance is that, in the short term, it is the least expensive death benefit coverage. However, this insurance is disadvantageous because it is valid only if the insured dies during the term of coverage.

Permanent life insurance is a contract in which premiums go toward both death protection and

savings. Cash-value insurance is often called permanent insurance and is intended to provide benefits over a lifetime. However, the policy will not be permanent if there is not enough cash value, if the insured is not able to continue paying the premiums, or if the investments decline substantially.

Determining which type of life insurance is right for you can be a challenge. For most people, especially students, renewable convertible term life insurance is the cheapest and best alternative. If your goal is income replacement, term insurance is relatively inexpensive and has the most affordable coverage when life insurance is needed the most; it is possible to carry the coverage for only the amount of time insurance is needed.

The five steps to purchasing life insurance are as follows:

1. Understand what you want.
2. Compare costs of competing policies.
3. Select only a high-quality insurance company; base your choice on company ratings.
4. Select an insurance agent with whom you feel comfortable and who does not pressure you.
5. Use wisdom in your decisions**.**

Assignments

Financial Plan Assignments

Your assignment is to prepare your vision, goals and plans and strategies for life insurance and include these in your PFP Insurance Template (LT01-09). First, determine whether you need life insurance. This drives your vision. Depending on your situation, you may not need it.

Second, determine your goal for having it. Deciding on your goal for insurance is a critical part of evaluating the different types of life insurance products.

Third, determine how much insurance you need based on the framework laid out in this chapter. Remember, as interest rates decline, the size of the assets you will need increases. I encourage you to use Calculating Life Insurance Needs (LT29 – Detailed) or Fin200 Calculating Life Insurance Needs (LT29B – Simpler) to determine how much insurance you need. This will be included in your Plans and Strategies, and will change over time.

Fourth, determine how much insurance you can afford based on your budget. This is a critical step. Take into account the potential for job loss or changes in lifestyle caused by children, teenagers, and so on when you are considering your budget.

Finally, evaluate the different insurance companies and the different products available. Using the criteria discussed, evaluate the different insurance companies for stability; look for signs that they will be around when benefits need to be paid. Determine the type of product you should

have, evaluate the different alternatives, and include your findings in your financial plan.

Learning Tools

Calculating Life Insurance Needs (LT29) - Detailed

This Excel spreadsheet gives a detailed framework for calculating life insurance needs. It gives estimates using multiples of salary, various rules of thumb, and a needs approach.

Fin200 Calculating Life Insurance Needs (LT29B) - Simpler

This is a simpler version of LT29, with fewer methods of calculation. Excel spreadsheet gives a detailed framework for calculating life insurance needs. It gives estimates using multiples of salary, various rules of thumb, and a needs approach.

Review Materials

Terminology Review

Annual Term Insurance. This is a type of term insurance. The face or death benefit amount is constant through the selected term of coverage. Premiums increase each time the contract is renewed, even though the face amount remains the same due to the increasing age of the beneficiary.

Convertible Term Life Insurance. This is a term policy that can be changed to permanent insurance within a specific number of years without evidence of insurability. Typically, it gives a contractual right to convert to some form of permanent insurance, typically whole life, within a certain number of years or before the policy holder reaches a certain age. Conversion allows the policy holder to lock-in the premiums, although at a higher rate, and avoid the ever increasing term premiums.

Equity Indexed Universal Life Insurance. Equity indexed universal life offers some of the upside of the equity market returns with the downside of insurance protection should the market returns be negative. It allocates assets to a stock market index, generally with options (and has a limited upside) but with a minimum guaranteed rate of return. It gives some (limited) upside in equity returns, and gives downside protection in down equity markets. It has huge commissions to salesmen for selling these products (up to 150% of first year commissions), a very high fee structure, large surrender charges, and is not transparent. Market returns are generally lower that historic market returns, are capped with limited upside of 2-4% after fees, and the insurance company can change the caps even after the product is sold if they are not making enough profit.

Renewable Term Insurance. This term policy allows the policy holder to unconditionally renew the policy for successive terms at higher premiums simply by paying the indicated premiums. Premiums increase with each renewal period, and can be renewed for a specific number of years

Universal Life Insurance. Universal life is a type of whole life insurance, but the cash-

value earns interest at current money market rates. Mortality risk is eliminated, and investment risk is low. It is a flexible policy that combines term protection and a tax-deferred savings element invested at current interest rates. Earnings will rise and decline with market interest rates. Its risks are the same with most permanent insurance: it is complex, expensive, with high surrender costs, and commissions to the salesmen are very high.

Variable Life Insurance. Variable life gives life-long insurance coverage with the ability to direct where the cash-value is invested. Mortality risk is eliminated, but investment risk is substantial. Policy holders are responsible for the investment outcome with their chosen investments. It allows for either a fixed (straight variable) or flexible (variable universal) premium, with fluctuating cash-value, reflecting the investment performance. It is complex, expensive, with high surrender costs, and commissions to the salesmen are very high.

Variable Universal Life Insurance. Variable universal life mixes the investment flexibility of variable life with the premium and face amount flexibility of universal life. Policy holders are responsible for the investment outcome with the chosen investment. It offers term protection with full policy flexibility and which can be managed by the account owner (within available options). It is complex, expensive, with high surrender costs, and commissions to the salesmen are very high.

Whole Life Insurance. Whole life insurance gives life-long insurance coverage for a fixed premium. Mortality risk and investment risk is eliminated. It is essentially term protection with a savings element provided by insurance company bonds and mortgages. Premiums are based on when you buy the policy. The earlier you purchase the product, the less your costs will be generally. It is also called “Straight Life” or “Ordinary Life” insurance. Tt is complex, expensive, with high surrender costs, and commissions to the salesmen are very high.

Review Questions

1. What is life insurance? Why should you have it?
2. What are the two different methods for determining how much life insurance an individual will need?
3. What is term insurance? What are the three types of term insurance?
4. What is permanent life insurance? What are the five major types of permanent life insurance?

Case Studies

Case Study 1

Data

Bill and Diana are concerned about their family’s welfare should Bill die. He is currently making $80,000 per year, has two children, and his company gives him $50,000 in life insurance coverage as a benefit. If Bill were to die, Diana could invest the insurance

settlement and make 5% with 2% inflation for 20 years until the kids finish school.

Calculations

What is the process for determining needs using the earnings multiple approach?
(Assume a 22-percent drop in living expenses after death.)
How much insurance should Bill have?

Case Study 1 Answers

a. Adjust salary downward:

Generally, family living expenses fall by 30 percent with the loss of an adult. The larger the size of the surviving family, the less living expenses drop.
Since Bill's family would go from four to three, his target replacement is $80,000 * (1 – .22) or
$62,400

b. Choose the appropriate interest rate:

The return after inflation is 1.05/1.02)-1 = 2.94%.

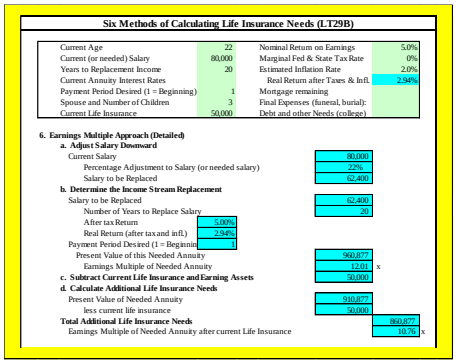
c. Determine the income stream replacement.

Number of years to replace income	N = 20 years
Estimated after-tax and inflation rate	I = 2.94%
Target $80,000 * (1 – .22) or	PMT = $62,400

Solve for the Present Value. Since Bill wants the payments at the beginning of each year, put your calculator in "begin" mode.
Bill needs $960,877

4. Subtract out current insurance available of $50,000:

$960,887 – 50,000 = $910,877
The multiple of salary is:
910,877 / 80,000 = 10.76x
Bill should have 10.8 times his salary, or $910,877.



Six Methods of Calculating Life Insurance Needs (LT29B)

Current Age	22	Nominal Return on Earnings	5.0%
Current (or needed) Salary	80,000	Marginal Fed & State Tax Rate	0%
Years to Replacement Income	20	Estimated Inflation Rate	2.0%
Current Annuity Interest Rates		Real Return after Taxes & Infl.	2.94%
Payment Period Desired (1 = Beginning)	1	Mortgage remaining	
Spouse and Number of Children	3	Final Expenses (funeral, burial):	
Current Life Insurance	50,000	Debt and other Needs (college)	

6. Earnings Multiple Approach (Detailed)			
a. Adjust Salary Downward			
Current Salary		80,000	
Percentage Adjustment to Salary (or needed salary)		22%	
Salary to be Replaced		62,400	
b. Determine the Income Stream Replacement			
Salary to be Replaced		62,400	
Number of Years to Replace Salary		20	
After tax Return	5.00%		
Real Return (after tax and infl.)	2.94%		
Payment Period Desired (1 = Beginnin	1		
Present Value of this Needed Annuity		960,877	
Earnings Multiple of Needed Annuity		12.01	x
c. Subtract Current Life Insurance and Earning Assets		50,000	
d. Calculate Additional Life Insurance Needs			
Present Value of Needed Annuity		910,877	
less current life insurance		50,000	
Total Additional Life Insurance Needs			860,877
Earnings Multiple of Needed Annuity after current Life Insurance			10.76 x

[1] 1 Timothy 5:8
[2] "Handbook for Families: Preparing for Emergencies," *Ensign,* Dec. 1990, 59
[3] Ibid., p. 113

13. Insurance 3: Protecting Health through Health, Long-term Care, and Disability Insurance

Introduction

Having adequate health insurance is crucial; health insurance ensures that you and your loved ones will receive necessary medical treatment throughout the course of your lives. Because of the importance of health insurance, it is extremely important for you to learn how this type of insurance fits into your Personal Financial Plan.

Health insurance is costly, largely because there is a lack of incentive to reduce costs. Rising insurance costs have gotten the attention of corporate managements. Companies are passing on a greater percentage of insurance costs to their employees. This shift is affecting many individuals' financial situations; as medical costs rise, individuals become less able to pay for medical care costs out of their own pockets. Therefore, the number of people who are uninsured and under-insured continues to rise. Health insurance is important and could be a major detraction from attaining your goals if health-related problems arise and you do not have appropriate health insurance to cover your costs.

Objectives

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

A. Understand how health insurance relates to your Personal Financial Plan and basic health insurance coverage and provisions.
B. Understand the key areas of disability insurance.
C. Understand the key areas of long-term care insurance.
D. Understand how to control your health-care costs.
E. Understand plans and strategies for health insurance.

Understand How Health Insurance Relates to Your Personal Financial Plan and Basic Health Insurance Coverage and Provisions

Health insurance protects you and your dependents from suffering a financial catastrophe caused by high medical expenses. Paying out of pocket for a hospital stay, even if short, can be very expensive. Health insurance offers peace of mind and eliminates the financial risk of having to make large payments to health-care providers for injury or illness.

Concerning the need for adequate insurance, N. Eldon Tanner remarked:

> Nothing seems so certain as the unexpected in our lives. With rising medical costs, health

> insurance is the only way most families can meet serious accident, illness, or maternity costs, particularly those for premature births . . . Every family should make provision for proper health and life insurance.[1]

Understand Obamacare and Basic Health Insurance Coverage

Obamacare (the Affordable Health Care Act) brought many changes to the health care industry. However, in the current Congress, there are likely changes coming. The main changes due to Obamacare were:

- Obamacare doesn't create health insurance; rather, it regulates the industry.
- Many people who have health insurance can keep their coverage, but not all people.
- Young adults can say on their parents' health insurance plan till age 26.
- If you don't have coverage, you can use the Health Insurance Marketplace during the open period.

Other features of Obamacare include:

- You can obtain private health insurance during each year's annual enrollment period.
- If you don't have insurance, you are taxed.
- The cost of your insurance is on a sliding scale.
- You cannot be denied coverage based on health status, and there are no pre-existing coverage limitations and no lifetime coverage limits on your policy.

Getting healthcare through Obamacare, you have many options. You can continue to get health insurance through your work if it is provided. You can obtain healthcare coverage outside or inside of the marketplace during open enrollment. During open enrollment, you can purchase federally regulated and subsidized health insurance through private providers. You can also purchase private health plans through a broker or directly from the provider.

Major Types of Health Insurance Coverage

There are four major types of health insurance coverage:

- Basic health insurance
- Major medical expense insurance
- Dental and eye insurance
- Dread disease and accident insurance

Basic health insurance describes most health insurance policies that cover hospital, surgical, and physician expenses. Hospital insurance covers hospitalization expenses, including room, board, nursing, and prescription fees. Surgical insurance covers only the direct costs of surgery, including the equipment costs and surgeon fees. Finally, physician expense insurance covers physicians' fees, including fees for office visits, lab tests, X-rays, and other necessary tests.

Major medical expense insurance covers medical costs that are in excess of those covered by basic health insurance. This type of insurance normally requires you to pay a co-payment and/or a deductible and has an overall limit.

A co-payment is an amount of money you pay to help cover medical costs. A co-payment may be a flat amount, such as a $15 payment each time you visit a doctor's office, or it may be a percentage of the total cost of a surgical procedure, such as a payment that covers 20 percent of the surgical fee. The insurance company pays the remaining balance of the medical cost—for example, the insurance company pays $50 for the office visit to supplement your $15 co-payment and 80 percent of the surgical fee to supplement your 20 percent co-payment.

A deductible is the amount you pay in full before you receive any benefits from an insurance company. For example, if your medical bill were $1,000, and you had to pay a $200 deductible on your insurance plan, then you would pay the first $200 and your insurance company would pay the remaining $800 of the bill.

Major medical insurance usually includes both a stop-loss provision and a lifetime cap. The stop-loss provision limits your total out-of-pocket expenses to a specific dollar amount. The lifetime cap limits the total amount the insurance company is required to pay over the life of a policy.

Dental and eye insurance pays for the costs of dental work, dentures, eye exams, glasses, and contact lenses. You should know which expenses your plan covers before you go to the dentist or eye doctor. Normally, this type of insurance covers only a portion of the costs and requires you to pay the rest. Dental and eye care insurance plans are often expensive unless they are provided as part of an employee insurance plan.

Dread disease and accident insurance is a unique type of insurance that covers specific diseases and accidents. If your illness is not on the list given by the insurance company, it won't be covered. This type of insurance provides a set dollar amount that is available for reimbursement. If your expenses exceed this amount, you must pay the difference. It is generally best to avoid dread disease and accident insurance unless it is included in your company's total health plan. Instead, you should concentrate on finding health insurance coverage that is as comprehensive as possible so that you will be protected against the widest variety of diseases and accidents that could occur.

Health-Care Plans

The three major types of health-care plans are as follows:

- Group private health-care
- Non-group and individual health-care
- Government-sponsored health-care

Group Private Health-Care Plans

Private health-care plans are sold by private insurance companies to individuals and employers as part of a benefits package. These plans include two types: fee-for-service plans and plans provided by managed health-care providers.

Fee-for-service plans, also called traditional indemnity plans, are private health-care plans in which doctors bill patients directly; the insurance company then reimburses a specific percentage or set amount of the bill to the patient. The advantages of these plans are that they provide patients with the greatest flexibility in choosing doctors and hospitals, and that individuals can go to whatever doctor or hospital they choose and still be reimbursed. Another advantage of these plans is that they define what percentage of each claim the policy will cover and what percentage the patient must cover. Finally, these plans clearly define how much the patient must pay before a claim is eligible for reimbursement. The disadvantages to these plans include that they are usually expensive for those insured and providers, and they require more paperwork than other types of insurance plans.

Plans provided by managed health-care providers offer prepaid health-care plans for employers and individuals. There are four main types of managed health-care providers: health maintenance organizations (HMOs), preferred provider organizations (PPOs), point-of-service plans (POSs), and exclusive provider organizations (EPOs). One of the advantages of managed health-care providers is that these organizations pay for and provide health-care services to policyholders, including preventive health-care. Also, managed health-care providers generally pay bills more efficiently than other providers because they do not require you to pay your doctor's bills and hospital bills first (with the exception of the nominal co-payment for visiting a doctor's office).

However, one disadvantage of working with managed health-care providers is that they limit the number of doctors and hospitals that participate in their program, thereby limiting your choices. Like fee-for-service plans, plans provided by managed health-care providers require you to pay a monthly premium and to share the cost of care; however, these costs are traditionally less than the costs of fee-for-service health care.

Health Maintenance Organizations (HMOs) provide prepaid insurance plans that entitle individuals to the services of specific doctors, hospitals, and clinics. These plans are the most popular form of managed health care because of their low costs, which are roughly 60-percent less than the costs of fee-for-service plans. HMOs provide a system of doctors and hospitals for a flat fee, and they emphasize preventive medicine and efficiency, which are advantages. The disadvantage of HMOs is that they provide limited choices of doctors and hospitals. Because of these limited choices, the quality of service may suffer, and referrals to other specialist doctors are sometimes difficult to get.

Preferred provider organizations (PPOs) provide insurance plans that are essentially a cross between traditional fee-for-service plans and HMO plans. PPOs negotiate with a group of

doctors and hospitals, and these doctors and hospitals provide care to PPO participants at reduced rates. PPOs then give individuals the option of choosing either "plan" or "non-plan" doctors. One advantage of PPOs is that they provide health care for less than the cost of fee-for-service plans while still allowing members to choose their doctor or hospital. Because PPOs provide a group of doctors who work at reduced rates for PPO participants, PPOs assess an additional fee if the participant uses a non-plan doctor or medical center. PPOs are generally more expensive than HMOs.

Point-of-service plans (POSs) have many of the attributes of HMOs, PPOs, and fee-for-service plans. For example, these plans generally have a network of contracted doctors, hospitals, and clinics. If you use these preferred providers, the fees are less. But you also have the option to go outside the network for other medical specialists if you are willing to pay a larger out-of-pocket fee. These plans may have a gatekeeper (a physician or other authority) that must be notified before participants are allowed to receive services.

Exclusive provider organizations (EPOs) are similar to HMOs, but they operate through an insurance company. These organizations are funded through an insurance company, and health care is provided by contracted providers. Only care received from contracted providers is covered, unless there is an emergency situation.

Non-Group and Individual Coverage Plans

Non-group coverage plans (also called individual health-care plans) insure individuals independently. These plans are often used by people who are self-employed or between jobs; they are also used by people whose companies do not offer group insurance. An advantage of these plans is that they provide a custom insurance policy. There are also several disadvantages to non-group coverage plans. These plans are expensive—they are usually 15 to 60 percent more expensive than group plans. Non-group coverage plans may also require subscribers to pass a medical exam prior to enrolling in the program; at a minimum, they require subscribers to submit a personal health history.

Before you sign up for a non-group coverage plan, check the insurance company's ratings and its claim service. It is best to avoid a company that raises premiums when claims are made or reserves the right to cancel policies at any time.

Instead of using a non-group coverage plan when you are between jobs, use COBRA, if possible. COBRA, which stands for the Consolidated Omnibus Reconciliation Act, requires companies with more than 20 employees to continue providing group health care to former employees, retirees, spouses, and dependents for a specific length of time. This length of time is based on the employee's reason for leaving the company and is usually about 18 months. If COBRA is used, the former employer must provide the insurance, but the discharged employee must cover the entire cost of the health insurance.

High deductible health plans (HDHP) are a form of catastrophic coverage with lower premiums and higher deductibles and is intended to cover catastrophic illnesses. Its advantage is that it is very low cost, as it covers only catastrophic illnesses. Its disadvantage is the high costs for medical coverage should it be needed. These should not be used without the following Health Savings Accounts.

Health savings accounts (HSAs) are a newer option to help people pay medical expenses. For 2019, almost anyone with a qualified high-deductible health plan (which is a plan with a minimum deductible of $1,350 for self and $2,700 for a family) can also have an HSA. Contributions can be made by an individual or an employer ($3,500 self, $7,000 family, with catch-up limits for those over 55 of $1,000). Maximum annual out of pocket expenses are $6,750 single and $13,500 family (see Table 2). Individuals contribute each year into an account that grows tax-free to pay for future qualified medical and retiree health expenses.

Advantages include you are paying for "qualified medical expenses" on a tax-free basis. It can be used to pay for medical expenses before you reach your deductible limits. Earnings grow tax-free, and carry over into retirement, and distributions may be used for spouse or kids.

Disadvantages include high deductibles, and if distribution not for qualified medical expenses, then it is included in income and subject to a 10% penalty (no penalty after age 65). These are not for the seriously ill

Table 2. High Deductible Health Plan Contributions, Deductibles and Limits

High Deductible Health Plan Limits			
Maximum Contributions:	Self	Family	Catch-Up *
2015	$3,350	$6,650	$1,000
2016	$3,350	$6,750	$1,000
2017	$3,400	$6,750	$1,000
2018	$3,450	$6,900	$1,000
2019	$3,500	$7,000	$1,000
Minimum Deductibles			
2015	$1,300	$2,600	
2016	$1,300	$2,600	
2017	$1,300	$2,600	
2018	$1,350	$2,650	
2019	$1,350	$2,700	
Maximum Out-of-Pocket Expenses:			
2014	$6,350	$12,700	
2015	$6,450	$12,900	
2016	$6,550	$13,100	
2017	$6,550	$13,100	
2018	$6,650	$13,300	
2019	$6,750	$13,500	

* If you turn 55 before the close of the tax year, you may also contribute an additional Catch Up amount.

Government-Sponsored Health-Care Plans

Government-sponsored health-care plans are sponsored by either the state or the federal government. These plans fall under four headings: (1) workers' compensation, (2) Medicare, (3) Medigap, and (4) Medicaid.

Workers' compensation is a state-sponsored insurance program that insures employees who have suffered work-related accidents or illness. An advantage of workers' compensation is that it provides insurance for workers injured on the job whether they have health insurance or not. A disadvantage is that it covers only work-related accidents and illnesses. Moreover, coverage is determined by state law and varies from state to state.

Medicare provides medical benefits to people who are disabled or are of age 65 and older and covered by Social Security. The costs of this federally sponsored program are covered by Social Security taxes.

The cost of private insurance for people who are disabled or are over age 65 is often unaffordable. Medicare provides a way for these individuals to get affordable health care. A disadvantage of Medicare is that it does not cover all the costs of care and treatment.

Medicare is divided into Part A and Part B. Medicare Part A is compulsory and covers all hospital-related expenses, including costs for hospitalization, skilled nursing-care facilities, home health care, hospice care, and prescription drugs furnished by the hospital.

Medicare Part B is voluntary and carries a monthly fee for services. Part B covers doctors' fees and other medical services, including clinical lab services, health care provided in the home, and outpatient hospital treatment.

Medicare does not cover the total costs of all services. Those insured by Medicare must still pay a portion of their medical costs in order to receive coverage. There are also limitations; for example, out-of-hospital prescription drugs are not covered, and the number of days a person can spend in a skilled nursing-care facility are limited.

Medigap is sold by private companies and covers the gaps between the two parts of Medicare. In all but three states, federal law has limited Medigap insurance provided by private companies to 10 set or standardized contracts, each with different options and costs. Another advantage of Medigap is that a person can't be rejected for health reasons if he or she enrolls in Medigap within six months of enrolling in Medicare Part B. A disadvantage of Medigap is that this type of insurance is expensive; however, consumers should shop around—costs can vary.

Medicaid is a medical assistance program that is jointly operated by states and the federal government through the Social Security program. It provides health-care coverage to persons who have a low income, to those who are blind or aged, and to needy families with dependent children. An advantage of Medicaid is that an individual's payments can be used to offset the

monthly premiums, deductibles, and co-payments incurred with Medicare. A disadvantage is that there is no guarantee Medicaid will still exist in its present form in the future.

Understand the Key Areas of Disability Insurance

Disability insurance provides payments to insured individuals in the event that regular income is interrupted by illness or an accident. Disability is similar to life insurance but is really earning-power insurance. An advantage of disability insurance is that it may provide you with between 50 and 80 percent of your after-tax income if you are disabled by a long-term illness or injury. Anyone who depends on earned income should at least look into disability coverage. The risk of disability is even higher than the risk of premature death.

Table 1. Different Types of Disability Insurance

Individual Disability Income	For personal protection, to provide income to individuals in the event of a disability.
Group Disability Income	For businesses to provide the owners and employees short-term and/or long-term benefits in the event of a disability.
Social Security Disability Income	Provides benefits to individuals covered under the Social Security system.
Workers' Compensation	Provides benefits to employees who incurred a job-related disability.
Disability Overhead Expense	Provides a monthly benefit for covered overhead expenses when a business owner is totally or partially disabled.
Key-Person Disability	Provides a benefit to the business in the event the key person is disabled.

The major sources of disability insurance are employers, the government, and private providers. Workers' compensation coverage is determined by individual states, with wide variability between states. Social Security benefits vary depending on your salary, how many years you have paid into the system, and how long the disability is expected to last.

The key question is how much coverage you should have. Generally, you should have enough coverage to maintain your living standard should you no longer be able to work. Your investment income will not stop with a disability, but your income from working will stop. If you have sufficient savings, you may not need much insurance, perhaps only 30 percent of after-tax income, depending on your investment portfolio. If you have little savings, you may need more,

perhaps 80 percent. Once a person has accumulated sufficient assets, it may be possible to self-insure fully or partially. If a person could stop receiving earned income and live comfortably for the rest of his or her life, then there would be no need for that person to insure his or her income.

Providers of Disability Insurance

Common providers of income in the event of a disability are the government, employers, and private providers.

Government

Disability income benefits may be provided by the government through the Social Security program. Benefits from this program are dependent upon income and time paid into the Social Security system. The Social Security website states:[2]

> The definition of disability under Social Security is different than other programs. Social Security pays only for total disability. **No benefits are payable for partial disability or for short-term disability**.
>
> "Disability" under Social Security is based on your inability to work. We consider you disabled under Social Security rules if:
>
> - You cannot do work that you did before;
> - We decide that you cannot adjust to other work because of your medical condition(s); **and**
> - Your disability has lasted or is expected to last for at least one year or to result in death.

This is a strict definition of disability. Social Security program rules assume that working families have access to other resources to provide support during periods of short-term disabilities, including workers' compensation, insurance, savings and investments.

Employers

Employers may offer two types of protection: workers' compensation and group disability insurance. The former is mandatory, and the latter is optional. Workers' compensation is state-specific and provides benefits only for job-related injuries or illnesses, while group disability insurance provides benefits for injuries or illnesses wherever or whenever they occur.

Group disability insurance is an optional benefit an employer may offer to its employees. The employer may implement or retract this benefit at any time for any reason. Typically a group disability plan will cover 50 to 70 percent of income, and most plans only cover base salary and do not cover bonuses or retirement contributions. The benefits are taxable when the insurance policy is paid for by the employer; sometimes the policy or a portion of the policy may be paid

for by the employee on an after-tax basis, which can result in tax-free benefits. Short-term disability and long-term disability benefits may be offered by group plans. Short-term disability can pay for the first few months of a disability, while long-term disability will start at the expiration of the short-term disability and typically pays out until normal Social Security retirement age. Frequently the definition of disability is constructed to change after 24 months of benefits and goes from an "own occupation" to an "any occupation" definition. An "own occupation" definition states that a person is disabled if he or she cannot perform the material duties of his or her current occupation. An "any occupation" definition requires the worker not be able to perform the material duties of any occupation that he or she may be physically, mentally, or educationally qualified to perform. Most group plans are also offset by any benefits received by Social Security, and group benefits typically do not increase with inflation.

Private Providers

Disability income insurance can be obtained most comprehensively through private providers. Individual disability income insurance policies are typically paid for with after-tax dollars, and the benefits are tax-free. The policies can stand alone or be used to supplement a group disability plan. Unlike group plans, individual plans typically do not change the definition of disability, are not offset by Social Security benefits, and may have benefits that increase with inflation. Individual disability income plans have many choices and factors. It is very important to choose wisely when selecting a company and a policy, as not all disability insurances are equal

Key Areas of Disability Insurance

There are eight key areas of disability insurance:

1. Definition of Disability.

Needs differ, which is why there are many different definitions of disability. It is important to understand the various ways disability is defined. What exactly does the policy consider a disability? Stick with a policy that defines disability as an inability to perform your normal job. A combination definition may include, "if you can't perform your normal job for the first two years, and afterward any occupation for which you are reasonably suited" and may be acceptable. The latter definition will have lower cost.

2. Partial Disability Benefits

Some policies offer partial disability payments that allow workers to return to work part-time. These payments make up the difference in earnings between part-time and full-time work.

3. Benefit Duration

Policies state how long the benefits will continue. Most policies provide benefits for a maximum period or until the disability ends (or the disabled reaches age 65 or 70). Short-term disability

policies, which are more expensive, generally provide benefits from six months to two years.

4. Waiting or Elimination Period

Policies determine the waiting period before the benefits begin. Short-term disability policies, which are more expensive, have a waiting or elimination period of 8 to 20 days. Longer-term policies have waiting periods of between one and six months. Generally the longer the waiting period, the less expensive the policy. Generally, a long-term policy makes more sense as your emergency fund protects you in the short-term.

5. Waiver of Premium

This option waives the premium payments if you become disabled.

6. Non-Cancelable Option

A policy may be purchased as either a non-cancelable and guaranteed renewable policy or as a guaranteed renewable policy. A non-cancelable policy cannot be changed unilaterally by the company. The premiums and provisions are guaranteed once the contract is issued. A guaranteed renewable policy cannot be canceled nor have its terms, other than premiums, changed by the company if timely payments of premiums have been paid. Make sure you have a policy that cannot be canceled. This protects you and guarantees your policy is renewable.

7. Rehabilitation Coverage

Rehabilitation coverage provides for vocational rehabilitation, allowing the policyholder to be retrained for employment through job-training and employment-related educational programs.

8. Cost-of-Living Rider

This provides for inflation adjustments to protect you from the impact of inflation.

Disability insurance is expensive. Generally, the annual premium will be around one to two percent of the income replaced. For example, a policy replacing $50,000 per year of annual salary would cost about $1,000 per year. However, it is something you should evaluate based upon your goals and objectives for you and your family.

Understand the Key Areas of Long-Term Care Insurance

Long-term care (LTC) insurance covers the costs of nursing-home facilities and long-term home health care. This type of insurance provides a daily dollar benefit—for example, $100 per day for the cost of long-term care. It may help families with a history of long-term diseases or disability to plan for the future. Two disadvantages of this type of insurance are that it is expensive and that it has many exceptions and conditions for coverage.

There are four basic ways of paying for long-term care: self-insurance, Medicaid, Medicare, and long-term care insurance. Self-insuring means having enough money set aside through saving and investing to pay for future care. Medicaid will provide coverage for long-term care if your income and assets are low and you have exhausted your own assets. Medicare is the federal medical insurance program for those 65 or older or disabled. It will pay the costs of certain benefits but generally will not cover personal or custodial care. Finally, long-term care insurance covers the costs of nursing-home facilities and the costs of long-term home health care.

Key provisions that control your qualification for benefits include the type of care covered, the benefit period, waiting period, inflation adjustment provision, waiver of premium provision, and non-cancel ability provision.

There are five key areas of long-term care insurance:

- Comprehensive or facilities-only plans
- Daily benefit amount
- Benefit period
- Elimination period
- Inflation adjustments

1. Comprehensive or Facilities-Only Plans

Comprehensive plans help pay for care received at home as well as care received in long term care (LTC) facilities. Facilities-only plans require care at LTC facilities, which include nursing homes, assisted living facilities, and hospice and respite care facilities. These plans are generally cheaper.

2. Daily Benefit Amount

This amount is either the maximum amount or the actual amount the insurance will pay per day for covered services. Some plans offer benefits on a monthly or weekly basis. Understand the rules for any policy you may be considering.

3. Benefit Period

This is the amount of time that you wish to receive the daily benefit amount. The period can range from 2 to 10 years or for an unlimited amount of time. Your total lifetime benefit is your daily benefit multiplied by your benefit period. For example, if your benefit amount is $110 per day * 1,825 days (five years), your lifetime benefit is $200,750.

3. Elimination or Waiting Period

Your elimination period is a period of time during which you are ineligible for benefits (this is the time before the insurance company begins paying claims). Policies with short or no

elimination period are more expensive than those with longer elimination periods.

4. Inflation Protection

There are a number of options to help you protect yourself against the increased costs of care in the future. You can add options for automatic compound inflation, simple inflation, periodic inflation, or future purchases.

Understand How to Control Your Health-Care Costs

Controlling health-care costs is critical for you to achieve your personal and financial goals. Group health-care plans are usually more desirable than individual plans for three reasons. First, participants can generally get group coverage at lower rates. Second, employers often provide group coverage as an employee benefit. And third, people with existing health problems may find it easier to obtain group coverage because this type of coverage is offered based on the group as a whole rather than on the individual.

There are four important things you can do to control your health-care costs:

1.Live a healthy lifestyle.
2. Use a group plan from work or subsidized plan.
3. Use a medical reimbursement or flexible spending account.
4. Use a health savings account.
5. Consider COBRA when changing jobs.
6. Opt out of a company insurance plan if you are already covered through a spouse's plan.

1. Live a Healthy Lifestyle

Living a healthy lifestyle is the most important part of controlling health-care costs. Take care of your body. Scriptures teach us that our bodies are temples (1 Corinthians 3:17). We must therefore learn to treat our bodies as the temples they are.

Learn to live in healthy mode. Get adequate exercise and adequate sleep. Going to bed early and rising early is wise counsel that dates back to Moses' time. Don't put anything into your body that would harm it.

Finally, maintain good relationships with family and friends. In times of trouble, family and friends can help and truly make a difference in our lives.

2. Use a group plan (from work) or subsidized plan

Group plans are generally cheaper, as companies can share the costs over multiple employers. Also, depending on your income, you may be eligible for a subsidized health plan through the health care marketplace. Check your options to find what is best for your current situation.

3. Use a Medical Reimbursement or Flexible Spending Account

A medical reimbursement account (sometimes called a flexible spending account) is an optional employer-established savings plan that allows you to save pre-tax dollars for non-reimbursable medical expenses. Each year, you set aside a specific amount of money in this account on a before-tax basis; as you pay for medical bills out of pocket, you are reimbursed from this account.

An advantage of a medical reimbursement account is that it provides a way for you to pay for non-reimbursable medical expenses with pre-tax dollars. This savings plan is very flexible and covers many items that may not be covered by insurance plans, such as braces, contact lenses, glasses, and other miscellaneous medical expenses. Disadvantages of this type of account include a lot of paperwork and some expenses that are not eligible for coverage. There is a chance that you may lose the money you set aside in this account; if you do not use all the money you set aside by the end of the year, you lose it.

4. Use a HDHP with a Health Savings Account

Depending on your health and needs, you might consider a High deductible health plans (HDHP), which is a form of catastrophic coverage with lower premiums and higher deductibles and is intended to cover catastrophic illnesses. Couple that with a Health savings accounts (HSAs) that will allow you to save for medical expenses with pre-tax money, and allows you to take more control over your health care expenses

5. Consider COBRA When Changing Jobs

If you use COBRA in between jobs, you are still able to have health insurance without getting individual coverage. However, a disadvantage of using COBRA is that you must pay the full cost of the insurance, and the cost may be substantially higher than it was before you left the company. Another disadvantage is that you must notify the company within 60 days of leaving that you are going to use COBRA.

6. Opt Out of a Company Insurance Plan If You Are Already Covered through a Spouse's Plan

Companies will sometimes offer you a cash incentive for refusing insurance coverage for yourself and your family. If you already have insurance through a spouse's (or parent's) company, and you are sure you will not lose coverage, opting out is an option.

If you opt out of insurance just to save money and you do not have other insurance, you may be giving up future financial security for additional cash now. This is a very dangerous situation; it is never recommended that you opt out unless you already have another form of insurance.

Know What to Look for When Shopping for Insurance

Selecting health insurance coverage may be the most important decision you make in regard to your financial plan. Medical problems are a leading cause of personal bankruptcy in the United States.

Health insurance is a technical and challenging issue; however, you can come to understand the different aspects of health insurance and use them to your advantage. Learn about the options for health insurance that are available to you and pick the options that will best help you achieve your personal goals. The following are some general tips to help you select the best option for health insurance.

1. **Always compare ratings.** As you look for health insurance, consider only high-quality insurance companies. Check with A.M. Best at http://www.ambest.com or Standard & Poor's at www.standardandpoors.com to review ratings on insurance companies. Look for strong companies with the least expensive, yet most comprehensive, plans.

2. **Protect yourself from catastrophic illnesses and accidents.** Know what you are buying. Read through the policies and avoid those with major exclusions or exemptions. Make sure you get needed coverage before you get optional coverage.

3. **Buy an individual policy if you are not covered at work.** If you are changing companies, consider using COBRA while you are between jobs. If your COBRA insurance has run out, consider joining a PPO or an HMO to reduce your medical costs. Group plans are generally less expensive than individual plans.

4. **Consider higher deductibles to reduce premiums.** By taking on some of the risk, you can reduce your monthly payments.

5. **Look for policies with a guaranteed renewal.** Avoid polices that are not guaranteed to be renewable. The last thing you want is to do is purchase a policy and then have it canceled after one period or year.

Understand Plans and Strategies for Health Insurance

As part of your Insurance Plan, you will need to include a section on health care strategies. Following are a few ideas for health strategies over different time periods of your life.

Health Insurance Plans and Strategies -
Students and young marrieds

- If planning for children and still on parents insurance, ensure parents insurance covers pregnancy. Deductible may be per person, and the baby is a person.
- If income levels are low, you may be eligible for Medicaid.

- If married without kids, compare your group plans to a Health Savings Account to see which plan has the best coverage for the costs.
- Once children come, switch to a traditional group plan to meet your family needs.
- Build your Emergency Fund to meet your needs.
- Use a flexible spending plan if offered by your employer to reduce your medical expenses.

Married with families

- Make sure you have sufficient health insurance to meet your family needs.
- Review your insurance needs annually during the open period to be most cost effective with your health expenses.
- Use a flexible spending plan if offered by your employer to reduce your medical expenses.

Empty nesters

- Make sure you have sufficient health insurance to meet your family needs.
- Review your insurance needs annually during the open period to be most cost effective with your health expenses.
- As children leave home, make adjustments to your health insurance to be cost effective with your coverage.
- Use a flexible spending plan if offered by your employer to reduce your medical expenses.

Summary

Having adequate health insurance is crucial; health insurance ensures that you and your loved ones will receive the necessary medical treatment throughout the course of your lives. Health insurance offers you peace of mind and eliminates the financial risk of having to make large payments to health-care providers for injury or illness.

There are four major types of health insurance coverage: basic health insurance, major medical expense insurance, dental and eye insurance, and dread disease and accident insurance.

The three major providers of health insurance are private health-care plans, non-group coverage plans, and government-sponsored health-care plans. There are two types of private health-care plans: fee-for-service plans and plans provided by managed health-care providers. There are four main types of managed care providers: health maintenance organizations (HMOs), preferred provider organizations (PPOs), point-of-service plans (POSs), and exclusive provider organizations (EPOs).

Non-group coverage plans (also called individual health-care plans) are health insurance plans that cover individuals on a case-by-case basis. Finally, government-sponsored health-care plans are insurance plans that are sponsored by either the state or the federal government. Government-

sponsored health-care plans fall under four headings: workers' compensation, Medicare, Medigap, and Medicaid.

There are best methods to control your health-care costs include:

1. Live a healthy lifestyle.
2. Use a group plan (work) or subsidized plan if available.
3. Use a medical reimbursement or flexible spending account.
4. Consider using a Health Savings Account (HSA).
5. Consider COBRA when changing jobs.
6. Choose no health care coverage if you already have coverage through a spouse (this is not recommended unless already have coverage).

Finally, we shared some possible health strategies for different periods of your life.

Assignments

Financial Plan Assignments

Health insurance is an important part of every family's financial plan. While it is not necessary (or cost-effective, perhaps) to have every type of health insurance, it is important to have basic coverage should catastrophic accident or illness strike. Determine what you should have and include these in your PFP Insurance Template (LT01-09).

What is your vision and goals for health insurance? What kind of insurance should you have?

Your assignment is first to get a copy of your health insurance plan if you have one. Who is the plan's provider? What kind of coverage do you have? Which of the major types of health insurance coverage do you have?

As part of this, get a copy of your health insurance manual. Go through the manual and review the different types of coverage you have, the co-payments, where you can go for service, the available doctors and clinics, and so on. Plan now so you know where you can go to get coverage. Keep a copy of your insurance company's summary pages in your financial plan. In case of accident or illness, you can go to that summary page to find all the necessary phone numbers and addresses. By having this information readily available, you will also minimize the problems that might arise from misunderstanding your available benefits.

Finally, you should determine what insurance you should have. Develop plans and strategies to obtain the type of insurance you determine to be best for your situation.

Review Materials

Terminology Review

Basic Health Insurance. This is basic health coverage which covers hospital, surgical and physician expense insurance. It covers hospital insurance, which is hospitalization expenses including room, board, nursing, and drug fees; surgical insurance, which is the direct costs of surgery including the surgeon's and equipment fees; and physician expense insurance, which covers physicians' fees including office, lab, X-ray, and fees for other needed tests.

Dental and Eye Insurance. This is insurance which covers only dental work and expenses relating to the eyes and teeth. Generally, it is only partial costs of eye exams, glasses, contact lenses, dental work, and dentures. Know your coverage, as the amount covered varies by plan provider. These plans are generally expensive, unless they are provided as part of an employer plan.

Dread Disease and Accident Insurance. This is a special insurance to cover a specific type of disease or accident. Generally it provides only for 'specific' illnesses or accidents on the "covered" list, and it provides a set maximum dollar amount of reimbursement. This insurance is generally expensive, unless included in your company's total health plan. Generally, concentrate on making your health coverage as comprehensive as possible.

Exclusive Provider Organization (EPO). These are similar to an HMO, but operates through an insurance company. It is funded through an insurance company, with health care provided by contracted providers. Only care received from contracted providers is covered (unless in an emergency situation).

Fee for-service (or traditional indemnity plans). These are health care plans where the doctor bills the patient directly, and the patient is reimbursed, to a specific percentage, by the insurance company. They provide the greatest flexibility for choosing doctors and hospitals, they define the percent of each claim the policy will cover, and they define the amount the insured must pay before a claim is eligible for reimbursement. Generally these plans are more expensive and require more paperwork.

Government-Sponsored Health Care Plans. Government-sponsored health care plans are insurance plans which are sponsored either by the state or the federal government. These plans fall under three headings: Workers' Compensation, Medicare, and Medicaid.

Health Care Coverage. Health Care Coverage is divided into four areas: basic health insurance, major medical expense insurance, dental and eye insurance, and dread disease and accident insurance.

Health Care Providers. These are the major providers of health care. They fall into three types: Private health care plans, which are either fee-for-service (or traditional indemnity plans) or managed health care (HMO, PPO); Non-group (individual) health care plans, or Government-sponsored health care plans.

Health Maintenance Organizations (HMOs). HMOs are prepaid insurance plans which entitle members to the services of specific doctors, hospitals and clinics. They are the most popular form of managed health care, due to their costs, which are roughly 60% of fee-for-service plans. They provide a system of doctors and hospitals for a flat fee, and emphasize preventive medicine and efficiency, and subscribers pay a relatively small co-pay for services rendered. They provide little choice of doctors and hospitals. As such,

service may be less than at other facilities and referrals sometimes difficult to get.

Liability Coverage. Liability is the financial responsibility one person has to another in a specific situation. Liability results from the failure of one person to exercise the necessary care to protect others from harm. Personal liability coverage protects the policyholder from the financial costs of legal liability or negligence. There are two major forms of liability insurance: the liability portions of homeowners and auto insurance and an umbrella liability coverage.

Major Medical Insurance. This is major coverage of medical costs over and above the basic health insurance coverage. It covers medical costs beyond the basic plan. These normally require a co-payment and/or a deductible. There is a stop-loss provision, which limits the total out-of-pocket expenses incurred by the insured to a specific dollar amount and a life-time cap for the insurance company, which limits the total amount the insurance company will pay over the life of a policy.

Managed Healthcare Providers. These are insurance companies which provide pre-paid health care plans to employers and individuals. There are four main types of managed care: Health maintenance organizations (HMOs), Preferred provider organizations (PPOs), POS Plans (POS), and Exclusive Provider organization (EPOs). They pay for and provide health care services to policy holders and are the most efficient payment of bills. However, they limit choices to the doctors and hospitals that participate and they require policy holders to pay a monthly premium and share the cost of care.

Medicaid. Medicaid is a medical assistance program, operated jointly by the states and federal government, to provide health care coverage to low income, blind, or aged persons. Medicaid payments may be used to offset the premiums, deductibles, and co-payments incurred with Medicare. There is no guarantee that this plan will be around in its present form.

Medicare. Medicare insurance provides medical benefits to the disabled and to those 65 and older who are covered by Social Security. Its cost is covered through Social Security taxes. Individuals can get insurance through Medicare that would be prohibitively expensive through other channels, however, it doesn't cover all the costs and expenses so individuals must pay certain amounts. In addition, there are limitations to the coverage, such as out-of-hospital prescription drugs and limitations to the number of days in skilled nursing facilities. Medicare is Divided into three parts: A,B, and C.

- Medicare Part A is compulsory and covers all hospital related expenses, such as bed,board, operating room costs, and lab tests. Patient pays a deductible and coinsurance payment.
- Medicare Part B is voluntary, with a monthly charge. It covers doctors' fees and other outpatient treatment. Patient pays a premium, deductible, and 20% of approved charges.
- Medicare Part C (Medicare Advantage) provides three program alternatives: coordinated care plans, private fee-for-service Medicare, and health savings accounts (HSAs).

Non-group Coverage Plans. These are health insurance plans which cover individuals on a case-by-case basis and are traditionally the most expensive type of coverage. They

provide a custom insurance policy to the purchaser. They are expensive, usually 15% - 60% more expensive than a group policy and may require subscribers to pass a medical exam.

Point of Service Plans (POS). These plans have attributes of HMOs, PPOs, and indemnity plans. The point at which benefits are received determines the amounts of benefits paid. POS may include HMO, PPO, and indemnity type programs, and the POS may also have a gatekeeper.

Preferred Provider Organizations (PPOs). PPOs are insurance plans which are essentially a cross between the traditional fee-for-service and an HMO. PPOs are organizations where in-plan provider's fees are covered, and out-of-plan providers results in higher fees. Insurers negotiate with a group of doctors and hospitals to provide care at reduced rates, while giving insurers the ability to go to non-plan doctors. PPOs provides health care at a discount to fee-for-service plans. They provide a group of doctors which work at reduced costs to the participants, while assessing an additional fee if the participant uses a non-member doctor or center. PPOs are more expensive than HMOs and use of non-PPO providers results in higher out-of-pocket costs.

Private Health Care Plans. These are health care plans sold by private insurance companies to individuals and employers as part of a benefits package.

Workers' Compensation. Workers compensation is state insurance program that insures against work-related accidents and illness. Workers' Compensation provides insurance to workers injured on the job, regardless of whether they have other health insurance or not. It only covers work-related accidents and illnesses, and coverage is determined by state law and varies state by state.

Review Questions

1. What is currently a major concern in the health-care industry? Why is the cost rising?
2. What are the four major types of health insurance coverage?
3. What is a co-payment? Is there a deductible?
4. What are the three major types of health-care plans?
5. What are four important things you can do to control your health-care costs?

Case Studies

Case Study 1

Data

Steven has a major medical policy for $1 million. The policy has a $500 deductible, an 80 percent co-insurance provision, and a $5,000 stop-loss limit. He recently incurred $10,500 worth of covered medical expenses.

Calculations

What amount will the insurer pay in this situation? What amount of these covered medical expenses will Steven pay?

Case Study 1 Answers

The insured pays the deductible first ($500), then the insurance company and the insured split the remainder (80 percent / 20 percent), up to the stop-loss limit of the insured ($5,000). The breakdown of payments for covered medical expenses are as follows:

Total Expenses	$10,500	Insurer Pays	Steven Pays
Deductible	$500	$0	$500
Remaining	$10,000		
80/20 Split		$8,000	$2,000
Total Payments	$10,500	$8,000	$2,500

[1] "Constancy Amid Change," *Ensign*, Nov. 1979, 80

[2] http://www.ssa.gov/dibplan/dqualify4.htm

14. Insurance 4: Protecting Your Assets through Auto, Home/Renters, and Liability Insurance

Introduction

In addition to life insurance and health insurance, you should own and understand three other important types of insurance: auto insurance, homeowner's/renter's insurance, and liability insurance.

These types of insurance are valuable assets for any family working toward financial security. They ensure that when the unexpected happens, you will not lose the things you have worked for all your life because you do not have the necessary funds to pay for damages.

As with all types of insurance, the amount of insurance and the type of coverage you carry should be updated annually. Your insurance policies should also be updated when you acquire additional personal property or when inflation increases the value of your home or other assets.

Objectives

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

A. Understand the key areas of auto insurance and know how to reduce your costs.
B. Understand the key areas of homeowner's and renter's insurance and know how to reduce your costs.
C. Understand the key areas of personal liability insurance.
D. Understand plans and strategies for asset protection.

Understand Auto Insurance and Know How to Reduce Costs

"There are 30 million accidents in the United States annually, which equals about 1 accident for every five licensed drivers. These accidents result in over $100 billion in economic losses, 2 million injuries, and 40,000 deaths."[1]

There are many steps you can take to reduce the probability of an accident. You can drive defensively, obey all traffic rules, avoid high-traffic areas, and use good judgment when driving. However, although you can control how you drive, you cannot control how others drive; therefore, your risk of being in an automobile accident remains high. Auto insurance is a necessity for all drivers.

Auto insurance is a contract between you and the insurance company in which you agree to pay a

monthly premium, and the insurance company agrees to pay a specified amount for any losses defined in your policy. Losses that exceed your policy's limit are your liabilities, so it is important that you have adequate coverage.

Basic Parts of Auto Insurance

To legally drive your car, you are required by law to carry a minimum level of auto insurance. However, most experts agree that the minimum coverage required by law is insufficient. There are four basic parts of automobile coverage:

- Part A: Liability coverage
- Part B: Medical payment
- Part C: Uninsured/underinsured motorist coverage
- Part D: Comprehensive physical damage coverage

Part A: Liability coverage pays for losses related to bodily injury, property damage, lawsuits, and defense costs. Bodily injury refers to expenses related to deaths or injuries resulting from an accident. Property damage refers to costs for damage to the car or cars involved in an accident, as well as damages to other property (such as lampposts or fire hydrants). Lawsuit coverage refers to losses related to any lawsuit resulting from an accident; in addition to the maximum amount of expenses your policy covers for a lawsuit, your policy may also cover your defense costs if the case goes to trial.

Liability coverage may be listed on your policy as a combined limit or as a split limit, depending on the type of insurance you have. Combined-limit insurance lists one maximum amount the insurance company will pay to cover all types of liabilities. Split-limit insurance lists the maximum amount the insurance company will pay for each of the specific types of liability. For example, if you have a 100/300/50 split-limit insurance policy, it means your limits are $100,000 per person for bodily injury liability coverage, $300,000 per accident for bodily injury liability coverage, and $50,000 per accident for property damage coverage. These dollar amounts are the maximum amounts your insurance company will pay per person or per accident. Should the costs of the accident exceed these limits, you will be responsible for paying the difference. My recommended split-limit minimum liability coverage limits are $100,000 per person and $300,000 per accident with $50,000 for property damage. My combined-limit recommended liability coverage limits are a minimum of $300,000 per accident with $50,000 property damage.

Part B: Medical payment coverage pays for accident-related medical costs and funeral expenses incurred by you or your family members within three years of an accident. It also covers the insured while walking, even though he is not in a vehicle. My recommended minimum medical payment coverage is $50,000.

Medical payment coverage does not cover all medical expenses, however. For example, it does not cover your medical expenses if you are injured by a vehicle that is not designed for public streets, such as an unlicensed three- or four-wheel all-terrain vehicle. Be sure you know what

types of injuries are excluded from your policy.

Part C: Uninsured or underinsured motorist coverage covers your costs if you are injured by an uninsured motorist or if you are injured in a hit-and-run accident. It also covers your costs if the other driver's insurance is insufficient to pay for your expenses (in other words, if the other driver is underinsured). The other driver must be at fault for you to collect on this coverage. I recommend that you keep your uninsured/underinsured insurance coverage the same as your liability coverage.

Part D: Comprehensive physical damage coverage (also called collision coverage) pays for damage resulting from any collision, regardless of who is at fault. If the other driver is at fault and has liability insurance, your insurance company should be able to recover losses from the other driver's insurance company. If the accident does not involve a collision with another car, comprehensive physical damage coverage pays for damage to your vehicle.

Standard Exclusions

Exclusions are clauses in your contract that limit the insurance company's liability to pay for specific claims. For example, your insurance company may not pay on a claim if the following situations apply:

- You intentionally cause damage or injury.
- You drive the vehicle without permission.
- Your vehicle has fewer than four wheel.
- You drive someone else's vehicle on a regular basis.
- Your automobile is not listed on your policy.
- You are carrying passengers for a fee.
- You are driving in a race or speed contest.

You should be aware of and avoid any circumstances where exclusions to your insurance would apply.

No-Fault Insurance

No-fault insurance is coverage that pays for the driver's injuries, regardless of who causes the accident. Such policies are designed to promote faster reimbursement and reduce the amount of litigation necessary. No-fault policies vary from state to state and are available only in "no-fault" states. There are many advantages to having no-fault insurance. It is easier to deal with because your insurance pays for your injuries, and the other driver's insurance pays for his or her injuries—there are no legal battles. Claims are processed faster because you are guaranteed immediate compensation for your losses.

However, there are disadvantages to having no-fault insurance as well. Damages from pain, suffering, and emotional distress are not usually covered by no-fault insurance; other

disadvantages include lower dollar limits on medical expenses and lost income, and losses above your established limits are not covered. Vehicle damage is not covered: to repair your vehicle, you must rely on your collision coverage or the other driver's. No-fault insurance also has liability thresholds that may restrict your ability to pursue a liability lawsuit.

Keeping Costs for Automobile Insurance Down

The cost of your auto insurance is determined by the type of car you drive, how much and how far you drive the car each day, and your driving characteristics. These driving characteristics include your driving record, where you live, and any discounts for which you qualify. Insurance companies also use your credit score to determine the cost of your insurance. The following are some tips for keeping your automobile insurance costs down:

1. **Shop comparatively.** Know what different insurance companies in your area are charging for similar coverage. Determine the amount and type of insurance you need and then shop comparatively.

2. **Consider only high-quality insurance companies.** Review insurance ratings from different companies such as A.M. Best (look for a rating of A and higher) at www.ambest.com, Standard & Poor's (AA and higher) at www.standardandpoors.com, Fitch (AA and higher), and Moody's (Aa2 and higher). Make sure the company you have chosen is sound. Find examples of others who have made claims with the company and determine how well the company handled those claims. Having cheap insurance is worthless if the company fails to pay on claims.

3. **Make use of all available discounts.** Apply for all discounts you think you or your family members would qualify for, such as non-smoking, non-drinking, good grades, and multiple vehicles. In addition, consider buying auto insurance from the same company with which you have your homeowners' insurance or life insurance because you should get a multiple-policy discount. Always ask your insurance agent, "Are you sure you can't do better than that?" and "Are you sure there are no other discounts?"

4. **Buy vehicles that are inexpensive to insure.** Ask your insurance company about the costs of insuring specific vehicles before you purchase a new car. Buying a car that is a favorite of thieves is likely to raise your insurance costs. However, buying a car with extra safety features and antitheft devices may reduce your insurance costs.

5. **Drive defensively.** Driving defensively is critical to reducing your insurance costs. Keep your driving record clear of tickets and accidents. If you or someone in your family gets a ticket, go to traffic school to keep the ticket off your record whenever possible.

6. **Raise your deductibles.** If you want to cut monthly insurance costs, raise your deductibles. Moreover, consider dropping collision coverage completely once the value of your car drops below $2,000; it may be more cost effective for you to pay repair costs out of your own

pocket if the car is in a collision.

7. **Keep adequate liability insurance.** Never reduce your liability limits to reduce your insurance costs! Liability insurance is fairly inexpensive, but it is very important: keep your limits high.

8. **Be cautious of allowing others to drive your car.** Remember that if a friend causes an accident in your car, and you gave your friend permission to drive the car, you (and your insurance company) will likely have to pay the bill, and your insurance costs may go up.

9. **Improve your credit score.** Take the steps necessary to improve your credit score; insurance companies believe that those with high credit scores are less of an insurance risk than those with lower credit scores. Review your credit score and credit reports every few years and make sure they are correct.

10. **Review your insurance coverage on a regular basis.** Review your insurance costs, coverage, liability limits, and discounts on a regular basis—at least annually. Make sure all your vehicles are included in your policy. Review your CLUE (Comprehensive Liability Underwrites Exchange) report at www.choicetrust.com and make sure it is correct.

Filing a Claim on Your Auto Insurance

If you are in an accident, the following tips may be helpful.

First, use wisdom in your actions: If there is an accident, call the police immediately and cooperate with them when they arrive. Move the vehicles out of traffic or put up flares. (I recommend that you keep flares in your vehicle's emergency kit.) Get help for anyone who has been injured. Write down the names and contact information of any witnesses to the accident. Insist that all drivers be tested for alcohol consumption if you are concerned that alcohol may have been a factor in the accident. Before leaving the scene of the accident, get the police case number for your records.

Second, keep calm and stay in control. Write down your memories of the events leading up to and following the accident. Don't sign anything or admit guilt. Remember to be firm on your views about what happened when you speak with the police officers. Don't be afraid to speak up and give pertinent information about the accident—even if that information contradicts the other driver's story.

Third, follow up on the accident properly and promptly. Get the name of the other driver's insurance company and call your insurance company as soon as possible. Cooperate with your agent and your claims adjuster, the person assigned by your insurance agent to determine the amount of the loss. Obtain a copy of the police report and keep records of all accident-related expenses. Review the settlement steps in your policy and follow these steps exactly.

Finally, if you are dissatisfied with the settlement the insurance company offers, request a meeting with your agent and your claims adjuster. If you are still not satisfied after this meeting, contact your insurance company's consumer affairs office or the state insurance commissioner and explain your concerns.

Understand Homeowner's and Renter's Insurance and Know How to Reduce Costs

Your home is likely one of the largest purchases you will ever make. Because your home is such an important purchase, it needs to be protected. The purpose of homeowner's insurance is to cover the costs of repairing or replacing your home in the event it is damaged by specific disasters, such as fire, theft, or storms. Know which risks you want homeowner's insurance to cover, and make sure you get the type of that covers those risks.

Basic Types of Homeowner's Insurance

There are six basic types of homeowner's insurance:

1. **HO-2** is a general form of homeowner's insurance and the least expensive type; it covers only named perils. These perils may be fire, lightning, hail, explosions, and so on. If a peril is not listed, it is not covered by the insurance.

2. **HO-3** includes open perils protection. Open perils protection covers all direct physical losses to your home and lists specific exclusions. All forms of homeowner's insurance exclude certain types of damage, including damage caused by law (problems caused by a lack of proper permits), earth movement (earthquakes), water damage (floods), power failure, neglect, war, nuclear accidents, and intentional loss. Although HO-3 excludes these perils as a general rule, coverage for some of these specific perils may be added separately to the policy. HO-3 coverage is generally recommended as a minimum level of homeowner's insurance.

3. **HO-4** is renters' and tenants' insurance. Because this coverage is available only to renters and tenants, it covers damage or loss of personal property rather than loss or damage to the structure itself. HO-4 provides liability coverage in case of an accident, but it does not cover structural damage. The personal property coverage provided by HO-4 is similar to the coverage provided by HO-2. All-risk coverage is available for HO-4 insurance and is recommended. All-risk coverage includes coverage for all risks except those excluded from homeowners coverage.

4. **HO-5** is a new, unique form of homeowner's insurance that covers open perils and includes a rider (HO-15) that allows open perils coverage on personal property in addition to other coverage. HO-5 covers all direct physical losses to your home, or open perils protection. HO-5 has the same exceptions as HO-3.

5. **HO-6** is condominium owners' insurance. HO-6 is similar to HO-4 coverage, but it is

available only to co-op or condominium owners. Besides covering personal property, this insurance also covers improvements you have made to the dwelling. All-risk coverage is available as an option and is recommended.

6. **HO-8** is modified coverage for older homes. HO-8 is similar to HO-1 coverage, or insurance against named perils. It insures the dwelling for the repair cost or market value instead of the replacement value. All-risk coverage is available as an option and is recommended.

Basic Parts of Homeowner's Insurance

Homeowner's insurance covers four key components: the main dwelling, other structures, personal property, and loss of use.

Coverage A: Main dwelling coverage protects the home and any attachments to the home. It does not cover any damage to the land.

Coverage B: Other structures coverage protects buildings on the property that are not attached to the main dwelling, as well as landscaping; however, it does not protect land or structures used for business purposes. Coverage of other structures is limited to 10 percent of the value of the home's coverage.

Coverage C: Personal property coverage pays for all personal property that is owned or used by the policyholder. It covers personal property regardless of the property's location. For example, loss to contents in your personal vehicle at work would be covered by the personal property component of your homeowner's insurance. Personal property coverage also covers property of guests in your home. It is limited to 50 percent of the home's coverage. For example, if your home is covered for $250,000, you can have up to $125,000 coverage for personal property. In addition, there is a $200 limit on cash, gold, and silver; a $1,000 limit on securities, tickets, and stamps; and a $2,500 limit on silverware. Note that birds, fish, and other animals are not considered personal property.

Coverage D: Loss of use coverage pays for losses that are incurred if your home becomes uninhabitable. It is limited to 20 percent of the home's coverage. Benefits of this type of coverage cover living expenses that are incurred if you need to relocate temporarily until your home is repaired. This type of coverage also covers fair rental value of any structure in which a renter was leasing part of the home. Finally, this type of coverage covers losses in the case that a civil authority prohibits you from using the structure.

If you need additional coverage, a homeowner's policy can be supplemented in a number of ways through endorsements or additions to your policy. Examples of endorsements include inflation, floaters, and specific risk coverage. An inflation endorsement allows insurance protection to increase parallel to the increase of repair and rebuilding costs. A floater policy

endorsement insures valuable personal property for an amount that is higher than your existing homeowner's policy limits. Flood insurance, earthquake insurance, and terrorism insurance provide protection in case of specific types of loss as well.

Keeping Costs for Homeowner's Insurance Down

Three basic factors determine how much a policy costs: location of structure, type of structure, and level of coverage. There are eight major areas you should consider when looking to reduce your homeowner's insurance costs:

Table 1. Homeowner's Insurance Coverage

Homeowners Insurance Summary 2019
Fin200/Fin418/MBA620 (02/18/19)

		Section 1: Property				Section 2: Liability	
Policy Type	**Description**	**Coverage A: Dwelling**	**Coverage B: Other Structures**	**Coverage C: Personal Property**	**Coverage D: Loss of Use**	**Coverage E: Comprehensive Liability**	**Coverage F: Medical Payments and Other**
HO 02: Basic Insurance Coverage							
	"Basic form" that provides insurance on a "named-peril basis for dwelling and personal property, " i.e., only covers losses listed on the policy	Broad form, $15,000 minimum	Broad form, 10% of A	Broad form, 50% of A	Broad form, 20% of A	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 03: Broader form, includes open perils (this has been the standard form for decades)							
	"Broad form" that provides "open-peril" insurance on dwelling and structures but "broad form" on personal property	Open Peril, $20,000 minimum	Open Peril, 10% of A	Broad form, 50% of A	Open Peril, 20% of A	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 04: Renters, or Tenant's Insurance							
	Renters insurance with liability and personal property covered up to the policy limits	Not covered	Not covered	Broad form, $6,000 minimum	Broad form, 20% of C	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 05: Broader form, incl. open perils coverage on Personal Property (only for newer homes, higher values and well maintained)							
	"Comprehensive form" that covers both the home and personal property on an "open-perils" basis--broadest form of insurance available	Open Peril, $20,000 minimum	Open Peril, 10% of A	Open Peril, 70% of A	Open Peril, 30% of A	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 06: Condominium Insurance							
	Condo policy that generally cover personal property and condo structure from the wall studs in	$1,000	Included in A	Broad form, $6,000 minimum	Broad form, 40% of C	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 08: Modified coverage for Older Homes							
	Policy used to insure older homes that would be difficult to replace if destroyed, hence the home is insured at market value	Basic, $15,000	Basic, 10% of A	Basic, 50% of A	Basic, 10% of A	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits

HO-3 Standard Named Perils: These include theft, fire, explosion, smoke, freezing, vehicles, falling objects, volcanic eruption, windstorm or hail, riot or civil commotion, aircraft damage, vandalism, snow damage, water damage. **Excluded generally from HO-3 and HO-5**: These include power failure, pollution, earth movement, flood damage, intentional loss, war, nuclear accident, pets, settling, wear and tear, negligence, actions by government, legal action, theft or damage from vandalism, and deterioration due to weather

1. Know your needs. Know what you want out of your homeowner's insurance. Remember to insure against the high-risk, high-severity items and self-insure against the

low-severity, low-risk events.

It may be wise to buy guaranteed full-replacement cost coverage for your home in case the home is damaged beyond repair. If you have this type of coverage, your home will be replaced without cost to you, regardless of what you paid for the home. Also, determine whether other structures or landscaping on your property have adequate coverage. Purchase additional insurance if part of your home is used as an office. You can also purchase extra coverage for unique situations if you have specific concerns that are not included in a policy; for example, if you live on a flood plain, you may want to add flood insurance to your policy. Finally, consider extra coverage, or floater policies, for valuables such as paintings, jewelry, or collections.

2. Don't underinsure. The 80-percent rule states that a dwelling should be insured within 80 percent of its replacement cost. If you do not carry adequate insurance on your home, co-insurance requires you to pay for a portion of your home's loss. If your home is not insured for at least 80 percent of its replacement cost, your settlement will be the greater of two amounts: either the settlement will be the cash value of the damaged or lost portion of the home or the settlement will be the amount of your insurance coverage divided by 80 percent of the replacement cost multiplied by the value of the loss. For example, if your home was insured for $300,000 but its replacement cost was $400,000, you are underinsured. You should have had a minimum insurance amount of $320,000, or 80 percent of $400,000. If you had a loss of $250,000, the company would pay $300,000 (your insured amount) divided by $320,000 (80 percent of the replacement value), times $250,000—or $234,375 (not including deductibles). You would be personally responsible for $15,625.

3. Select a financially sound insurance company with comparatively low costs, and stick with them. Shop around for homeowner's insurance—knowledge is your most important asset. Remember, the more types of insurance you have with a single insurance company, the lower your costs on specific types of insurance will be (multiple-policy discounts can be substantial). Once you have decided on an insurer, check with www.ambest.com to review your insurer's ratings and financial health. Pick a good insurer that is not likely to go out of business. Different companies have different discounts for different areas; talk with your agent and get as many discounts as you possibly can.

4. Get a CLUE (Comprehensive Loss Underwriting Exchange) report for both your home and your automobiles. A CLUE report is similar to a credit report. It gives a list of all payments made by the insurance company on your behalf. Review this report—this is what potential insurance companies will see when they are considering you as a client. You can get one copy a year from www.choicetrust.com. Be careful that inquiries are not listed as actual payments.

5. Reduce the insurance company's risk. There are a number of ways to do this. First,

you may want to consider paying your premiums annually instead of monthly; paying your premiums annually lowers administrative costs for your insurer and usually lowers your costs as well. In addition, some companies will give you a 5 to 10 percent reduction in costs if you allow them to deduct your insurance costs monthly through electronic funds transfers (EFTs). Second, increase your deductible. The higher your deductible, the lower your premium costs; by raising your deductible you are self-insuring a greater part of your risk.

Third, make your home more disaster-resistant and safer. Companies may give discounts if you make your home more disaster-resistant, for example, by adding storm shutters or buying strong roofing materials. Contact your insurance company to find out about possible discounts. Insurance companies may also give a 5 to10 percent discount if you add fire extinguishers and burglar alarms that are connected to police monitoring. Because of the high cost of home security systems, contact your insurance agent to see what the agent recommends and how much savings would be before you purchase these systems.

6. Know your coverage. You should read and understand your policy completely. Remember, the amount paid by the insurance company will never exceed the limit listed on your policy. An important restriction you should be aware of stipulates that in order to receive full insurance benefits, you must rebuild in the same location. If you don't rebuild in the same location, your insurance company will give you only the cash value of the home and not the replacement value.

7. Make your coverage work. Create an inventory of everything you insure, preferably on videotape, to establish proof of ownership. Keep the inventory in a safe place away from the house and update it yearly. Videotape the exterior of your home to document the value of landscaping and the condition of the house and update this record yearly as well. Make a list of the value of your assets. These records will be invaluable if your home or assets are damaged.

8. Keep your credit score high. Having a solid credit history can reduce your insurance costs. Monitor your credit report annually, check your credit score every two years, and keep your credit score high.

Filing a Claim on Your Homeowner's Insurance

If you have to make a claim on your homeowner's insurance, there are a number of steps you should take to protect yourself and speed the insurance process.

First, notify the police immediately of any theft or loss. Get copies of all police reports. Call your insurance company and notify the company of the loss as well. In some circumstances, you will need to follow up your call with a written claim.

Second, make a list of damaged, stolen, and destroyed items. If the loss required you to live outside the home, submit receipts for any additional living expenses to your insurance company as needed. Provide information requested by your claims adjuster, and accommodate the insurance company as much as possible.

Finally, review the steps of settlement explained in your policy and follow these steps exactly. If you are dissatisfied with the settlement offer, request a meeting with your insurance agent and claims adjuster. If you are not satisfied after this meeting, contact your insurance company's consumer affairs office or the state insurance commissioner and explain your concerns.

Understand the Basics of Personal Liability Insurance

A liability is the financial responsibility one person has to another person in certain situations. Liability results from negligence or the failure of one person to exercise the necessary care to protect other people from harm.

The cost of liabilities can be substantial. Every year, thousands of people are sued for more than one million accidents caused by or related to cars or homes. The purpose of personal liability insurance is to protect you from the financial costs of legal liability and negligence.

There are the two major forms of liability insurance: (1) the liability portions of homeowner's and automobile insurance and (2) an umbrella liability policy.

An umbrella liability policy is an insurance policy that adds additional protection to the protection provided by your homeowner's and automotive policies. An umbrella policy becomes effective only after the limits of your homeowner's or automotive policy have been reached. Therefore, many companies require specific coverage limits on homeowner's and automotive policies. For example, an insurance company may require you to have 250/500/100 insurance on all vehicles and $300,000 on all homes before they will write an umbrella policy.

Understand Plans and Strategies for Asset Protection

As part of your Insurance Plan, you will need to think through what asset protection strategies you will use during your live. Following are a few ideas for asset protection strategies over different time periods.

Asset Protection Plans and Strategies

Students and young marrieds

- Keep your credit score high to keep your insurance costs low.
- Have adequate auto insurance, with a minimum 100/300/100 split coverage initially.
- Have adequate renters insurance. If you get renters insurance from your auto insurer, there is likely a reduction in auto insurance costs. Some actually save money by purchasing renter's insurance.

- Keep an adequate emergency fund. With a higher emergency fund, you can raise your auto and home deductibles to reduce costs and co-insure a greater proportion of your assets.
- Raise your auto and home deductibles to reduce costs and co-insure a greater proportion of your assets.

Married with families

- Raise your split coverage to 250/500/100 to offer more protection when you have teenage drivers.
- Make sure teenage drivers keep grades, us, take "safe-drivers courses" to reduce their insurance costs, and take all "good student discounts" for auto insurance.
- Stay ticket free. If you get a ticket, go to traffic school. Get the ticket removed from your record.
- Raise your auto and home deductibles to reduce costs and con-insure a greater proportion of assets
- Consider an umbrella policy to reduce the risk of future litigation expense as your assets rise.
- Buy Guaranteed Full Replacement cost coverage.

Empty nesters

- Make sure you have sufficient auto and home insurance to meet your family needs.
- Review your insurance needs annually to ensure you have adequate coverage.
- As children leave home, make adjustments to your asset insurance to be cost effective with your coverage.
- Consider an umbrella policy to reduce the risk of future litigation expense as your assets increase.
- Take into account toys that are used for kids and grandkids and keep coverage up.
- Consider an umbrella policy to reduce the risk of future litigation expense as your assets rise.

Summary

Auto insurance is a contract between you and the insurance company in which you agree to pay a monthly premium, and the insurance company agrees to pay a specified amount for any losses defined in your policy. Losses that exceed your policy's limit are your liabilities, so it is important that you have adequate coverage.

Your home is likely one of the largest single purchases you will ever make; it is important for you to protect this important purchase. The purpose of homeowner's insurance is to repair or replace your home in the event it is damaged by specific disasters. Know which risks you want homeowner's insurance to cover, and make sure the policy you choose covers those risks.

An umbrella liability policy is an insurance policy that adds additional protection to the protection provided by your homeowner's and automotive policies. This policy becomes effective only after the limits of your homeowner's policy or automotive policy have been reached.

As part of your Insurance Plan, you should come up with strategies how you will utilized insurance in asset protection.

Assignments

Financial Plan Assignments

There are several different assignments for this chapter. Having auto insurance is a critical part of owning and driving a car; in fact, it is illegal to drive a car unless you have insurance. Your assignment is to get a copy of your auto insurance and include it in your financial plan and include these in your PFP Insurance Template (LT01-09).

Auto insurance. Look at your credit score if it is reported on your policy. The credit score shown on your policy should be consistent with the credit score you received from the credit-scoring agencies for an earlier assignment. Improving your credit score can lower the cost of your auto and other insurance.

Look at the discounts on your policy, such as discounts for good students, good drivers, multiple cars, and so on. Call your insurance provider and find out if there are any other discounts you qualify for. Discounts can reduce the cost of your insurance policy.

Review each of the four basic parts of your insurance: liability coverage, medical coverage, uninsured/underinsured coverage, and comprehensive physical damage coverage. What are your liability limits? If you have split coverage, how is the coverage split? Remember that most state requirements for liability insurance were set more than 30 years ago; these requirements are generally insufficient, given the rising costs of medical and automobile repair. If you must reduce your insurance costs, increase your deductible rather than reducing your liability limits.

Homeowners/renters insurance. If you own a home or a condo, get a copy of your homeowner's policy and review it carefully. Which type of homeowner's insurance do you have? Is your homeowner's insurance sufficient for your needs? Does it cover the current value of your home? What could you do to improve your coverage?

Liability insurance. Do you have a need for umbrella coverage? As the size of your assets increases, umbrella insurance may be something to look into.

Find out what insurance companies see when they look at your insurance reports. Under the FACT Act of 2003 (Fair and Accurate Credit Transactions Act) you can obtain a free copy of the following reports each year from the Comprehensive Liability Underwriting Exchange, or CLUE:

- CLUE Auto: A five-year loss-history report is generated if a loss is filed against your automobile insurance policy and the insurance company reports the information to CLUE.

- CLUE Personal Property: A five-year loss-history report is generated if a loss is filed against your homeowner's insurance policy and the insurance company provides this information to CLUE.

To get both CLUE reports, go to www.choicetrust.com, click on *CLUE Reports*, click on *CLUE reports* again, then *order options*, then *both reports*, then *new member*. Fill out the information for new members, including Social Security number, driver's license number, and address. Then verify the information and obtain the reports. If claims that the insurance company has paid are shown on these reports, copy the reports and include them in your Personal Financial Plan. You can also dispute the information if it is not correct or if you are planning on switching insurance companies.

Review Materials

Terminology Review

Auto Insurance. Insurance against financial loss due to an auto accident. It is a contract where you agree to pay the premium and the insurance company agrees to pay up to a specified amount for any policy defined losses. Losses in excess of policy limits are your responsibility.

Auto split-coverage insurance limits. These limits have reference to your coverage amounts which includes bodily injury liability per person, bodily injury liability per accident, and property damage liability per accident. These are the maximum amounts your insurance company will pay per person or per accident. Should the cost of the accident exceed the stated limits, you are personally responsible for any amounts exceeding these limits.

Exclusions. Exclusions are contract clauses which limit the insurance company's liability in specific situations or events. Your insurance may not pay up if: there is intentional injury or damage, there was use of the vehicle without permission, the vehicle has less than four wheels, someone else's vehicle was provided on a regular basis, its your automobile, but not listed on your policy, you were carrying passengers for a fee, or you were driving in a race or speed contest.

Homeowners Insurance. Homeowners insurance repairs or replaces your home from specific perils or accidents including: Fire, theft, storms; faulty household systems or appliances; and riot, volcanoes, vehicles, aircraft. Three key areas of homeowners insurance are: Dwelling: direct and consequential loss resulting from damage to the dwelling itself; Personal Property: loss or damage to personal property, and Liability: liability for unintentional actions arising out of the non-business, non-automobile activities of the insured and the insured's family. It is sold in six basic versions.

Homeowners Insurance Coverage. Homeowners insurance is divided into six areas:

- **Coverage A: Dwelling**. This protects the dwelling and any attachments. It does not cover any damage to the land.
- **Coverage B: Other Structures**. This protects other, unattached, dwellings on property. It also covers landscaping as well as buildings, but not the land. It also

does not cover other structures used for business purposes. It is limited to 10% of the home's coverage.

- **Coverage C: Personal Property**. This covers all personal property owned or used by the policyholder up to policy limits, and covers it regardless of location. It also covers property of guests in your home as well. It is limited to 50% of the home's coverage, with a $200 limit on cash, gold, and silver; $1,000 limit on securities, tickets, and stamps; and $2,500 limit on silverware. Animals, birds, and fish are excluded.
- **Coverage D: Loss of Use**. This covers losses incurred as a result of your home being uninhabitable or un-useable. It is limited to 20% of the amount of coverage on the home. There are three benefits of coverage: additional living expenses should to need to relocate temporarily; fair rental value, and prohibited use.
- **Coverage E: Personal Liability**. The insurer will pay, to the limit of liability in the contract, all amounts due to bodily injury or property damage.
- **Coverage F: Medical Payments**. The insurer will pay all reasonable medical payments to others, claims, expenses, and damage to the property of others to the limits of the policy. Other coverage includes claims expenses, first aid expenses, damage to the property of others, and loss assessment coverage

Homeowners Insurance Types. Homeowners insurance comes in various forms.

- **HO-2**. It is a broad form homeowner's insurance, and covers only named specific named perils. These perils may be fire, lightning, hail, explosions, etc. If the peril is not named, it is not covered by the policy. In general, all forms of coverage exclude law, earth movement, water damage, power failure, neglect, war, nuclear accidents, and intentional loss.
- **HO-3**. It is a special form of homeowner's insurance that includes open perils. This is generally recommended at a minimum. It covers all direct physical losses to your home, i.e. open perils protection. It lists specific exclusions to the policy for perils not covered.
- **HO-4**. It is Renter's or tenant's insurance. It is equivalent to HO-2 perils for personal property, but only for renters and tenants. It covers personal property rather than the dwelling, and provides liability coverage in case an accident, but does not cover causing damage to the structure. All-risk coverage available as an option (this is recommended).
- **HO-5**.It is a newer special form homeowner's insurance that includes open perils and includes a rider (HO-15) that allows open perils coverage on personal property in addition to other coverage. It covers all direct physical losses to your home, i.e. open perils protection. The listed exceptions are the same as HO-3.
- **HO-6**. It is condominium owner's insurance. It is similar to HO-4 coverage, has the same named perils for personal property as HO-2, but is available to co-op or condominium owners. It also covers improvements you've made. All-risk coverage is available as an option (recommended).
- **HO-8**. It is modified coverage for older homes. It insures the dwelling for the

repair cost or market value, instead of the replacement value and is designed specifically for older homes. All-risk coverage available as an option (recommended).

Homeowners Policy Riders. Should you need to add additional coverage, a homeowners policy can be supplemented in a number of ways through specific endorsements or riders including: Inflation: This allows protection to increase with the increase in repair and rebuilding costs; Floater Policies: These are policies that provide protection for valuable personal property over and above existing policy limits; and Flood, Earthquake and Terrorism Insurance: This provides protection in the event of a flood, earthquake, or terrorist activity.

No Fault Insurance. No-Fault Insurance is insurance coverage that pays for each driver's own injuries, regardless of who caused the accident. No-fault varies from state to state. Such policies are designed to promote faster reimbursement and to reduce litigation, and is only available in "no-fault" states (including Utah). The advantages of no-fault insurance are its easier and faster as your insurance pays for your losses and their insurance pays for their losses. However, generally damages from pain, suffering, emotional distress are not covered and there are dollar limits on medical expenses and lost income and vehicle damage is not covered.

Other than collision, it covers comprehensive physical damages.

Personal Automobile Policy. This includes the four key areas of automobile coverage: A. Liability, Part B: Medical Payment, Part C: Uninsured/Underinsured Motorist's Protection, and Part D: Damage to Your Car.

- **Liability Coverage** (Part A). Liability coverage is payment for losses due to: Bodily injury: Death or injury for all those involved in the accident; Property damage: All damage to the car or cars and any property damage; and Losses due to lawsuits: Losses from lawsuits resulting from the accident. Liability coverage may be a combined single limit or a split-limit coverage.
- **Medical Payment Coverage** (Part B). Medical payments covers all reasonable medical costs and funeral expenses incurred, by the insured or the insured's family members within 3 years of an accident. It also includes coverage for the insured when walking. It does not cover medical expenses if the insured is injured by a vehicle not designed for public streets, such as an unlicensed 3 or 4 wheeler (quad, four wheeler or go cart).
- **Uninsured/Underinsured Motorist's Coverage** (Part C). Uninsured/underinsured insurance covers costs if injured by an uninsured motorist or a hit-and-run driver. The other driver must be at fault to collect on this coverage. It also covers costs in excess of the other driver's liability coverage (i.e., under-insurance), if it is inadequate to pay for your losses.
- Comprehensive Physical (Part D). Comprehensive covers collision loss regardless of who is at fault. If the other driver was at fault and has liability insurance, your insurance company should be able to recover losses without collision coverage from the other driver's insurance company

Renters Insurance. Renters insurance repairs or replaces your rental property's contents

from specific perils or accidents including fire, theft, storms, water damage, etc. It also provides liability insurance against accidents caused by you or a member of your family. Your landlord has insurance only for the rented property and building. You are responsible for your contents and the liability risks you and your family bring. Renters insurance is relatively cheap and protects your property regardless of location.

Umbrella Liability Coverage. It is an insurance policy that adds protection over and above the insured's homeowners and auto policies, i.e., the policy becomes effective only after the limits of the homeowner's and automotive policies have been reached. As such, many companies require specific coverage limits, i.e., 250/500/100 insurance on all vehicles and $300,000 on the home before they will write an umbrella coverage.

Review Questions

1. What is auto insurance? Homeowner's insurance? Liability insurance? Why have them?
2. What are the four basic parts of an auto insurance policy?
3. What are "exclusions"? What is an example?
4. What are the four basic components of a homeowner's insurance policy?
5. What is an umbrella policy? When does it become effective?

Case Studies

Case Study 1

Data

Larry has a split-limit 100/300/50 automobile liability insurance policy. Several months ago Larry was in an accident in which he was found to be at fault. Four passengers were injured in the accident and were awarded $100,000 each because of Larry's negligence.

Application

How much of this will Larry's insurance policy cover? What amount will Larry have to pay out of pocket? Note: Larry's coverage is (A/B/D) 100/300/50: A = Liability: bodily injury liability per person, B = Medical: coverage per accident, D = Damage: collision or comprehensive coverage.

Case Study 1 Answers

Larry's maximum liability limit is $300,000 per accident. This amount must cover payments to all persons involved in the accident.

Unfortunately, it is not enough, because the four liability claims total $400,000. The remaining $100,000 awarded in the settlement will not be covered by Larry's insurance, and Larry must pay this expense out of his own pocket.

Case Study 2

Data

Janet currently insures her home for 100 percent of its replacement value with an HO-2

policy. For Janet, dwelling coverage (A) comes to $280,000.

Calculations

What are the maximum-dollar coverage amounts for parts B, C, and D of her homeowners policy?

Case Study 2 Answers

To determine the base amount of coverage on B, C, and D, use the $280,000 of the dwelling coverage (A) as a starting point. Coverage B (other structures) is limited to 10 percent of the dwelling coverage and is calculated as ($280,000 * 10%) = $28,000. Coverage C (personal property) is limited to 50 percent of the home's coverage and is calculated as ($280,000 * 50%) = $140,000. And coverage D (loss of use) is limited to 20 percent of the home's coverage and is calculated as ($280,000 * 20%) = $56,000.

Case Study 3

Data

Kelly has personal property coverage with a $250 limit on currency; a $1,000 limit on jewelry; and a $2,500 limit on gold, silver, and pewter. She does not have a personal property floater. Her deductible is $250.

Calculations

A. If $500 in cash, $2,500 of jewelry, and $1,500 of pewter ware were stolen from Kelly's home, how much of the loss would be covered by her homeowner's policy?

B. How much will she pay (or lose) on the claim?

Case Study 3 Answers

Kelly's policy would pay as follows:

Item	Amount Insurance Pays	Amount Kelly Pays	Total
Cash	$250	$250	$500
Jewelry	1,000	1,500	2,500
Pewter	1,500	0	1,500
Totals	2,750	1,750	4,500
Deductible	-250	250	
Total Amount Paid	$2,500	$2,000	$4,500

The insurance company would pay $2,500, and Kelly would pay $2,000.

Case Study 4

Data

Catherine called her insurance agent to learn how she could reduce her $1,000 annual homeowners insurance premium. The agent suggested increasing the $250 deductible on her policy to $500, which would result in a 10 percent premium savings. Her agent also indicated that if Catherine were to increase her deductible to $1,000, she would save 18 percent, and if she were to increase her deductible to $2,500, she would save 25 percent.

Calculations

A. How much will Catherine save per year in premiums if she increases her deductible to

$500, $1,000, or $2,500?

B. What are the advantages and disadvantages of increasing Catherine's policy deductible? What should be the key factor in her decision?

Case Study 4 Answers

A. Her current policy is $1,000 per year. Annual savings would be as follows:

$500 deductible = 10 percent savings, or $100
$1,000 deductible = 18 percent savings, or $180
$2,500 deductible = 25 percent savings, or $250

B. The advisability of increasing homeowner's insurance deductibles depends on the adequacy of her emergency fund or her capacity to cover a loss from current earnings. Catherine would save $250 on her annual premium by increasing her deductible from $250 to $2,500. On the other hand, she would be responsible for the first $2,500 of losses. Catherine would need about 10 claim-free years ($2,500/$250) to break even. Her decision should be based primarily on her emergency fund.

<u>Case Study 5</u>

Data

Paul is confused about his umbrella policy. His insurance agent requires him to have 250/500/100 split insurance on each of his automobiles before they can be put under his umbrella policy. He also has to have similar liability coverage for his home.

Application

What is the purpose of an umbrella policy? Does it pay before or after Paul's home or auto coverage?

Case Study 5 Answers

Paul's umbrella policy provides protection against lawsuits and judgments. It doesn't go into effect until after he has exhausted his homeowner's and automobile liability coverage. For that reason, the insurance company requires high liability coverage on his home and automobiles.

[1] Louis Boone, David Kurtz, and Douglas Hearth, *Planning Your Financial Future*, 3rd ed., 2003, 275

15. The Housing Decision I: The Process

Introduction

Once you understand the principles for using wealth, have your priorities in order, decide what you want to accomplish in life, and learn to live on a budget, one of your next goals may be to own a house. I like how some have defined the word *house*, "A house is a hole in the middle of land that you pour money into."

How true that statement is. There are very different connotations of the word "home" and the word "house," as illustrated by the following story:

> A while back a house caught fire and burned down. A local journalist went to cover the story. Upon arriving at the site, the reporter found a little boy. The child was standing in the midst of ashes and ruins. The reporter asked the boy what his family would do without a home. "Oh, we still have a home, we just don't have a house to put it in" the child replied.[1]

It is important to remember the difference between a home and a house as you look for and eventually purchase a house. A house is what you live in while a home is what you bring to the house. The purpose of this chapter is to help you avoid some of the pitfalls of buying a house for the first time. For the remainder of this chapter, I will use the words "home" and "house" interchangeably.

Objectives

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

> A. Understand our leaders guidance and the principles of home buying and ownership.
> B. Understand the process of buying a home.

Understand our Leader's Guidance and the Principles of Home Buying and Ownership

Buying a home is not easy. The purchase of a home will likely be one of the largest financial commitments you will ever make. As such, you should not rush into this commitment. If you use wisdom and judgment in trying to decide what you want, what you can afford, and where you want to live, and if you will listen to and obey the promptings of the Holy Ghost, you will make correct decisions regarding your housing needs.

There are risks in home ownership—not just the risks of owning the home but the risks of owning the wrong home. What happens if you buy a house you can't afford? Your most

important financial goals will likely be downgraded to goals of minor importance because you will not have sufficient funds to meet them. Individuals who own a house they can't afford are referred to as being "house poor."

What if you buy a "fixer-upper," but you don't have the necessary skills or time to do the fixing up? Your new home will likely remain a fixer-upper.

What if you buy the wrong type of house for your lifestyle? For example, if you are a condo person in a family neighborhood, you will likely want to pay others to keep up the landscaping and other exterior elements.

Or what if you buy a house without obtaining the necessary inspections? You could pay dearly for the problems the previous owners left behind and should have fixed before your purchase.

Finally, what if you get too far in debt, and you lose your job? Quite simply, you could damage your credit score, lose your house, and lose your self-respect as well.

Principles of Home Ownership

Gordon B. Hinckley shared principles of home ownership when he shared what his father told him regarding a home:

> When I was a young man, my father counseled me to build a modest home, sufficient for the needs of my family, and make it beautiful and attractive and pleasant and secure. He counseled me to pay off the mortgage as quickly as I could so that, come what may, there would be a roof over the heads of my wife and children. I was reared on that kind of doctrine.[2]

The decision to buy a house, since it is one of the most expensive purchase you will make in your lifetime, should be done in wisdom and order. You should do significant research as to yourself, your budget, your needs, the market, the mortgage process, and how to get the best mortgage you can. It is important that you understand the key principles of home ownership. Following are five key principles that are important to the housing decision.

> **1. Understand yourself, your vision, goals and plans, and your current and future housing needs.** Understand yourself. What needs does your home fulfill? What are your family needs now and in the future? What is your vision and your goals? What are the things you want to accomplish in life? A good start is to determine your needs. What are your housing needs that you have? What different options do you have for those needs? Whatever you choose, make sure it is the right type of house and right time for your lifestyle and budget.
>
> **2. Seek, receive and act on the Spirit's guidance**. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it

once it is received.

3. Understand the key areas and process of finding, buying, and funding a home. Know the process of how mortgages are marketed and sold, so you know how to get the best deal on your mortgage. You have received the best deal on your mortgage when you have the lowest Effective Interest Rate (EIR) calculation that includes all your points and fees (to be discussed later).

4. Be wise in your finances. Spend your money wisely and carefully. Be wise in your budget and in your spending. Make your house fit your budget, not your budget fit your house. Use the recommended 25-40% of take-home for housing expenses (which will be discussed later). Going beyond these limits will put significant financial burdens on you and your family. Get the necessary inspections (even if its new). Finance it wisely and try to pay it off before retirement or sooner.

5. Be a good steward over all your blessings. Don't just live in it—keep it up. Plan 1-2% of the cost per year for upkeep and maintenance on your home.

Based on this counsel, we can see that our challenge is to determine what a modest home is. The *Handbook for Families* recommends, "Avoid spending more than 25 to 40 percent of your take-home pay for the total house payment, including insurance, taxes, and maintenance costs."[3] That advice gives us a good start as we begin our study of home-buying.

Doctrines

As you work on the housing decision, finding balance among doctrines, principles and application is important in helping you make better decisions. We have shared some ideas for principles, although I am sure you can find others. Below are a few ideas for doctrines on which the principles are based. As you strive to increase your ability and effectiveness in the housing decision, I recommend you study and ponder the doctrines and principles supporting the housing decision.

Principles	Doctrines
Understand yourself, your vision, goals and plans	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Be wise in your finances, make sure it is in your budget	Stewardship
Understand the key areas of making the home decision	Agency
Be a good steward over your blessings	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with our housing decision, which is an application. Rather, from a higher perspective, or increased vision,

> We are children of Heavenly Parents (identity), striving to live worthy of the Spirit (obedience), learning about available housing options (accountability), so we can find the best housing option for our family (stewardship). This will allow us to enjoy a safe and secure home (accountability) at an acceptable cost (stewardship), so we can accomplish our personal missions and achieve our individual and family vision and goals.

Understand the Process of Buying a Home

There is a process to buying a home, which, if followed, will help you make wise decisions and may help you reduce some of the problems people face when they do not understand this process. It is a four-step process:

- Understand your limits
- Find your home
- Find, fund, and service your loan, and
- Enjoy home ownership.

Step 1. Understand Your Limits

Understand yourself and your limits in the following areas:

1.a. Know your budget. The first part of understanding your limits is to check whether or not you have developed and are living on a budget. We have already talked about many important topics related to budgeting in **Chapter 3: Budgeting and Measuring Your Financial Health.** If you have questions about budgeting, please review that chapter.

1.b. Know your credit history and credit score and keep it high. If you don't have good credit or a satisfactory credit score, you may find that no one is willing to lend you money. Keep your credit score high.

We have already talked about many important topics concerning credit in **Chapter 6: Understanding Credit.** If you have questions concerning credit, please review Chapter 6. As we have discussed previously, your credit history can play an important role in your opportunity to buy a home. When you request credit, financial institutions will pull your credit history to determine how likely it is that you will pay back the loan. If you have made timely payments in the past, creditors assume it is likely you will continue to make payments in the future. Because your credit history can have a big impact on how much you pay for your loans and whether or not you get a loan in the first place, you need to periodically examine your credit reports from all three major reporting agencies. Make sure the reports are correct.

1.c. Know your affordability ratios. The third topic you should understand is mortgage lending. We have already talked about the different types of mortgage loans in **Chapter 7: Consumer and Mortgage Loans.** Review this chapter if you need to.

It is critical that you know your affordability ratios, or how much debt the bank thinks you can take on. There are two main ratios: the housing-expense ratio (or front-end ratio) and the debt-obligations ratio (or back-end ratio).

You should know how to calculate your housing-expense ratio, or front-end ratio. It is your monthly payment of principal, interest, property taxes, and insurance (PITI) divided by your monthly gross income. Banks have determined that if this ratio is 28 percent or less, there is much greater chance you will be able to pay back your loan.

The back-end ratio is your monthly payment of principal, interest, property taxes, and insurance (PITI) plus any other long-term debt (including any debt older than 12 months, i.e., car payments, student loans, alimony payments) divided by your monthly gross income. Banks have determined that if this ratio is 36 percent or less, it is an indicator that you have much more flexibility in your finances and are more likely to pay back your loan.

Know your affordability ratios before you get your loan. Don't use all the money the bank will lend, and don't buy the most expensive house on the block. Know how much you can afford.

1.d. Calculate your affordability ratios taking into account payment of tithes and offerings. Before you calculate affordability, take into account the amount you should be saving. Look at your budget realistically. I recommend you set aside 10 percent for tithing, plus an additional amount for other offerings. Set aside 10 to 20 percent more for paying yourself, for money you are saving for retirement and other goals. Since you pay the Lord first with tithes (10 percent of your increase) and offerings and since you pay yourself each month as well, you should really adjust these affordability ratios downward to take your donations and savings into account. I would encourage you not to borrow too much money for your home. To help you review your situation, please see Maximum Monthly Payment for Christian Savers (LT11). This spreadsheet takes the front- and back-end ratios, as well as the fact that you pay tithing and savings, into consideration when it calculates the amount a bank will likely lend you.

1.e. Choose your preferred loan type and term. The best type of loan takes into account your goals, budget, income stream, down payment, and view on risk. There are a number of different types of mortgage loans available. These include:

> *Fixed rate (FRMs):* I generally recommend this type of loan. The lender takes the interest rate risk, and you make constant payments throughout the life of the loan. This makes planning and budgeting easier.
>
> *Variable or adjustable rate* (ARMs): You take the interest-rate risk, so the lender may accept a lower rate of interest. However, there is the risk that interest rates will rise in the future.
>
> *Interest-only options, variable or fixed interest:* This is an option on a fixed or ARM loan. However, once the interest-only period is over, for example, 3 to 10 years, the loan

resets so the principal and interest is paid over the life of the loan, generally 30 years. There can be substantial payment shock when the loan resets. This is not like a minimum payment on a credit card.

There are also special loans, if you can qualify for them. They include Federal Housing Assistance loans for lower-income borrowers or Veterans Assistance loans, which are guaranteed by the U.S. Department of Veterans Affairs for those in the military.

Choose your loan term. Generally, I recommend a 30-year fixed-rate loan, which may give you flexibility in case financial concerns arise in the future. However, I recommend you make additional payments on principal to pay off the loan sooner if possible.

1.f. Determine down payment and up-front costs. Before you buy, remember that the down payment on a loan may be from 3 to 20 percent of the cost of the home, and the closing costs may be an additional 2 to 5 percent. Be aware that these costs are significant; given that these costs are paid up front, they must be planned for before you purchase the house.

Points are one percent of the loan value, or 100 basis points of the loan. Lenders charge points to recover costs associated with lending, to increase the effective interest rate they are receiving, to provide for negotiating flexibility in a market where interest rates fluctuate, and to adjust for differences in risk between loans. Points are deducted directly from the loan amount at closing. In other words, if you have a $200,000 loan with two points (2 * $2,000), you will only receive $196,000 at closing—the mortgage broker will keep $4,000. However, you will have to pay back the full $200,000.

Other up-front costs include title insurance, attorney fees, property survey fees, recording fees, lender's origination fees, appraisals, credit reports, termite/mold inspections, escrow payments, and the home inspection report.

Your impound account (or escrow, or reserve account) is the portion of your monthly loan payments that is held by the lender or servicer to pay for specific costs. These costs include property taxes, hazard insurance, mortgage insurance, and other items as they become due. These payments are made in addition to your monthly mortgage payments of principal and interest. An impound account may or may not be required for a loan, depending on your lender.

1.g. Have copies of two years of tax returns. Lenders want confirmation that you can pay back the loan. As such, they generally want to see two years of tax records for documentation. If you are a recent college graduate, you might share a confirmed job letter with salary.

1.h. Get pre-approved—not pre-qualified. Know that you should get pre-approved for a mortgage, not just pre-qualified. In addition, know your affordability ratios that the bank uses to determine credit worthiness. Pre-approved means the financial institution has done all the necessary analyses to qualify you for a loan, including checking your credit report and approving you for a specific amount. Pre-qualified, on the other hand, means that the financial institution

has essentially said that you will roughly qualify for some undetermined amount on a mortgage loan. Many times people have thought that they were pre-approved for a loan when they were only pre-qualified. When it comes time for these people to close on a house, they may discover they can't get all the money they need. Not only do they lose the house but they may lose their earnest money as well. (Earnest money is given by a buyer to a seller to show their good faith.) Should the deal fall through, the earnest money may be forfeited.

Step 2: Establish a Sound Plan and Find Your Home

Plan what you want, and then work your plan. There is a five-step process for finding your home.

2.a. Determine what is important to you. Determine what is important to you: how much of a commute are you willing to endure? How important is it that your house is close to schools? Do you need a yard for your kids? Do you want a flat lot or a lot on a hill? Write down which qualities you will and will not do without; articulate what you want regarding your desired location, type of home, future plans, and so on. Realize you will probably move within five to seven years if you are like the average US family.

2.b. Develop a plan and build your team. Once you know your limits, what you can afford, where you want to be, and what you want, you can then start developing your plan. How will you find your home? What resources will you use, including realtors, online resources, etc. In what areas will you look, in in what types of homes?

Be wise in your decisions, as you may be in the house you buy for a long time. Therefore, be patient and take your time in deciding which house to purchase.

Estimate the amount of time you will be in the house. If it is less than three to five years, consider renting. Remember, you will have to make at least seven percent on the selling price when you sell your house to break even from realtor's fees alone; you must also consider how much you paid for other up-front fees. Buying a house will likely be the largest financial commitment you will make for a long time, so be wise.

I often recommend that recent college graduates should generally plan to rent a nice apartment for at least 6 to 12 months before they buy a house. This gives them the time they need to search thoroughly, figure out what they want, decide on the area where they want to live, and determine which amenities they want in a house and location.

Do your homework—and footwork. Buying a house is not easy. It takes time, thought, and effort. Find a good realtor to help you. Realize that realtors work for the seller instead of for you, the buyer: as the seller pays the realtor's fees. It may be wise to hire a buyer's broker (or realtor), who works for you and gets paid by you as well. This buyer's realtor should be someone who knows the ins and outs of the neighborhoods you are interested in.

Use a team approach. Get others to help you in the process of buying a home. Remember, you can't, and shouldn't, do everything by yourself. Get a good appraiser who can help you make

sure you don't pay too much for a house. Get a good lawyer who can help you make sure you fill out the correct forms. Most importantly, get a good home inspector. The last thing you want to do is buy someone else's problems. Use multiple home inspections if necessary. Don't become emotionally attached to a potential house. The best thing you can do in many cases is to just walk away.

2.c. Have a home inspection. Once you have found the home you like, can afford, and is where you want to live, have a home inspection. While this is at your expense, it may alert you to potential problems with the home before you decide on the purchase. Many of these problems should be fixed by the seller prior to purchase at the seller's expense. Don't buy someone's problems.

2.d. Determine any CCRs, fees, and costs. With your home you like, look to potential costs. Look first through all Covenants, Conditions and Restrictions (CCRs) for your potential home. What additional costs are required. These can be quite restrictive as to what you can and cannot do with your home. If you cannot live with the CCRs, don't buy there.

There also may be lane or other monthly fees. Moreover, for condos or town homes, determine the amount of the transfer/setup fees. Understand any other homeowners/association fees for potential homes and what they include.

Finally, ask to see records of monthly utility costs and other monthly expenses. Compare these to your current costs for additional expenses. Remember that these costs will vary depending on the season so try to find the last few years of utility costs. Make sure these costs are consistent with your budget.

2.e. Negotiate the price of the home. Use the best available resources to negotiate a price for the home. Use wisdom and judgment in determining what you can and should pay for the home. Compare the cost of your potential home to those which may have sold recently. If you are working with a realtor, have them do a "comps" study of homes that have sold recently in the area.

This is a negotiation process—do not be afraid to haggle, and your best negotiating technique is walking away. Also realize that closing costs, things that need to be fixed from your home inspection report, and other things can all be part of the negotiated price. Most things are negotiable.

Step 3: Find, Fund and Service the Loan

Finding, funding, and servicing the loan is a five-step process.

3.a. Understand the lending process. This process utilizes the services of a number of different professionals, including realtors, lenders, title insurance professionals, and escrow professionals (see Chart 1).

The key players in this process are the realtors and mortgage brokers. Realtors, or real estate brokers, are individuals or companies who act as intermediaries between sellers and buyers of real estate. Unless stated otherwise, they represent the seller and the seller's interests and are paid by the seller. Generally, sellers pay a commission to the realtor for selling the property, which is split between the listing realtor (the realtor who listed the property), and the selling realtor (the realtor who brought the buyer of the property to the seller). The commission is generally a percentage of the value of the property and may range from five to seven percent or more.

Mortgage brokers are individuals or companies that arrange loans between the lenders (those who have money to lend for mortgage loans) and borrowers. Traditionally, banks and other lending institutions sold their own products. However, as the markets for mortgages became more competitive, the mortgage brokerage industry evolved and broadened beyond banks.

Mortgage brokers make money two ways: origination fees and discount points. Origination fees are the costs and profits on making the loan, while discount points are payments by the borrower to lower the loan interest rate.

3.b. Choose Multiple lenders and get Loan Estimates (LEs). To get the best deal in the lending process, the key is competition. You will get a lower interest rate on your loan when lenders compete for your business. Work with multiple lenders. Talk with friends and others who have gone through the process and ask for the names of their favorite brokers. Hold brokers accountable for what they say.

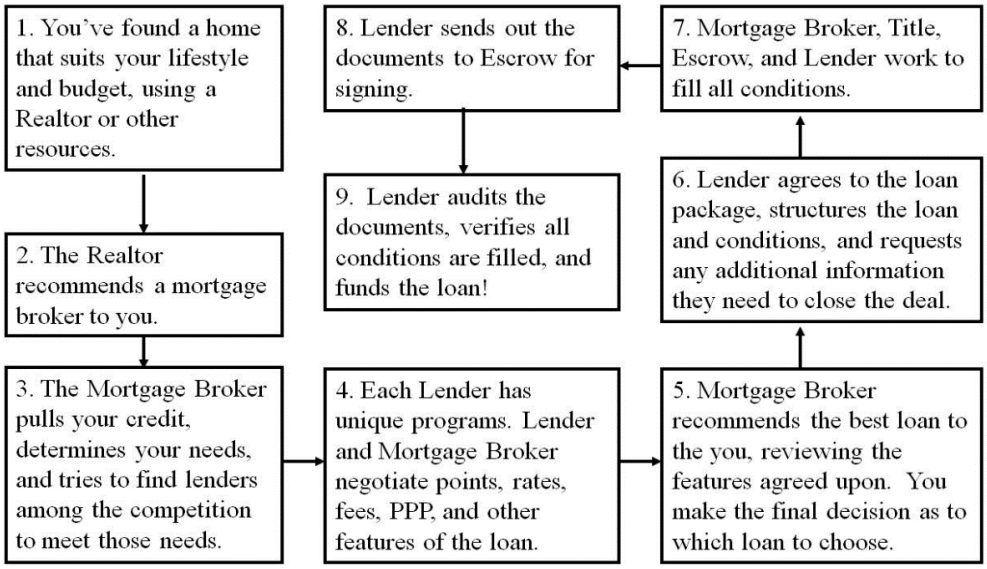
Get Loan Estimates (LEs) from each lender (and not just a Summary). A LE is an outline of the cost to be charged upon the closing of the loan. The LE also acts as protection for borrowers to keep lenders honest on what they charge. These are the estimated costs you will likely pay when the loan closes. Then compare LEs from each lender.

3.c. Calculate your Effective Interest Rate. Calculate your effective interest rate from each of your lenders. As inputs to this, estimate how long you will be in the home. This is important as it helps determine over what period you can allocate points and other costs. From your GFE, calculate your effective interest rate for each loan. Your effective interest rate is the interest rate you will pay after all your points, costs, and fees are taken into account and will be discussed in the next section.

The key is to get your best rate. Your lowest effective interest rate is the best indicator that you got a good rate on your loan.

3.d. Negotiate with your favorite lender. Once you have multiple offers from multiple lenders, you have bargaining power. Determine your lowest effective interest rate, which includes points, fees, and the loan APR after evaluating each of the offers from the various lenders. That is your beginning point. You can take that offer if you want.

Chart 1. The Lending Process



However, generally I recommend you take that offer to your favorite lender, and ask them to beat it by 1/8 to 1/4 percent and you will go with them. Remember, if they don't get your business they don't make any money.

In summary, mortgage brokers make money in two ways: origination fees and discount points. Origination fees are the costs and profits on making the loan. Discount points are payments by the borrower to lower the loan interest rate.

The objective in borrowing for a home is to minimize the interest rate you pay and the points and fees you pay (origination and discount points). How do you minimize these two areas? Following are a few ideas:

1. Talk with multiple mortgage brokers. Make this a competitive process. Remember that multiple institutions requesting your credit report and score within a specific period of time are only counted as a single request on your credit score. Get multiple bids.

2. Compare rates and points across different brokers from different companies. This will give you a general idea of rates and points, which can be very helpful.

3. Look at the minimum interest rate they will let you buy down to. Perhaps it is close to the lender's required rate. Once you have a feel for that rate, it may give you an indication of what the mortgage broker's back-end bonus would be.

4. Once you find the best rate and points from the multiple mortgage brokers you checked on, go to your favorite broker and agree to go with him or her if he or she can beat the best offer by 1/8 to ¼ percent.

Pay off the loan early and save. The key now is to service the loan consistently. Make sure payments are on time. Set up procedures to ensure you do not miss payments.

Strive to pay off the loan early. We recommend you set a goal to pay it off after a certain number of years. This increases the money you can save for your personal and family goals once the loan is paid off. This also brings freedom from worry when you own the home instead of still needing to make payments.

Step 4: Enjoy Home Ownership

If you have completed the home-buying process well, you will enjoy the fruits of your labors for many years. Maintain your home well. If you take care of your purchase, it will take care of you. For example, having your home professionally cleaned a few times a year can help retain your home's value. For budgeting purposes, realize that maintaining your home will generally require roughly one percent of the home's value each year, so add that amount to your budget. This amount should be an included expense you will likely pay each year.

Summary

Buying a home is not easy. The purchase of a home will likely be the largest financial commitment you ever make. As such, you should not rush into this commitment. If you use wisdom and judgment in trying to decide what you want, what you can afford, and where you want to live, and if you will listen to and obey the promptings of the Holy Ghost, you will make correct decisions regarding your housing needs.

Understanding the key principles of home ownership are critical. These include:

- Understand yourself and your current and future housing needs.
- Seek, receive, and act on the Spirit's guidance.
- Understand the process of finding, buying, and funding a home.
- Be wise in your finances.
- Be a good steward over all your blessings.

There is a process to buying a home, which, if followed, will help you make wise decisions in buying a home. The process is the following.

- Understand your limits.
- Establish a plan and find your home.
- Negotiate your loan.
- Enjoy home ownership.

There is much to learn and remember when buying a home. Keep your goal of buying a home in the perspective of your overall goals and objectives. Develop a home buying strategy, and follow it when you are buying a home. Buying a home is an important goal—but it is not the only one.

In spite of the challenges associated with buying a home, having a home may bring many blessings and opportunities.

Assignments

Financial Plan Assignment

As you think about where you want to live, it is important to develop your own housing strategy. Include this as part of your PFP Education, Mission, Home and Auto Template (LT01-15).

Start first from where you are. What is your current housing strategy? Where do you currently live? What expenses and fees are you paying, including rent, mortgage, maintenance, utilities, gas, repair and insurance? How can you reduce your housing expenses?

Then work on your Housing Plan. This will be covered in the following chapter.

Learning Tools

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

Maximum Monthly Payment for Christian Savers (LT11)

This Excel spreadsheet will help you determine the maximum amounts that financial institutions will generally lend; the spreadsheet uses traditional front-end and back-end ratios. However, traditional banking ratios do not take into account the fact that Latter-day Saints pay tithes and other offerings and save a certain percentage of their earnings. This spreadsheet allows you to take these other factors into account and illustrates that you should be borrowing less for a home than those who do not pay tithes and offerings.

Home Loan Comparison with Prepayment and Financing (LT19)

This Excel spreadsheet helps you determine the effective interest rate for multiple home loans; it takes into account the loan amount, interest rate, compounding periods, points, and other fees. In addition, it also calculates the rate, assuming prepayment, after a certain number of years. The spreadsheet also helps you determine how much time and money you will save if you prepay a specific amount of principal each period over the life of your loan.

Debt Elimination Schedule with Accelerator (LT20)

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

Terminology Review

Annual Percentage Rate (APR). The APR is a rate that is generated from a precise calculation specified in Regulation Z. It only takes into account the fees going into the loan and does not take into account the time value of money.

Balloon Mortgages. These are mortgage loans whose interest and principal payment won't result in the loan being paid in full at the end of the term. The final payment, or balloon, can be significantly large. These loans are often used when the debtor expects to refinance the loan closer to maturity.

Buyer's Broker. This is a realtor that works specifically for the buyer and is paid by the buyer. The have a fiduciary responsibility to the buyer and not the seller which is different from the traditional buyer seller broker relationship.

Conventional Loans. These are loans that are neither insured nor guaranteed. They are below the maximum amount set by Fannie Mae and Freddy Mac of $417,000 in 2014 (single family). They require Private Mortgage Insurance (PMI) if the down payment is less than 20%.

Covenants, Conditions and Restrictions (CCRs). These are legal documents that can affect what you can do with any potential homes. These can be quite restrictive as to what you can and cannot do with your home including exterior, landscaping, and other requirements. If you cannot live with the CCRs, don't buy there.

Debt Obligations or Back-end Ratio. This housing affordability ratio calculates what percent of your income is used for housing expenses plus debt obligations. It should not exceed 36% of your monthly gross income. The formula is: Monthly PITI and other debt obligations/ monthly gross income < 36%. Debt obligations include mortgage payments, credit card, student loan, car, and other loan payments. PITI = Principal, interest, property taxes, and property insurance

Discount Points: These are payments made by the lender to reduce the interest rate on the loan. They are somewhat similar to prepaid interest. You pay more upfront in points but you will pay less on interest costs in the future. Your challenge is to minimize your overall interest costs, i.e., your effective interest rate.

Down Payment. This is the amount that you pay on the house to reduce the cost of the loan. Generally, lenders like a significant down payment as that indicates that the borrower is not likely to walk away from the loan. Different loans require different down payment amounts, i.e Conventional loans – 20 % recommended (but you can get in with 5%), FHA loans – 3.5%, and VA loans – 0% down payment required.

Good Faith Estimates (GFE). This is an estimate from each lender (not just a Summary) of the likely costs you will likely pay as you complete the loan process. I recommend you get GFEs from each potential lender and compare them.

Home Inspection. This is a service, usually paid for by the buyer, to alert them to potential problems with the home. Many of these problems should be fixed by the seller

prior to purchase and so these problems need to be discovered and disclosed. Don't buy someone's problems.

Housing Expenses or Front-end Ratio. This is a housing affordability ratio that calculates what percent of an your income is used to make mortgage payments. Housing expenses should be less than 28% of your monthly gross income. The formula is: monthly PITI*/monthly gross income <28%. PITI = mortgage principle, mortgage interest, property taxes, and property insurance.

Impound/escrow/reserve accounts. These accounts are that portion of a the monthly payments held by the lender or servicer to pay for: Taxes, Hazard insurance, Mortgage insurance, Lease payments, and Other items as they become due. These are for payments for items above which are over and above your monthly mortgage payments of principle and interest. These may or may not be required by your lender.

Housing Ratios for Christian Savers. As Christians, we have other important obligations that we also pay, i.e., tithing and paying ourselves, i.e., savings. As such, should have smaller houses (at least less expensive), because we pay the Lord first and ourselves second. For a spreadsheet that takes into account the fact that we pay the Lord first and ourselves second within this front-end and back-end ratio framework, see: Maximum Monthly Mortgage Payments for Christian Savers Spreadsheet (from the website).

Loan term. This is the duration of the loan. It can be 10, 15, 20 or 30 years depending on your goals and your cash flow situation.

Origination fees: These are the costs and profits made by the mortgage broker for originating the loan.

PITI (Principle, interest, property taxes and insurance). This is the acronym for the separate parts of a typical mortgage.

Piggyback loans. These are two separate loans, one for 80% of the value of the home and one for 20%. The second loan has a higher interest rate due to its higher risk. The second loan is used to eliminate the need for PM Insurance. With a piggyback loan, PMI is not needed, but these are much harder to get now.

Points. Points are fees for a loan. 1 Point is one percent or one hundred basis points of the loan. This money is pre-paid interest, money paid to the mortgage broker (not the lender). It is deducted from the loan proceeds (you still must pay it back), and is essentially another fee for helping you arrange the loan (minimize points). Lenders charge points to recover costs associated with lending, to increase their profit, and provide for negotiating flexibility. You will like have to pay origination points, but buy-down points (to reduce the interest rate on the loan) are purely optional.

Pre-approval. Pre-approval is the process whereby lenders have pull your credit score, looked at your tax records and approve you for a specific amount of a loan. Get pre-approved for your loan by a number of lenders (with mortgage loans, you can have multiple loans requested within a 90 period and its counted as one loan request). You can borrow up to this pre-approved amount without a problem. Remember however that you do not need to borrow that amount. I recommend you borrow less than that amount.

Pre-paids. These are the expenses put into escrow at closing, usually including real

estate taxes, insurance, and interest.
Prepayment. Prepayment is the process where you repay the loan early, either through paying off the loan or selling the house and then paying off the old loan.
Prepayment Penalties. These are penalties enforced by the lender for prepaying a loan too soon. Prepayment penalties have a stated period of time, i.e., 1, 2, or 3 years the prepayment penalty is in effect, a maximum pay down percentage (MPP), i.e., 6% of the principal per year, and a prepayment penalty if you sell it before, i.e., 6 months interest. With a soft prepayment you cannot within the stated period of time without penalty, refinance at all, sell the loan to family members, or pay down more than your MPP each year. The only way to get out of a soft prepayment penalty is to sell the property to an unrelated party. With a hard prepayment, you cannot within the stated period of time without penalty refinance at all, sell the loan to anyone, or pay down more than your MPP each year. There is no way to get out of a hard prepayment penalty before the defined period without paying the penalty.
Pre-qualified. Pre-qualified is a process where lenders estimate your credit based on information you tell them. I recommend you get pre-approved, not pre-qualified.
Private Mortgage Insurance (PMI). This is an insurance policy the borrower buys to protect the lender from non-payment of the loan. PMI policies are usually required if your down payment is less than 20% of the appraised value.
Realtor or Real Estate Broker. This is a person supposedly trained in the process of selling and buying real estate. You want a realtor that know the market in the area you are looking at. Remember that realtors are paid by the seller, so remember that in your associations. Sellers divide the sales commission (usually 6-8%) between the listing realtor and the buying realtor.
Title Insurance. This is an insurance policy that insures you against errors in the title search, guaranteeing your and your lenders financial interest in the property.
Total Costs Analysis. This is a form of loan analysis that does not take into account the time value of money, but is simple to calculate. To do this, calculate your total new costs and fees from the loan until it is paid off, your total current monthly principal and interest costs remaining without refinancing, your total refinance monthly principal and interest costs. If you will be paying equal or less overall, it likely does not make finance sense.
Underwriting. Underwriting is the process whereby the borrower fulfills the requirement of the lender and the lender funds the loan. It also includes the lender selling the loan and the loan being syndicated and sold to investors.
Upfront costs. These are cost due at the signing of the loan which include closing costs and points, down payment (3-20 percent of the loan amount), and other closing costs including points (3-7 percent).

Review Questions

1. We have been counseled to stay out of debt with the exception of what two things?
2. What are the four options in regards to the home decision?
3. According to the *Handbook for Families*, how much of our take-home pay should we

spend on our total house payment, including taxes, insurance, and maintenance costs?

4. In regard to a home mortgage, what are "points"? Why do lenders charge points?

Case Studies

Case Study 1

Data

Bill and Brenda make $60,000 per year. They found the house they want for $225,000. They are looking at a 30-year fixed rate loan at 6.5%, and estimate property taxes and insurance costs at $200, a car loan of $270 and student loans of $50 per month. They pay tithes/offerings of 11%, save 15% in their company 401k (tax deferred and with a 5% match), and they estimate their marginal tax rate at 17%.

Calculations

Calculate Bill and Brenda's front-end ratio and back-end debt to income ratios for banks (28 percent and 36 percent, respectively) and for savers. What is the amount most banks will lend them (remember that most banks will lend to the lower of the two ratios)?

Case Study 1 Answers

1. Bank Front-End Ratio Calculations at 4.5%

PITI / Gross Income

Monthly Income ($60,000 / 12) $5,000

$5,000 * 0.28% 1,400

Real Estate Tax (T) and Insurance Payments (I) –200

Maximum Monthly Mortgage Payment of Principal (P) and Interest (I) 1,200

Set 4.5% = I, PMT = 1200, N = 30 * 12, PV

Maximum Amount Bank Will Lend = $236,833

1. Saver Front-End Ratio Calculations at 4.5%

Income ($60,000 / 12) $5,000

Adjustments

- 11.0% *(1-.17% tax shield) = 9.1%
- 15.0%*100%*(1-.17% tax shield) = 12.5%
- Total adjustments = 21.6%

Subtract adjustments, percentages and insurance

- 5,000 * (1-.216) = $3,920 *.28 – 200 = $898

Calculate amount based on adjustments

- Set 4.5% = I, Pmt = 1200, N=30, PV = ?
- $177,207 Maximum Monthly Mortgage Payment

2. Bank Back-End Ratio Calculations at 4.5%

(PITI + Debt Expenses) / Gross Income

Monthly Income	$5,000
$5,000 * 0.36%	1,800
Real Estate Tax and Insurance Payments (I)	200
Monthly Debt Payments: Car Payment	270
Student Loan	50
Maximum Monthly Principal and Interest	1,280
Set 4.5% = I, PMT = 1280, N = 30 * 12, PV	
Maximum Amount Bank Will Lend	$252,622

2. Saver Back-end DTI Ratio Calculations at 4.5%

   Monthly Income = $5,000

   Adjustments

   - 11.0% *(1-.17% tax shield) = 9.1%
   - 15.0%*100%*(1-.17% tax shield) = 12.5%
   - Total adjustments = 21.6%

   Subtract taxes & insurance, and loans

   - 5,000*(1-.216) = $3,920*.36 – 200 - 320 = $892

   Calculate amount based on projections

   Set 4.5% = I, Pmt = 892, N=30, PV = ?

   $175,959

Maximum Monthly Mortgage Payments for LDS Borrowers (LT11)
Includes Charitable Contributions and Savings

Directions: Fill in the green cells with your data. Be careful not to modify the blue cells

Loan Data and Closing Costs:	
Estimated Mortgage maturity (in years)	30
Estimated FIXED interest rate	4.50%
Estimated monthly real estate tax and insurance payments	200
Marginal Tax Rate	17.0%
Method 1: Housing or Front-end Debt to Income Ratio (LT11)	
Maximum Mortgage Payment Using the Ability to Pay and PITI Ratio	
a. Annual income	60,000
Calculated monthly income	5,000
b. Percentage of PITI (principal, interest, taxes and insurance) to monthly gross income that lenders will lend in the form of a mortgage loan	28%
Estimated Maximum monthly mortgage payment	1,400
c. Estimated monthly real estate tax and insurance payments	200
Maximum monthly mortgage payment using the 28% Rule	1,200
d. Maximum mortgage amount using the Front End Ratio	$236,833
With Adjustments for Christians Paying Tithes/Offerings and Paying Yourself:	
Tithes and Other Offerings (in percent)	11.0%
Effective cost of donations (after your tax shield)	9.1%
Payments to yourself, i.e. retirement savings, 401k, Roth IRA, IRAs,	15.0%
Percent of personal savings that is tax-deferred (IRA, 401k, SEP IR	100.0%
Effective cost of savings (after your tax shield)	12.5%
Total Additional Payments not usually included in this calculatio	21.6%
Maximum adjusted monthly mortgage payment using the 28% Rule	897.88
e. LDS adjusted maximum mortgage using Front-end DTI ratio	$177,207

Maximum Monthly Mortgage Payments for LDS Borrowers (LT11)
Includes Charitable Contributions and Savings

Directions: Fill in the green cells with your data. Be careful not to modify the blue cells

Loan Data and Closing Costs:	
Estimated Mortgage maturity (in years)	30
Estimated FIXED interest rate	4.50%
Estimated monthly real estate tax and insurance payments	200
Marginal Tax Rate	17.0%
Method 2: Debt or Back-end Debt to Income Ratio (LT11)	
Maximum Payment Using the Ability to Pay, PITI Plus Other Fixed Debt Expenses	
a. Monthly income	5,000
b. Percentage of PITI+current monthly fixed payments to your current gross income that lenders will lend in the form of a mortgage loan	36%
Total amount at 36% ratio	1,800
c. Estimated monthly real estate tax and insurance payments	200
d. Current nonmortgage debt payments on debt that will take over 12 months to pay off and other monthly legal obligations	
Auto loans, credit card debt you cannot pay off in 12 months	270
Student Loans, child support, alimony, or other long-term debt	50
Total long-term non-mortgage debt payments	320
e. Maximum payment using the Debt or Back-end DTI Ratio	1,280
f. Maximum payment using PITI plus Other Fixed Debt Payments R	$252,622
With Adjustments for Paying Tithes/Offerings and Paying Yourself:	
Tithes and Other Offerings (in percent)	11.0%
Effective cost of donations (after your tax shield)	9.1%
Payments to yourself, i.e. personal/retirement savings, 401k, IRAs,	15.0%
Percent of personal savings that is tax-deferred (IRA, 401k, SEPs,	100.0%
Effective cost of savings (after your tax shield)	12.5%
Total Additional Payments not usually included in this calculatio	21.6%
Maximum adjusted monthly mortgage payment using the 36% Rule	891.56
e. LDS adjusted maximum payment using Back-end DTI ratio	$175,959

Application

Since the bank will generally lend the lesser of the two ratios, they would likely be allowed $236,855.

The saver would adjust his prices downward toward $180,000.

Conclusions (LT11):

Maximum Mortgage Amount using Method 1:	$236,833
Maximum Mortgage Amount using Method 2:	$252,622
Lower of the Two Methods, and Most likely to be used by the Bank	$236,833

Maximum Adjusted Mortgage Amount using Method 1:	$177,207
Maximum Adjusted Mortgage Amount using Method 2:	$175,959
Average of the Two Methods (for food for thought) for LDS	$176,583

[1] All Things Cherished Blog, http://allthingscherished.blogspot.com/2008_05_04_archive.html
[2] "The Times in Which We Live," *Ensign*, Nov. 2001, 72
[3] "Preparing for Emergencies," *Ensign*, Dec. 1990, 59

16. The Housing Decision II: Comparing Loans and Creating Your Housing Plan

Introduction

Once you understand the home buying process, it is important that you understand your options in the home decision, the process of comparing different mortgage loans, and how to crate your housing plan.

Objectives

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

A. Understand your options in the housing decision.
B. Understand how to compare different types of loans with different fees and points.
C. Understand and create your Housing Plan.

Understand Your Options in the Housing Decision

Some individuals will be making decisions about buying a house soon because of graduation, marriage, or prospective job offers. Should you buy a house immediately, or should you rent for a while? Are you interested in building or renovating? Decisions about housing are challenging but inevitable. As you understand yourself, your goals, and your job, you will be equipped with valuable information that will help you as you make the home decision. There are four major options for the home decision: renting, buying, building, renovating and other.

Renting

Renting has many advantages, including mobility. When you rent, it is relatively easy and relatively inexpensive to move from one place to another if your job or life situation changes. There are no costs for repairs or maintenance: for example, you don't have to worry about the cost of replacing the water heater or other household appliances if they break down. Another advantage is that financial commitments are lower with renting than with buying: rent costs are relatively low, there are fewer initial costs associated with moving in, and there are none of the legal headaches that often accompany buying a home. Finally, rent is easy to budget. You generally have only one bill—rent—to worry about.

Nevertheless, renting also has its disadvantages, such as a lack of stability and lack of the pride that comes from ownership. You can't modify your rental house as you would be able to modify a home. Although you can put up pictures, you can't paint walls, put up wallpaper, or renovate

the kitchen. Another disadvantage is that rent may increase unexpectedly. Someone else makes major financial decisions that affect you; these decisions can have a huge impact on your budget and pocketbook. There may also be restrictions on where you can rent: zoning laws make some locations unavailable. Tax benefits are also missing when you rent. Since you pay no interest as part of your rent, you cannot deduct interest costs from your taxable income. Finally, there is no potential for property appreciation with renting.

Buying

Many of the disadvantages of renting are advantages to buying a home. With buying, there is permanence and a pride of ownership. You can change the paint color, the kitchen, the landscaping, the garage, and so on. Generally, the monthly payment is fixed. The decision on how you pay for the house is between you and the bank, and once you decide, you won't have to worry about payment fluctuations. Buying allows you to use leverage, which means you can own the house using borrowed money, up to 95 percent in some cases. Another advantage to buying is that you get Uncle Sam's help. The interest payments you make to the bank or mortgage company on your house can be deducted on your itemized tax forms from your adjusted gross income, or AGI. Finally, you can borrow against the equity in your home. Equity is the difference between what your house is worth and how much you have borrowed to buy it. In emergencies, you can borrow money from the bank against your home's equity to meet your specific goals and needs.

However, buying also comes with disadvantages. Mobility is low, since houses are not liquid assets. It would likely be a challenge to sell the house quickly, and it is generally expensive to sell illiquid assets. Other disadvantages to buying include significant up-front costs, such as the down payment, points, title, and title insurance. Also, it generally costs more to own and operate a home than to rent. Costs for utilities, repairs, water, landscaping, painting, and so on are avoided when you rent but must be paid when you own. Finally, buying a home is a large financial commitment. Owning a home is a costly investment—in terms of dollars, time, and energy. And because a home is a large financial commitment, you need to remember that the home's value could decrease, that its mortgage could default, or that it could need repairs.

Building

There are many advantages to building. You can build exactly what you want because you design the house. Sometimes it is even cheaper to build than to buy, depending on market conditions. With building, you get new appliances and housing systems, so repairs in the first few years are generally less. And you can pick the location of where you want to build, assuming lots are available.

However, building also has disadvantages. It may be difficult to interpret building plans, such as the size of rooms, if you are unfamiliar with these plans. Building, like renovating, often exceeds the budget and has delays if not done correctly by competent labor. Building also necessitates additional expenses for a yard and fencing. There are also expenses for construction-loan interest

and rental costs that are incurred while you are waiting for the home to be built. Most importantly, there are high monitoring costs, in terms of time and money; high stress tolls, as you make the myriad decisions about the house; and high risk that the project may become more expensive than planned.

Renovating

The advantages of renovating include that you can often accomplish your housing goals faster than with building because the outside structure of the house is already in place. Another advantage is that you can generally see the house you are getting. It may be cheaper to buy and renovate than to build, particularly if you can do much of the work yourself (i.e., sweat equity). Renovating may be preferable if there are no available lots in a desired area, but there are existing homes for sale.

The disadvantages of renovating include that it may be more expensive to renovate than to build. Renovations often go over budget and have delays because of the uncertainty about what will actually need to be renovated. The rule of thumb for renovating, and sometimes building, is that you should double your budget and then double the resulting amount again. Moreover, you should be aware that you may have unanticipated additional expenses for a yard and fencing, depending on what was renovated. Also, the same construction-loan interest costs and rental expenses may be applicable, depending on how extensive the renovation is. During the renovation process, you may encounter other costly problems that were not noted before. Most importantly, just like in building, there are high monitoring costs, high stress tolls, and high risk that the project may become more expensive than planned.

Other Options

Other options include mobile homes, tiny houses, and recreational vehicles. The advantages of these are their lower costs. The main disadvantages are their much lower resale value, lack of permanence, challenge in getting financing, and the difficulty in building equity.

Understand How to Compare Different Types of Loans with Different Fees

Once you determine what you want and find a house you like, the next step is to determine how much you can afford. Don’t buy the most expensive house in the neighborhood—use wisdom in your purchases. Remember, statistics indicate that most people are likely to move within seven years.

Many factors go into your decision of which loan to choose, and you have lots of options for your mortgage, fixed rate, adjustable rate, fixed with an interest only option and variable with an interest only option. The key factors that go into your choice of mortgage include time horizon, how long will you be in the home; risk tolerance, who will take the interest rate risk; cash flow preferences, how stable is your cash flow; and goals, what are your goals for this home. For help with these questions, see Choosing a Mortgage Loan (LT35).

It is critical that you understand all fees and expenses before you close on a house—there are many expenses. One of the largest expenses is your mortgage. With so many different options available for a mortgage, it is critical that you understand how to calculate a comparable rate on loans with different points and fee structures. Understanding the different expenses involved in buying a house and how to compare different loans with different points and fees will save you a lot of money overall. Critical to this ability to compare is an understanding of points, effective interest rates, how to calculate effective interest rates, and prepayment.

Points

Points are one percent of the loan, or 100 basis points of the loan. Some lenders offer mortgage loans with high contract interest rates and low points, while others offer the opposite. The borrower's challenge is to choose the mortgage contract that minimizes the effective cost of borrowing. How do you differentiate between loans with different interest rates, different points, and different costs? One way is to calculate the effective interest rate (EIR) for each of your loan options; you will then be able to choose the loan that minimizes the effective interest rate.

Effective Interest Rates

The effective interest rate (EIR) is the precise interest rate the borrower pays after all fees and costs have been taken into account. The EIR is different from the annual percentage rate, or APR. The APR is generated from a precise calculation specified in Regulation Z of the Truth in Lending Act. The difference between the APR and the EIR is that the EIR takes into account the costs of points and fees. If the loan has no prepayment, points, or other fees, then the EIR is the same as the APR.

The EIR is important because it allows you to quickly compare rates from various lenders with various schedules and costs; the EIR allows you to choose the rate that gives you the lowest cost. To calculate the EIR, you must make a major simplifying assumption. Many of the fees associated with home-buying are paid out of pocket, meaning that they do not come out of the loan. Other fees (like points) do come out of the loan. The assumption necessary for this calculation is that all fees come out of the loan. This is not an unreasonable assumption, especially if you assume you will pay back all out-of-pocket expenses with proceeds from the loan. Remember, the lender will retain the amount of the loan attributable to points when distributing loan proceeds, but the monthly payment will be based on the entire loan amount.

Calculating Effective Interest Rates

The three-step process for calculating the EIR is:

1. Calculate the payments on the total amount you will be repaying (the amount borrowed). Using your financial calculator, set N = your number of years, I = your interest rate, PV = minus the loan amount, and solve for your payment, or PMT.

2. Calculate the amount of money you actually received (the total loan minus all costs). Again, assume that all costs for the home come out of the loan. This amount becomes your present value (with a minus sign).

3. Set your payment (PMT) to your annual/monthly payment. PV = minus what you actually received, N = your years, and solve for your interest rate. This is the rate you are actually getting based on the costs you are paying.

If you are borrowing $200,000 at 3.75% for 30 years, and you agree to pay one point and $1,500 in fees, the following is your process:

1. Your monthly mortgage payment will be $926.23 (PV = –200,000, I = 3.75, N = 30 P/Yr = 12, and solve for your PMT).

2. One point and $1,500 in fees will be $3,500, resulting in a net to your amount of $196,500 ($200,000 – 3,500).

3. Inputting these figures into the equation, your PMT = $926.23, PV = –196,500, N = 30, P/Yr=12. Solve for your effective interest rate, and you get a rate of EIR of 3.89 percent (see Home Loan Comparison (LT19)).

Home Loan Comparison (LT19.a)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					2
Loan Information:		**Amount Needed (after points & fees):**			$ 200,000
Loan Amount	$ 200,000.00	Total Periods		360	**Rates:**
Interest Rate (APR)	3.75%	Loan Payments:		360	**APR**
Years (1-30)	30	***Prepayment of Principal***			3.75%
Payments per year (12)	12	Number of Prepayments:		0	**Effective**
Monthly Payments	$ 926.23	Total of Prepayments:		$ -	**Interest Rate**
Prepayment after # years?		Savings from Prepayments:		$ (0)	3.89%
	(blank = no early payoff)				
Received Before Fees	$ 200,000	Amount Received After Fees			$ 196,500
Points 1.00	2,000	Other Fees	1,500	Total Costs	3,500

Regular Pmts.	Extra Payments	Pts & Fees	Balloon Pmt	Total Paid	less Received	Interest Paid
333,443	-	3,500	-	336,943	200,000	136,943
Cost of loan without prepayment				Total Paid	less Received	Interest
333,443				336,943	200,000	136,943
					Interest Saved by Prepayment:	**(0)**

Prepayment

Prepayment is the process of paying down the loan early by increasing principal payments or by selling the home. On average, most homeowners in the United States move every five to seven years. You should know how to calculate your effective interest rate when you plan to prepay the

loan (or sell the house) before maturity.

The EIR with prepayment is calculated in a similar manner to the EIR, except you must make an additional calculation for the balloon payment you will make when you pay off the loan:

1. Calculate the payments on the total amount you will be repaying (the amount borrowed). Using your financial calculator, set N = your number of years, I = your interest rate, PV = the loan amount, and solve for your payment, or PMT.

2. Calculate the amount of money you actually received for your loan (the total loan minus all costs). Again, assume that all costs for the home come out of the loan. This amount becomes your present value (with a minus sign).

3. Calculate the balance that will remain after you prepay; in other words, calculate your balloon payment. This is the amount you will need to pay off the remainder of the loan. To calculate the balloon payment, set N to the number of years or periods you will pay off the loan early. If you have a 30-year loan, and you pay the loan off after 12 years, you want to know the present value of 18 years of payments. Set I to your interest rate and PMT to your monthly or annual payments, then solve for the present value. This balloon payment is the amount of principal you will still owe after you prepay your loan. This amount becomes your future value.

4. Finally, set the number of years before prepayment as N (12 years in the above example), the balloon payment or balance remaining as FV, the PMT as monthly or annual payments, and the PV as negative the amount you received after paying points and fees, then solve for I to find your effective interest rate.

For example, assume from the previous problem that you want to know the effective interest rate should you pay off the loan after seven years. The first two steps are the same.

1. Your monthly mortgage payment will be $926.23. (PV = –200,000, I = 3.75%, N = 30, P/Yr = 12, and solve for your PMT).

2. One point and $1,500 in fees will be $3,500, resulting in a net to your amount of $196,500 ($200,000 – 3,500).

3. Your final payment at the end of year seven will be $. This is calculated at PMT = $926.23, N = (30 – 7), P/Yr = 12, I = 3.75%, and solve for your present value.

4. Finally, put these figures into the equation— your PMT = $926.23, PV = –196,500, N = 7, P/Yr = 12 months, FV = 171,116.08—and solve for your effective interest rate. You will get a rate of 4.06 percent (see Home Loan Comparison (LT19)).

Home Loan Comparison (LT19.a)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					2
Loan Information:		**Amount Needed (after points & fees):**			$ 200,000
Loan Amount	$ 200,000.00	Total Periods		360	**Rates:**
Interest Rate (APR)	3.75%	Loan Payments:		84	**APR**
Years (1-30)	30	***Prepayment of Principal***			3.75%
Payments per year (12)	12	Number of Prepayments:		0	**Effective**
Monthly Payments	$ 926.23	Total of Prepayments:		$ -	**Interest Rate**
Prepayment after # years?	7	Savings from Prepayments:		$ 84,524	4.06%
	(blank = no early payoff)				
Received Before Fees	$ 200,000	Amount Received After Fees			$ 196,500
Points 1.00	2,000	Other Fees	1,500	Total Costs	3,500

Regular Pmts.	Extra Payments	Pts & Fees	Balloon Pmt	Total Paid	less Received	Interest Paid
77,803	-	3,500	171,116	252,420	200,000	52,420
Cost of loan without prepayment				Total Paid	less Received	Interest
333,443				336,943	200,000	136,943
				Interest Saved by Prepayment:		**84,524**

Understand and Create Your Housing Plan

As you prepare your Housing Plan, it will be helpful to develop a housing strategy for different periods of your life. This Plan will guide you as you make the housing decision which will impact your financial situation for a long time. Just a few suggestions before you develop this Plan.

- Before you begin looking for a home, spend a significant amount of time trying to understand your needs and requirements. What is important to you, spouse, and children? How important are schools, shopping, work? How long are you willing to commute each day?

- Generally, this will require you to rent for a period of time. Use this time wisely. Try to rent in your preferred area first. Check into rental houses. These can be a good intermediary between renting and buying.

- When you are planning to buy, calculate how much you can afford to spend. Don't spend so much on this goal that you are crimped in your other personal goals. Calculate into your spending the fact that you will be paying tithes and offerings and saving 10-20% each month for savings. Don't buy a "fixer-upper" unless you have the time and the inclination to do it. Remember your first priority is to do well at work. Having a beautiful house may not advance your career (although your spouse may love it).

- Once you have decided on a home don't scrimp on home inspections—they are good investments. Don't let the current owners discourage you from doing home inspections. Beware of the hidden costs of home ownership. Keep room in your budget for these.

- Get pre-approved for your loan, not pre-qualified. Don't spend the maximum amount banks will lend you. Keep good records of improvements for tax purposes. These can increase the cost basis of your home and reduce taxes when you sell.

- If you decide to build the key decision is your contractor. He will either make it extremely easy or difficult for you. Choose wisely. Interview his past clients, and check their financial condition and licenses. Ensure permit repairs have final inspections. Know what you want and put it on the plans in the beginning. Changes are four times as expensive after plans are completed. Work with the contractor (but a penalty clause for completion may be useful). Keep back 5% of the cost of the home until all problems are fixed.

- If you decide to renovate, make sure you have your vision of the house, and make sure that vision is on paper (plans). For every change, ensure a change order is drawn. Keep a running tally of all past, current, and estimated costs to complete the project. Review this weekly with the contractor. You might even put in a clause that if the contractor goes over the planned amount, he makes no new money on the excess over the planned amount. And be aware of the large time commitment necessary to renovate.

Housing Plan Example

As you think through the housing decision, it is necessary for you to create a Housing Plan. Following is an example of a possible Housing Plan that may give you some ideas. We have divided the plans and strategies into each of the specific areas discussed.

Vision

- This will be likely from your Plan for Life. It may also include:
    - We will have a home where the Spirit of the Lord is present.
    - We will dedicate our home and strive to make it a place where the Spirit is felt.
    - It will be both a modest and a model home, modest in terms of the neighborhood and model in that we will keep its value up and live within front- and back-end ratios.
    - It will be a home that is open to our children's friends, as well as open to foreign exchange students and others needing temporary lodging.
    - It is a place where we can be safe and comfortable and we can raise a righteous family.
    - It is where we will teach our children to work.

Goals

- A modest and model home, that we can share with family, neighbors and friends.
- A play area for the kids, and garages for dad, which we will use to bring the family together.
- We will pay our home off by age 45.
- A home that we keep up it value and live within front- and back-end ratios.

- We would eventually like to retire to a smaller home, one that is close to the grandkids and is in the mountains that opens up to the open area by lakes and streams.
- A home that is open to our children's friends, foreign exchange students, and others.

Plans and Strategies

Understand your limits

- We will buy a home consistent with the front- and back-end ratios and keep housing expenses (PITI and utilities costs) at less than __% (40% maximum) of my monthly budget. We will not buy too big a house.
- We will make sure our home fits our budget, not our budget fits our home.
- We will save 5-20% for our first home down payment and pay 20% down on each future home.
- We won't buy a home on two incomes when we know you will go to one income in the future.

Finding your home

- We will do our homework before buying/renting to ensure that we are in the best place for ourselves and our family.
- We will do our homework to ensure that the schools are the best for our children and the neighborhood safe for my spouse.
- We will understand our "must haves" for our home and the "would like to haves" as well.
- We will not buy the largest home in a neighborhood as we know that the highest priced home generally does not sell for more than 10% above the median for a neighborhood.

Finding, funding and servicing the loan

- We will get a minimum of three realtors to bid for my business to ensure that I get the best loan for myself and family.
- We will get the lowest EIR for the loans provided given my expectations of how long we will be in the home.
- We will make additional payments each month to pay off the loan in __ Years (i.e., 15 years).

Enjoying home ownership

- We will dedicate our home to the raising of a righteous posterity. A home need not be paid for to be dedicated to the Lord.
- We will ensure that we keep up the value of the home by budgeting ___% for home maintenance and repair (recommended 1-2% of the value of the home).
- We will keep up the appearance of the home by taking care of yard, interior and structure as a good steward.
- We will have my house paid off by age ___. I recommend that you have your home paid off by retirement and that you do not have mortgage debt in retirement.

- We will strive to have 20% saved for a down payment or to get rid of PMI as quickly as we can.
- We will maintain the value of the home by spending 2% of the home's value each year on maintenance.
- We will replace the roof every 20 years, 10% of the landscaping each year, and internal machinery as needed.
- We will pay off the home as soon as we can, and will not go into additional mortgage debt after age 60.
- We will up each mortgage payment to the closest $100, and will strive to be wise stewards over all areas of home ownership.

Constraints

- Key to paying off the home is living on a budget and saving 20%.
- One half of all unexpected money (bonuses, tax refunds, etc.) will be put toward paying down principal (after our emergency fund).
- We will do all required maintenance and plan on replacing key housing machinery as needed. We will also not skimp on required maintenance.
- While we will try to do most of the work ourselves as a family, and will learn as we go, we will bring in experts in areas outside of our proficiency.
- We will stay strong in the gospel to keep our perspective, keeping our family focused, attending the temple and our meetings, and serving each other.

Accountability

- Children will have daily and weekly indoor jobs, as well as weekly yardwork.
- Home is where we teach our children to work. They will learn to use all landscaping and woodworking tools as we work together on our modest and model home.
- We will rotate the jobs weekly so all children will have the opportunities to work throughout the home and will become proficient on all tools.

For answers to additional questions regarding your housing decision, see The Housing Decision III: Questions and Answers.

Summary

Buying a home is not easy. The purchase of a home will likely be the largest financial commitment you ever make. As such, you should not rush into this commitment. If you use wisdom and judgment in trying to decide what you want, what you can afford, and where you want to live, and if you will listen to and obey the promptings of the Holy Ghost, you will make correct decisions regarding your housing needs.

There are four major options for the home decision: renting, buying, building, and renovating. Each of these options has specific advantages and disadvantages.

One of the largest expenses is your mortgage. With so many different options available for a mortgage, it is critical that you understand how to calculate a comparable rate on loans with different points and fee structures. Understanding the different expenses involved in buying a house and how to compare different loans with different points and fees will save you a lot of money overall. Critical to this ability to compare is an understanding of points, effective interest rates, how to calculate effective interest rates, and prepayments.

There is much to learn and remember when buying a home. Keep your goal of buying a home in the perspective of your overall goals and objectives. Develop a home buying strategy, and follow it when you are buying a home. Buying a home is an important goal—but it is not the only one. In spite of the challenges associated with buying a home, having a home may bring many blessings and opportunities. Develop a Housing Plan when you are young, and follow it. It can be a great tool to helping you accomplishing your individual and family vision and goals.

Assignments

Financial Plan Assignment

As you think about where you want to live, it is important to develop your own housing strategy. Include this as part of your PFP Education, Mission, Home and Auto Template (LT01-15).

Start first from where you are. What is your current housing strategy? Where do you currently live? What expenses and fees are you paying, including rent, mortgage, maintenance, utilities, gas, repair and insurance? How can you reduce your housing expenses?

Then work on your plans and strategies. What is your housing strategy? I would break this down into your four areas: understanding your limits; finding your home; finding, negotiating, and funding your loan, and enjoying home ownership.

Strategies may include how often you will move, down payment strategy, negotiation strategies, strategies for warranties, how long you will stay in the house, etc. Again, the purpose of this strategy is to help you make wise decisions as to your housing needs and wants.

Learning Tools

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

Maximum Monthly Payment for Christian Savers (LT11)

This Excel spreadsheet will help you determine the maximum amounts that financial institutions will generally lend; the spreadsheet uses traditional front-end and back-end ratios. However, traditional banking ratios do not take into account the fact that Latter-day Saints pay tithes and other offerings and save a certain percentage of their earnings. This spreadsheet allows you to take these other factors into account and illustrates that you should be borrowing less for a home

than those who do not pay tithes and offerings.

Home Loan Comparison with Prepayment and Financing (LT19)

This Excel spreadsheet helps you determine the effective interest rate for multiple home loans; it takes into account the loan amount, interest rate, compounding periods, points, and other fees. In addition, it also calculates the rate, assuming prepayment, after a certain number of years. The spreadsheet also helps you determine how much time and money you will save if you prepay a specific amount of principal each period over the life of your loan.

Debt Elimination Schedule with Accelerator (LT20)

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

Terminology Review

Breakeven Analysis. This is a form of loan analysis that does not take into account the time value of money, but is simple to calculate. You calculate all new costs and fees for the new loan, and savings in principle and interest over the old loan. You then divide all new costs by monthly savings which will give you your breakeven point in months. If your breakeven point is less than 4 years, it may be a good idea, 5-7 years, it might be considered, or greater than 7 years, be careful. You may likely move before 7 years.

Internal Rate of Return (IRR). This is a form of loan analysis to determine whether you should refinance or not. The process is to calculate all costs and fees for the loan, calculate the monthly savings, determine the number of months of savings, and set the number of months on the new loan equal to the number of months remaining on the old loan so you are not extending the loan! If your IRR is greater than your risk-free rate, then refinance.

Housing Ratios for Christians. As Christians, we have other important obligations that we also pay, i.e., tithing and paying ourselves, i.e., savings. As such, should have smaller houses (at least less expensive), because we pay the Lord first and ourselves second. For a spreadsheet that takes into account the fact that we pay the Lord first and ourselves second within this front-end and back-end ratio framework, see: Maximum Monthly Mortgage Payments for Christian Savers Spreadsheet (from the website).

Refinance. The process of getting another mortgage loan on your home and repaying the old loan with a goal to reducing your interest and other costs overall.

Short-sell. A short-sell is where a lender allows a property to be sold for less than the

amount owed on a mortgage and takes a loss. A short sell allows the borrower to avoid foreclosure, which involves hefty fees for the bank and poorer credit outcome for the borrower, and the lender to make "less" of a loss on the property and to not enter foreclosure. A short sell does not necessarily release the borrower from the obligation to pay the remaining balance of the loan.

Review Questions

1. What are the four options in regards to the home decision?
2. According to the *Handbook for Families*, how much of our take-home pay should we spend on our total house payment, including taxes, insurance, and maintenance costs?
3. What is the best measure of the total cost of a loan?
4. What is the best way to determine if you received a good loan or not?

Case Studies

Case Study 1

Data

You have decided on your dream house (well, at least your first house). In discussions with your mortgage broker, you have the choice between two loans, both of which are amortized over 30 years. Loan A is for $200,000 at 6.0 percent with no points or loan-origination fees, and Loan B is for $203,535 at 5.75 percent with a $1,500 loan fee and one point (both loans will receive $200,000 after the stated fees). In the problem we assumed you use the money from the loan to pay for the points and fees.

Calculations

Assuming you plan to stay in the house for 30 years, which loan is more advantageous based on the effective interest rate (EIR) and assuming annual payments?

Loan A: $200,000 at 6.0 percent, no points, no fees, 30 years

Loan B: $203,535 at 5.75 percent, 1 point, $1,500 fees, 30 years

Case Study 1 Answers

Notes:

a. Loan A has an EIR of six percent, as there are no fees and points. In that case, your EIR = your APR.
b. To get the amount borrowed after fees to equal the same amount for Loans A and B, I used Teaching Tool 19 and Excel Goal Seek and set Amount Received After Fees to the total loan amount for Loan A.

1. Calculate payment for Loan B.

   N = 30, I = 5.75%, PV = –$203,535, PMT = ?

   PMT = $14,393.25

2. Calculate the amount you received after all fees.

   $203,535 – 1 point ($2,000 * 1) – 1,500 = ?

   $200,000

3. Calculate your effective interest rate.
   Set your PMT = $14,393.25, N = 30, PV = –$200,000, Solve for I.
   I = 5.91%
   Loan B is cheaper.

Home Loan Comparison (LT19.a)

Amount Needed: After points and fees = 1, Before Points and Fees=2:				2
Loan Information:		**Amount Needed** (after points & fees):		$ 300,000
Loan Amount	$ 300,000.00	Total Periods	30	**Rates:**
Interest Rate (APR)	6.00%	Loan Payments:	30	**APR**
Years (1-30)	30	*Prepayment of Principal*		6.00%
Payments per year (12)	1	Number of Prepayments:	0	**Effective**
Annual Payments	$ 21,794.67	Total of Prepayments:	$ -	**Interest Rate**
Prepayment after # years?		Savings from Prepayments:	$ (0)	6.00%
	(blank = no early payoff)			
Received Before Fees	$ 300,000	Amount Received After Fees		$ 300,000
Points	-	Other Fees	Total Costs	-

Regular Pmts.	Extra Payments	Pts & Fees	BalloonPmt	Total Paid	less Received	Interest Paid
653,840	-	-	-	653,840	300,000	353,840
Cost of loan without prepayment				Total Paid	less Received	Interest
653,840				653,840	300,000	353,840
					Interest Saved by Prepayment:	(0)

Home Loan Comparison (LT19.b)

Amount Needed: After points and fees = 1, Before Points and Fees=2:				1
Loan Information:		**Amount Needed** (after points & fees):		$ 200,000
Loan Amount	$ 203,535.35	Total Periods	30	**Rates:**
Interest Rate (APR)	5.75%	Loan Payments:	30	**APR**
Years (1-30)	30	*Prepayment of Principal*		5.75%
Payments per year (12)	1	Number of Prepayments:	0	**Effective**
Annual Payments	$ 14,393.25	Total of Prepayments:	$ -	**Interest Rate**
Prepayment after # years?		Savings from Prepayments:	$ (0)	5.91%
	(blank = no early payoff)			
Received Before Fees	$ 203,535	Amount Received After Fees		$ 200,000
Points	1.00 2,035	Other Fees	1,500 Total Costs	3,535

Paying Off Your Loan Early:

Regular Pmts.	Extra Payments	Pts & Fees	BalloonPmt	Total Paid	less Received	Interest Paid
431,798	-	3,535	-	435,333	203,535	231,798
Cost of loan without prepayment				Total Paid	less Received	Interest
431,798				435,333	203,535	231,798
					Interest Saved by Prepayment:	(0)

Case Study 2

Data

Your spouse suggests that you will likely only be in the home for six years, although you estimate a longer time frame because current job looks very positive. You compromise and estimate that you will be in the home for 12 years. Review your choice between the two loans, both of which are amortized over 30 years but which will be paid back in 12 years with a balloon payment at year 12. Loan A is for the same $200,000 at 6.0 percent with no points or fees, and Loan B is for $203,535 at 5.75 percent with a $1,500 loan fee and one point.

Calculations

Calculate the EIR for both loans, assuming a balloon prepayment after 12 years and annual payments.

Application

Which loan is more advantageous with prepayment using the EIR?

Case Study 2 Answers

1. Calculate payment for Loan B.
   N = 30, I = 5.75%, PV = –$203,535, PMT = $14,393.25
2. Set PV = to the amount you receive after all costs.
   $203,535 – 1 point ($2,000 * 1) – 1,500 = $200,000
3. Solve for your balloon payment at year 12.
   N = 18, PMT = $ 14,393.25, I = 5.75, PV = $158,812.56
4. Solve for your effective rate.
   PMT = $14,393.25, PV is –$200,000, N = 12, FV = $158,812.56, solve for I.
   I = 5.97%
   Loan B is still cheaper (barely).

Home Loan Comparison (LT19.b)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					1
Loan Information:		**Amount Needed (after points & fees):**			$ 200,000
Loan Amount	$ 203,535.35	Total Periods		30	**Rates:**
Interest Rate (APR)	5.75%	Loan Payments:		12	**APR**
Years (1-30)	30	***Prepayment of Principal***			5.75%
Payments per year (12)	1	Number of Prepayments:		0	**Effective**
Annual Payments	$ 14,393.25	Total of Prepayments:		$ -	**Interest Rate**
Prepayment after # years?	12	Savings from Prepayments:		$ 100,266	5.97%
	(blank = no early payoff)				
Received Before Fees	$ 203,535	Amount Received After Fees			$ 200,000
Points 1.00	2,035	Other Fees	1,500	Total Costs	3,535

Paying Off Your Loan Early:

Regular Pmts.	Extra Payments	Pts & Fees	BalloonPmt	Total Paid	less Received	Interest Paid
172,719	-	3,535	158,813	335,067	203,535	131,532
Cost of loan without prepayment				Total Paid	less Received	Interest
431,798				435,333	203,535	231,798
					Interest Saved by Prepayment:	**100,266**

Case Study 3

Data

Your broker has said that for one more "buy down" point (a total of two points with the same $1,500 fees), he can give you Loan C with an interest rate of 5.50 percent. Because of the additional point, the new loan amount is $205,612.

Calculations

Calculate the EIR for Loan C of $205,612 at 5.5%. How much did that extra point save you in terms of your effective interest rate over Loan A and Loan B?

Application

Assuming the same 12-year prepayment plan, which loan should you take?

Case Study 3 Answers

1. Calculate payment for Loan C.

   N = 30, I = 5.5%, PV = –$205,612, PMT = $14,147.21

2. Calculate amount received after all fees (two points).

   $205,612 – 2 points ($2,000 * 2) – 1,500 = $200,000

3. Calculate the balance owed after 12 years (18 years remaining). The PV of 18 years of the PMT is:

   N = 18, I = 5.5%, PMT = –$14,147.21, PV = $159,100.62

4. Calculate effective interest rate to lender.

   Set your FV at year 12 to = $159,100.62, PMT = $14,147.21, N = 12, PV = –$200,000, solve for I = ?

   I = 5.85%

   Loan C saves 0.15% and 0.13% over Loans A and B, but because of the increase in points, the amounts of the loans increases to give the same $200,000 needed.

Home Loan Comparison (LT19.c)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					1
Loan Information:		**Amount Needed (after points & fees):**			$ 200,000
Loan Amount	$ 205,612.24	Total Periods		30	**Rates:**
Interest Rate (APR)	5.50%	Loan Payments:		12	**APR**
Years (1-30)	30	***Prepayment of Principal***			5.50%
Payments per year (12)	1	Number of Prepayments:		0	**Effective**
Annual Payments	$ 14,147.23	Total of Prepayments:		$ -	**Interest Rate**
Prepayment after # years?	12	Savings from Prepayments:		$ 95,549	5.85%
	(blank = no early payoff)				
Received Before Fees	$ 205,612	Amount Received After Fees			$ 200,000
Points 2.00	4,112	Other Fees	1,500	Total Costs	5,612

Paying Off Your Loan Early:

Regular Pmts.	Extra Payments	Pts & Fees	BalloonPmt	Total Paid	less Received	Interest Paid
169,767	-	5,612	159,101	334,480	205,612	128,868
Cost of loan without prepayment				Total Paid	less Received	Interest Paid
424,417				430,029	205,612	224,417
				Interest Saved by Prepayment:		**95,549**

17. The Transportation Decision: Making it Wisely

Introduction

One of the challenges consumers face is making wise large-ticket purchases. Besides the decision to purchase a home, one of the next largest financial decisions for many is buying a car. Therefore, you should ask yourself how you can become a wiser steward and make the best automotive decision for yourself and your family. This chapter covers a few ideas you may find helpful regarding the automobile decision.

Objectives

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

A. Understand key areas and principles of car ownership.
B. Understand how to buy or lease a new car.
C. Understand the lease versus buy decision.
D. Understand and create your auto and adult toy plan.

Determine the Key Issues and Principles of Auto Ownership

There are a number of important topics you must understand before you buy or lease a new or used vehicle, including the following: choosing a vehicle, steps to take before you go looking, and steps to take after you have found the vehicle.

Buying means you are purchasing the vehicle outright. The advantages of buying include that you are protected against losing your vehicle in case of job loss or change of employment if you have paid cash for the vehicle. If you buy, you can drive unlimited miles each year, and if you pay cash for the vehicle, you have no monthly payments. The vehicle can be used for any purpose, and you can modify the vehicle as you like (e.g., changing the color, rims, or tires). The main disadvantage of buying is that there are higher up-front costs. Buying is also expensive if you want to have a new car every few years.

The advantages of leasing include that the payments are usually lower because you pay for only a portion of the car you are using. When you lease, you pay a depreciation fee and sales tax on a monthly basis instead of making a payment on the total cost of the vehicle. As a result, leasing can be economical if you want to have a new car every two or three years.

However, there are many disadvantages of leasing including higher costs, loss of flexibility, increased costs due to buying new cars every few years, and risks of ownership, which will be included in the next section on the challenges of leasing.

1. Choosing a Vehicle

There are four steps to choosing a vehicle. This includes knowing your vision, goals and budget; evaluating safety; estimating total vehicle costs; and estimating insurance costs.

Know your vision, values, goals and budget. What is important to you? What is your vision for this vehicle and have you written down your goals? Are you living on a budget? It makes no sense to purchase a vehicle on which you cannot afford to make the payments. It is important that the money you spend on a vehicle does not take away your ability to achieve your other important goals. Make sure you can afford the vehicle by knowing your goals and budget.

If you are planning to finance the vehicle (which I do not recommend), are there sufficient funds to cover the costs of the vehicle and still attain your other personal goals? In addition, are you putting aside money each month to fund the purchase of another vehicle once it is no longer cost effective to run your current vehicle?

Evaluate vehicle ratings and safety. As you are making decisions about an automobile, remember to pick a vehicle that is safe for your family. There are a number of good websites that evaluate vehicle safety records. A good place to start is the National Highway Traffic Safety Administration site at www.nhtsa.gov. Other sites include Safer Car at www.safercar.gov and the Insurance Institute for Highway Safety at www.iihs.org. Each of these sites offers information on safety ratings, crash tests, and other important information about specific vehicles.

Examine total automobile costs. In addition to looking for a strong safety record, look at overall costs of the vehicle, including maintenance and repair. Repair records can be found on in reviews of the various automobiles. How many miles per gallon does the vehicle get on the highway and around town? With gas prices constantly on the rise, having a fuel-efficient vehicle makes a lot of sense.

Mileage and repair information can be found at a number of different websites, including Consumer Reports at www.consumerreports.org. Consumer Reports gives relatively unbiased information on mileage and repair histories, so you can determine which vehicles have the best track records on repairs and which vehicles will be less costly to operate.

Evaluate insurance costs. Pick a vehicle that is inexpensive to insure and drive. The Insurance Services Office (ISO) rates each vehicle on its loss history, a study on how much it costs to repair the vehicle, using a number between 3 and 27. Generally, the higher the number, the more expensive the vehicle is to repair and the more expensive the coverage. Sports cars, high-performance cars, and SUVs are more expensive to insure. Work with your insurance agent when you are considering purchasing a new or used automobile.

2. Steps to Take Before You Go Looking

Once you have determined which vehicle you want, there are a few more key issues you should

be aware of. These issues include finding new and used vehicle prices, understanding holdbacks, warranties, service contracts, and lemon laws.

Finding new and used vehicle prices: There are a number of automobile websites that provide reliable estimates of what a dealership paid the manufacturer for a particular car. There are a number of different prices you should be aware of. The MSRP (manufacturer's suggested retail price) is the amount the dealership hopes to get for the vehicle. This amount is a recommended price only. The dealer invoice is the reported amount the dealership actually paid to the manufacturer for the vehicle. This price is often called the invoice price. Some of the websites that can help you determine the dealer invoice price include www.edmunds.com, www.autosite.com**,** and www.kellybluebook.com**.** It is important to know the dealer invoice price because you should use the invoice price rather than the MSRP as the beginning point when you are negotiating for a vehicle.

You can find pricing information for used cars in the same manner you find pricing for new cars, although the final price of a used car depends on how well the car has been taken care of. Key sources those previously mentioned as well as www.nada.com and www.vehix.com.

Understanding holdback: A holdback is a rebate the manufacturer gives the dealership as compensation for holding the vehicle on the dealer's lot. It is important for you to realize that even when the dealership sells a vehicle at a low cost, or even below invoice, the dealership still makes money because the dealer's profit includes the holdback. The holdback money is not usually negotiable, but it is important to understand. Different manufacturers have different holdback amounts for dealers.

Warranties: Companies offer warranties to guarantee a product has the features and capabilities promised at the time of purchase. Warranties guarantee that any problems that arise after the purchase is completed will be resolved within a reasonable period of time.

Full warranties are contracts that promise the following: (1) the product will be fixed at no cost to the buyer within a reasonable time frame after the buyer makes a formal complaint, (2) the buyer will not have to perform an unreasonable task to bring the product back for repair, and (3) if the product cannot be repaired, the defective product will be replaced with a new product, or the buyer's money will be returned.

Service contracts: Service contracts are agreements between the contract seller (the dealership, the manufacturer, or an independent company) and the buyer in which the contract seller agrees to provide specific services on the vehicle. These contracts may specify that the contract seller must provide free or discounted repair services or that the contract seller must cover components of the car for a specified length of time or mileage (for example, five years or 70,000 miles) after the original warranties expire. When purchasing a service contract, you should be concerned about what components are covered, the length of the coverage, and the number of miles covered. Generally, service contracts that come from the manufacturer are better because you can get service nationwide, rather than from a single dealer.

Lemon laws: Lemon laws are laws to protect the consumer if the vehicle he or she purchased is a "lemon." According to these laws, your car is defined as a lemon if you make at least four attempts to fix a problem and if the car is out of service for at least 30 days during the first 12 months or 12,000 miles following your purchase. These laws give a consumer the right to return a car and request a replacement or a full refund if the circumstances meet the criteria of the lemon law.

3. Steps to Take after You Have Found the Vehicle

After you have found a vehicle you are interested in buying, look at a printout of the vehicle's history, have the vehicle checked by a good mechanic, and look at the vehicle's service records.

Vehicle history: Before you purchase a vehicle, get its vehicle identification number (VIN) so you can get a printout of its history. The vehicle history is a record of every time a different owner has registered the vehicle with the state; it lists all past owners and their locations. You can get a copy of a vehicle's history for a fee by going to www.carfax.com and typing in the VIN. This record is important because you can see where and when a vehicle was registered, the type of title the vehicle has (i.e., was it salvaged or not), and the mileage listed on previous registrations. Generally, the more times a vehicle has been sold, the more likely it is that one or more of its owners has not done the maintenance required to keep the vehicle in good operating condition.

Inspection by a good mechanic: After you have found the vehicle you think you may want, get the vehicle checked by a qualified mechanic, preferably one from a dealer; the mechanic will do a major checkup to make sure there are no hidden problems. While it may cost between $80 and $250, the expense will be worth it if the mechanic finds problems you may not have discovered otherwise.

Service records: After you have found a vehicle you are interested in, ask the seller for a copy of the vehicle's service records. Sellers should have kept a record of all services performed, including repairs, oil changes, tire rotation, etc. It is likely that vehicles with good service records were better taken care of than vehicles without such records.

The most important reason for having a car is convenient transportation. Less important reasons for having a car include that cars are fun, they can make a statement about your lifestyle, and they just look cool. If a car fits into your budget and you are achieving your other financial goals, then it may be appropriate for you to have a car for any one of these reasons.

Principles of Effective Auto Ownership

Keep in mind that buying a car can hurt your financial goals if you must borrow money to pay for it. When you borrow money for a car, you must use your money to pay interest, which means it can't be used to earn interest or build wealth. If you have not considered car expenses in your budget and you purchase a car, it can take the place of more important goals. In addition, if you

spend more than you had planned for the car, making payments can become a financial burden and can limit your ability to achieve other goals. Before ever purchasing a vehicle, determine if the purchase fits into your financial plan and if the costs fit into your budget.

There are five key principles of effective car ownership:

1. Understand yourself, your vision, goals, values and budget. What are you trying to accomplish and how will transportation help you accomplish those goals.

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of vehicle ownership. Ideally, the purpose of car ownership should be to provide safe, dependable transportation in a cost effective manner. Realize that a car is a tool to achieve your other goals, not necessarily a goal in itself.

4. Make your car fit your budget, not your budget fit your vehicle. Understand the total cost of the vehicle ("the out the door price"), and negotiate this amount.

5. Understand and minimize your costs. These costs include the basic purchase price, gas, oil, and insurance. However, it also includes other costs such as scheduled maintenance, repair, taxes (which includes sales tax, registration, licensing, documentation, and in many places, property tax), depreciation, and resale value. Be wise in your choice of vehicle to minimize these costs.

6. Be a wise steward over your vehicles. In terms of your car, this means to minimize all costs over the car's effective life. This means that you do the necessary repairs, maintenance, and other activities to ensure the car will last for many years. While skipping a scheduled maintenance may save you money short-term, in the long run it may result in higher maintenance and repair costs.

Finding Balance

As you work on developing a transportation plan, finding balance among doctrines, principles and application is important. We have shared some ideas for principles, although I am sure you can find others that are important to you. Below are a few ideas for doctrines on which the principles are based.

Principles	Doctrines
Understand yourself, vision and goals	Identity
Seek, receive, and act on the Spirit's guidance	Obedience
Understand the key areas of vehicle ownership	Stewardship
Make vehicle fit budget	Agency

Minimize all costs over the car's useful life	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on obtaining a vehicle for transportation, which is an application. From a higher perspective, or with increased vision,

> We are children of a loving Father in Heaven (identity), striving to live worthy of the Spirit (obedience), learning to be a wise stewards over the things God has blessed us with (stewardship). We understand the benefits and costs of vehicle ownership and we use that agency wisely as we choose good vehicles, minimize costs, maintain them well, and keep them our predetermined amount of time (stewardship) so we can accomplish our personal missions and our individual and family vision and goals.

If you think about a car with correct perspective, as a tool to help you achieve other more important goals, you will make better decisions when purchasing your car.

Understand How to Buy or Lease a New Car

Buying or leasing a new car can be both exciting and frightening—you are looking forward to driving a new car, but you want to make sure you get the best deal possible. The information in this chapter can help guide you through the process of buying or leasing a new car.

Buying a vehicle is a fairly straightforward process. If you pay cash, the vehicle is yours. If you finance, you borrow money from a lending institution and as you make payments, you build equity in the vehicle until it is eventually yours. You can keep the vehicle as long as you like and you can do whatever you want with the vehicle.

Because you are typically paying back the entire cost of the vehicle, your loan's payments are higher than when leasing. And when you are ready to get a new car, you either need to trade in or sell your old vehicle.

Leasing may seem to be more appealing that buying. Your monthly payments compared to financing a purchase will be much lower. You enjoy a trouble-free 2-3 years of the vehicle's life and either lease another vehicle or simply walk away. There is often no down payment, many can get a higher-priced, better equipped vehicle than they might otherwise be able to afford, and they always have a late-model vehicle that's usually covered by the manufactures warranty. However, should you decide to lease a new or used vehicle, the section after this describes the challenges with leasing, which are many and which are not well understood and thought through by most consumers.

Before you buy or lease, there are five general guidelines you should know about the buying and leasing process. The decision to lease or buy comes in guideline four.

1. Know the Terminology

Knowing the terminology associated with buying and leasing a car is very important. The following terms are critical to both leasing and buying:

MSRP is the price a manufacturer hopes to get for a vehicle. Remember that it is acceptable and expected that you will negotiate for most vehicles. Research has found that those who negotiate generally pay less for their vehicles than those who do not.

Interest rate is the rate of interest you will be paying each year on the loan should you choose to finance the loan.

Loan period is the period over which you will finance the loan should you choose to finance.

Capitalized cost is the agreed-upon or negotiated cost. This amount is often significantly different from the MSRP. Realize that the MSRP is a hoped for amount, and not the negotiated amount.

Capitalized cost reduction is the capitalized cost that has been reduced by any rebates, incentives, and/or a trade-in vehicle.

Net capitalized cost is the agreed-upon or negotiated cost minus the capitalized cost reduction.

Residual value is the bank-determined expected value of the vehicle at lease term end. The actual value at term end may be either higher or lower than the residual value. This value is expressed as a percent of MSRP, such as 55 percent, meaning that the residual value at the end of the term would be 55 percent of the MSRP.

Lease term is the number of months the vehicle is leased.

2. Narrow Your Choices and Select Your Vehicle

When choosing an automobile, it is critical that you comparison shop. You should compare prices, features, and quality to find out exactly what you want. Be informed. Check the library and the Internet, and look at the alternatives. As you look at different cars, determine what is available in your price range and budget.

After you have looked at what is available, the next step is to choose your vehicle. As you narrow the choices, test-drive the exact vehicles you are considering. Do not buy any car without test-driving it first.

As you make your final decision, it is critical that you remember to make your car fit your budget. Don’t make your budget fit your car. If you must finance your car, determine exactly how much you can afford to spend each month and select a vehicle with a payment plan that fits within that limit. Do not spend more on a car than you can afford.

3. Determine Your Total Price and Negotiate for This Price

Once you know which car you want to buy and how much you can spend from your budget, you are ready to begin negotiations. Do your homework to find out how much the dealer paid for the car (the dealer invoice), the rebates that are available, how much the holdback from the manufacturer is, the amounts of the total markup, and the MSRP.

Start your negotiations at the dealer invoice. The dealer invoice is the price that appears on the invoice that the manufactures ends to the dealer when the dealer received the car from the factory. Please note that this price is almost always higher than the amount the dealer actually ends of paying to the manufacture, but it is a good starting point. If the company you are working with won't share the dealer invoice, go someplace that will. Most car dealerships will share this information with you. Often you can buy a car for invoice plus $100–$500, and sometimes you can negotiate for even less depending on dealer sales quotas and how long they have had the vehicle on the lot.

The dealer's inventory often impacts how much of a difference there is between the invoice price and the price for which the dealer will sell the vehicle. The fewer the number of available cars and the more people who want those cars, the more the dealership will charge—this follows the basic principle of supply and demand. The calendar date may also affect how willing the dealer is to work with you on price. The end of a month or year is a particularly good time to buy because salespeople are trying to reach their quotas and are therefore more willing to negotiate.

Remember that no matter what price you negotiate, there are many other fees you will be expected to pay on top of the sale price. For example, if you and the dealer agree on a price of $30,000 and a trade-in credit of $5,000, the difference is $25,000. But in addition to that $25,000, you will need to pay for state tax and documentation, registration, and licensing fees. You will either pay for these costs in cash or finance them along with the price of your vehicle. In addition, if you lease a vehicle, you may also have to pay an acquisition and termination fee. Know that most of these fees—except for title, documentation, and licensing fees—are negotiable before you purchase or lease the vehicle.

Be careful in your negotiations, as dealers will try to sell you additional services such as extended warranties, leather or seat protection, tire warranties, additional service contracts for oil changes, theft protection services, vehicle care programs, and gap protection services, which can increase the cost of the vehicle substantially and may not add value. You are not required to purchase any of these programs.

4. Make Your Purchase

This is where the leasing versus buying decision comes into play.

Buying. If you must finance your automobile purchase (which is not recommended), remember that banks and credit unions will charge different interest rates than the dealer will charge.

Usually, financing provided through the dealership is the most expensive type of financing, so compare interest rates on auto loans from multiple institutions before you purchase a car. If you choose financing from the dealership, make sure your credit financing is approved before you drive the vehicle off the lot.

When comparing different loans, look at the term of the loan, the interest rate, and the fees. Financial institutions will typically finance newer vehicles for longer periods of time than they will finance older vehicles. Your credit score will have a major impact on the interest rate you will pay on your auto loan, so keep your credit score high. For more information on this topic, refer to the chapters on Understanding and Managing Credit and Consumer and Mortgage Loans.

Calculate the overall costs of the purchase, including down payment, fees, taxes, license, documentation, and any dealer options. Know your total cost for the vehicle before you sign any sales documents so you will know how much you are paying. Realize that many of the dealer-installed options, such as rust coating, leather treatment, special rims and tires, and so on, are not required for the sale, even though the dealer may have done the work beforehand. Also, realize that nearly all costs are negotiable.

Leasing. If you decide to lease, realize that each leasing organization has different rates and programs, depending on your credit worthiness. Keep your credit score high and find the cheapest source of financing for your vehicle. Information on how to calculate your lease cost is given in the next section. Make sure you understand the challenges and costs of leasing before you sign the lease document.

5. Enjoy Your Purchase and Keep It Well Maintained

Once you have made your purchase, read the owner's manual carefully and follow the suggested maintenance schedule. One of the best things you can do for your car is to change the oil every 3-5,000 miles. Don't ignore warning signals when your car doesn't work as it should. When problems arise, get them fixed. Find a good garage with well-trained and experienced mechanics, and let the mechanics take good care of your new vehicle.

Understand the Challenges of Leasing and Calculating Lease Costs

Leasing may at first seem to be more appealing that buying. The payments are usually lower because you pay for only that portion of the car you are using. When you lease, you pay a depreciation fee and sales tax on a monthly basis only on the part of the vehicle used instead of making a payment on the total cost of the vehicle. As a result, leasing can be economical in the short term and allows you to have a new car every two or three years.

In getting a new car every two to three years, think about your perspective, what you are doing longer-term. You are purchasing the vehicle new, which is a major cost. You are developing the habit of buying a new car every 2-3 years, which is perpetual renting. You are paying the most for depreciation and insurance, as these costs are higher with new vehicles. And you are paying

higher costs due to higher finance charges and fees that are coming due every few years. Moreover, you are constraining future decisions because of your lease term and mileage allotments. Is this what you want? In short, most consumers only look at the monthly costs and fail to take into account the real costs of leasing which are significant.

Challenges of Leasing

While there may be a place for leasing, particularly if your business can expense your lease costs. Monthly costs are cheaper. However, for most people, there are challenges of leasing which should be understood before you make the decision to lease.

1. Leasing typically costs more than an equivalent loan. This is in part because of the higher finance charges, which are often difficult to understand unless you know how they are calculated. We will detail those costs below. In addition, assuming similar rates and fees, the total cost of leasing will still be higher due to the way interest and fees are calculated.

2. Once you get into the leasing habit, monthly payments go on forever. You are perpetually paying interest, instead of earning it. In contrast, the longer you keep a vehicle after the loan is paid off the more value you get out of it.

3. There is a fixed-mileage allotment for your lease, generally 10-15,000 miles a year, with a high cost if you go over. If you go beyond your allotment, you are required to pay a penalty charge for every mile you drive over your predetermined mileage allotment. These costs are substantial (.10-.25 per mile). This may limit flexibility in moving to another location or going on internships because of the possibility of exceeding mileage limits.

4. You must maintain the vehicle in good condition, or there may be wear-and-tear charges. If you choose to lease, be sure to find a *closed-end* lease, not an *open-end* one. With a closed-end lease, you simply pay the monthly payments and various fees and then return the car when the lease is over. If you have an open-end lease and the dealer is not able to sell the car for what he or she originally estimated, then you must pay the difference. Open-end leases are generally not a good idea due to the risks involved. An open end lease with your child's messy behavior can have financial consequences later on.

5**. At the end of your contract, you do not own the car.** Your is not an asset; rather, it is a monthly expense. While this may be good if a business is expensing the car payments monthly for tax purpose, for an individual or family this is not the case.

6. There are many extra fees for leasing and profits are hidden. These include acquisition and termination fees, and other hidden recurring fees with each new lease. Because leases are generally short-term, dealerships make a lot of money by leasing new

cars to buyers every few years. However beneficial to the dealer, it is likely more cost effective to keep your vehicles for more years.

7. Leasing has early termination penalties and fees. If you need to get out of the lease before the lease term expires, you may need to pay thousands in early termination fees and penalties which could equal the amount you would have paid had you stuck with the lease in its entire term. Moreover, should you opt for a longer lease than the car warranty or should the vehicle have problems, you will be required to fix these problems at your expense before you can return the vehicle. If you choose to do a longer lease, it is advisable to get an extended warranty to ensure you do not have to pay these additional costs.

Calculating Lease Costs

Once you have negotiated the cost of the vehicle with your chosen options, determined your capitalized cost reductions (rebates, and trade in allowances), and added your required additional fees, such as license, registration, and documentation, now is when you begin the determination of whether you will lease or buy.

The first decision is how much you will pay outside the loan versus in the loan. If you can pay cash for the vehicle, this is best. However, if that is not possible, payments outside the loan would include a down payment, and any other fees you decide to cover. The more you pay upfront, the less you will have to finance.

Once you have the total cost you need to finance, the next decision is whether to lease or buy. The key areas are the interest rate and loan term. With that information, you are able to determine the monthly payments.

However, with a lease there are other things you need to determine, including additional costs, lease term, money factor, and residual value.

Additional Costs. There are specific costs with a lease that you do not have when you buy and finance through a bank. For example, you may have an acquisition and/or termination costs which are not part of the buy decision. These fees need to be understood and applied up front.

Lease term. Generally, most vehicles depreciate more in the early years of a lease than in the later years. As such, you will pay more for newer vehicles than you will pay for older vehicles. Lease terms can be as short as 24 months and as long as 72 months. Remember that if you choose a lease term that is longer than your new vehicle's warranty (generally three years or 36,000 miles) you will be responsible for any repairs beyond the new vehicle's warranty period. If you are looking at a longer lease, it may be wise to get an extended warranty or a service contract to minimize the risk of additional costly repairs (See Table 1).

Residual value. Your residual value is the bank-determined expected value of the vehicle at

lease term end. The actual value at term end may be either higher or lower than the residual value. This value is expressed as a percent of MSRP, such as 55 percent, meaning that the residual value at the end of the term would be 55 percent of the MSRP. If your MSRP is $25,000 and your residual value was 38 percent, the residual value of the vehicle would be $9,500.

Money Factor. Your money factor is simply the APR in percentage terms divided by 24. It is an archaic way of showing interest rates, which has led to some confusion by consumers.

Lease Costs. Once you have your total amount to finance, there are three parts to the cost of a lease.

Part 1. Usage or depreciation charge. Usage is the amount of the value of the vehicle that is used over the lease life. This charge is the difference between your net capitalized cost (which is your negotiated price less any down payment, rebates, or trade in) and your residual value (which is the value the bank estimates the vehicle to be worth at term end). This is the amount you will be charged for the depreciation on the vehicle over the life of the lease.

Part 2. Interest (or finance costs): This is your monthly interest cost for leasing the vehicle. It is calculated by determine your average amount borrowed times your average monthly interest rate, which would give you your monthly interest or finance charge.

In a lease, you agree to a specific price for the vehicle now (your negotiated cost less any rebates, down payment and trade in) and a specific price that the vehicle will be worth at the end of the lease (which is your residual value). To determine the average amount borrowed over the lease term, use the following calculation:

If you leased a $20,000 vehicle which has a $10,000 residual value (i.e., the bank-determined value of the vehicle at term end), the average amount borrowed would be $20,000 cost + $10,000 residual divided by two, or $15,000. This is your average amount borrowed. Remember that leases are not like buying where your equity increases the more you pay down the loan. With a lease, you never have equity in the vehicle because you are in essence renting the vehicle in perpetuity. You simply add what you paid, plus the value at term end and divide by two to get the average amount borrowed.

(net capitalized cost + residual value) / 2

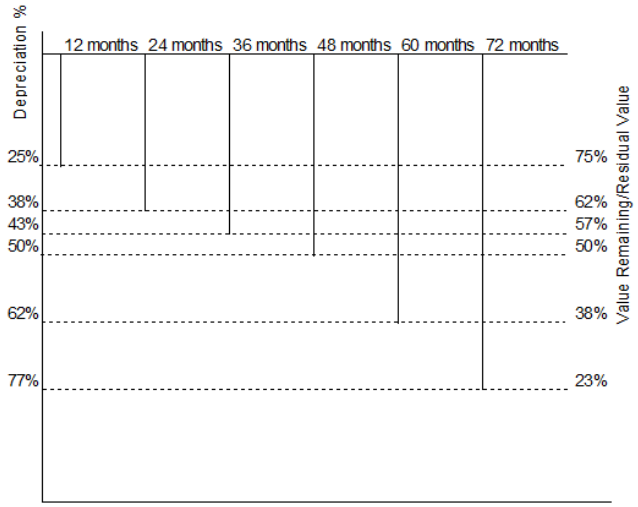
The average monthly interest rate is easier to determine. The calculation is simply your annual percentage rate (APR) in decimal form divided by 12, or APR / 12.

Your monthly interest expense is found by multiplying your average amount borrowed by your average interest rate; the result is your monthly interest expense, or your monthly finance charge, on the lease.

In leasing terms, your monthly interest cost is calculated as your net capitalized cost plus the

residual value multiplied by the money factor ((NCC + Residual) * MF). This is in essence just the average amount borrowed times your average interest rate.

Table 1: **Depreciation Schedule of a Typical Vehicle**



Part 3. Taxes (or government costs): In addition to paying taxes on the down payment of a lease, you must also pay taxes on your usage or depreciation charge and your interest or finance charge. Taxes are calculated as your usage and interest costs multiplied by your tax rate.

> Calculate the amount of your residual value, usage or depreciation charges, interest or finance charges, taxes, and all the fees you will be paying. It is a good idea to compare the cost of leasing versus the cost of buying over the life of the lease. For an example of how to compare the costs of leasing versus buying, see Lease versus Buy Analysis (LT22).

Understand and Create your Auto and Adult Toy Plan

Autos and adult toys are expensive and can have a significant impact on the family budget. As such, it is important to develop and auto and toy strategy to ensure these costs are planned for an in the budget.

Having an auto strategy for what you will and will not do for transportation is critical. Without a defined auto strategy, it is easy to succumb to the following challenges.

- You borrow the money for the autos and toys, so instead of earning interest, you pay it.
- You get in the habit of buying or leasing a car on credit, so you pay interest for the rest of your life and find it difficult to fund your other important goals because of the cost of transportation.
- It's not in your budget or is more than you planned, so it relegates more important goals to a lesser position.
- You buy a new car too often, and so you pay too much for expensive depreciation,

insurance and other costs.

What should your Transportation Plan include? It can include a number of different areas, depending on your vision for these vehicles, your goals, and your tactical plans to achieve your vision and goals. Examples include:

- Budget: Ensure the auto fits the budget, not the budget fits the auto; Budget for all costs, including purchase, fuel, maintenance, and insurance before you buy.
- Vehicle age: Keep your cars for 10 years or 200,000 miles whichever comes first; buy new vehicles 1-2 years old with less than 24,000 miles, then buy 100,000 extended warranty at $150 over invoice; spouse gets newer vehicle.
- Maintenance: Be diligent in oil changes every 3-5,000 miles and do the recommended maintenance.
- Financing: Pay cash for all vehicles; save a specific amount each month for purchase of your next vehicle.

Transportation Plan Example

Using the creative process, we can put together a Transportation Plan that will guide is in our financial lives. Following is an example of an auto strategy for someone close to me.

Vision

- This will likely come from your Plan for Life. It may also include:
    - I will have reliable transportation to meet the needs of my spouse and family and not for pride purposes.
    - Autos will be used for transportation; we will pay cash and take good care of them. We will keep them an extended period of time, thereby reducing overall costs.

Goals

- Budget: We ensure the auto fit the budget, not the budget fits the auto.
- Vehicle age: We will keep vehicles for 10 years or 200,000 miles, whichever comes first.
- New car purchases: We will buy used vehicles until our net worth is > $750,000.
- Financing: We pay cash for all vehicles.
- Maintenance: We will be diligent in oil changes every 3-5,000 miles, and do the recommended maintenance.

Plans and Strategies

- Before you buy a vehicle, check out the vehicle thoroughly.
- Budget for all costs, including purchase, fuel, maintenance, and insurance.
- Purchase new vehicles 1-2 years old with less than 24,000 miles, then buy the 100,000 extended warranty at $150 over invoice.
- Spouse gets the newer vehicle.

- Once you have a vehicle, save a specific amount each month for purchase of your next vehicle when this vehicle dies.

Constraints

- We will buy a new vehicle only after we have a $750,000 in net worth; and spouse gets the newer and safer car.
- The value of vehicles and toys will not exceed 50% of annual income (Dave Ramsey)

Accountability

- From your Plan for Life, but may also include:
    - Spouse and family will help with the process of selecting, maintaining, and cleaning the vehicles.

Adult Toy Strategy

Adult toys are adult motorized vehicles that are not necessary for transportation yet still may be important for some individual and families for recreation. These include boats, motorcycles, all terrain vehicles (ATVs), side by sides (SxSs), jet skis, bikes, trailers, RVs, etc. It is generally anything motorized and not used in the landscaping or yard.

The challenge becomes what happens when you don't have an effective toy strategy. Individuals and families can spend significant amounts of resources on things that are not consistent with their personal and family goals and do it at the wrong time, thereby displacing other important goals.

What can your toy strategy include? These could include different things, such as:

- Age: Purchase good toys which have parts available (and close by) and keep those toys for 20 years. Be careful of no-name vehicles as parts and repair may be difficult to find.
- Maintenance: Do all required maintenance so toys will last--expect toys to last a minimum of 20 years; include toy gas, oil, maintenance and insurance in the family budget.
- Goal Priority: Pay cash for all toys, and only after saving 20% for our other goals. Toys should only be purchased if you are on track for your other goals.
- Usage: Don't allow others to use toys unless they take good care of them so they will last your required age.

Toy Strategy Example

Following is an example of a Toy strategy which is part of your Transportation Plan. Again, you can be very creative when you put these strategies together.

Vision

- Likely from your Plan for Life. May also include:
    - Toys will be used for new experiences and to bring our family closer together. We

will pay cash for good toys that are budgeted for and will take good care of them. We will keep them an extended period of time.

Goals

- Our first toys will be bikes, then tents and camping equipment, then later perhaps a small ATV for the kids. As our net worth increases, we may purchase a trailer, and move to larger ATVs consistent with our budget and savings.

Plans and Strategies

- Our first toys will be bikes, then tents, camping equipment, then perhaps a small ATV for the kids.
- As net worth increases, we may purchase a trailer and larger ATVs consistent with our budget and savings.
- We will purchase good toys with available parts.
- We will pay cash for all toys, and only after saving 20% for our other goals.
- We will not allow others to use toys unless they take good care of them so they will last our required time.

Constraints

- We will keep close to the Spirit so we are not enticed by the traps of the world to spend more.
- We will buy toys only if we are reaching our budget and savings goals.

Accountability

- Froom your Plan for Life. It may also include:
    - Spouse and family will help with the process of selecting, maintaining, and cleaning the toys.

While it is not easy to discipline our desire for automobiles and adult toys for recreation and other usage, it is important that we keep our goals in perspective and that we use wisdom in our purchases, particularly those that are not critical to our family responsibilities.

Summary

Besides the decision to purchase a home, the largest financial decision for many individuals is the decision to buy a vehicle. While it is important to have a car for convenient transportation, having a car can become a significant financial burden if you must borrow money to pay for the purchase, if a car is not in your budget, or if the car costs more than you planned.

There are a number of important topics you must understand before you buy or lease a new or used vehicle. Know your budget and understand safety reports, automobile reports, and insurance. Before you look for a vehicle, understand the pricing on new and used vehicles, holdbacks, warranties, service contracts, and lemon laws. After you have found the vehicle you

want to buy, be sure you look at vehicle reports, have the vehicle checked by a mechanic, and review the vehicle's service or maintenance records.

Before you begin the process of buying a vehicle, you should understand five general guidelines for the buying or leasing process:

1. Know the terminology.
2. Narrow your choices and choose your vehicle.
3. Determine the dealer invoice and use it to calculate the vehicle's total price.
4. Finance the vehicle.
5. Enjoy your purchase and keep it well maintained.

While the process of buying a used car is similar to the process of buying or leasing a new car, there are additional challenges to purchasing a used car that are important to consider, including locating, evaluating, negotiating, and financing the used car.

Leasing has become a popular way for many people to have a car because the up-front costs of leasing are lower than the up-front costs of buying. Additional challenges of leasing include negotiating, calculating the costs, and understanding lease warranties.

Finally, we discussed the importance of having an auto and adult toy strategy to ensure that our most important goals are not relegated to a lesser importance because of poor choices for things that are not as important.

Assignments

Financial Plan Assignment

Transportation Plan. As you think about your transportation needs, it is important to develop your own transportation strategy. Include this as part of your PFP Education, Mission, Home and Transportation Template (LT01-15).

What auto(s) are you currently driving or using? What monthly expenses and fees are you paying, including gas, maintenance, repair and insurance? Are you within your budget?

What is your transportation strategy for now and in the future? Ideas may include:

- How often you will get a new vehicle?
- Will you buy new versus used?
- Will you pay cash or go into debt?
- What negotiation strategies will you use to obtain your vehicles?
- What are your strategies for extended warranties and repair?

- How long you will keep each of your vehicles?

Adult Toy Plan. What is your adult toy vision and goals for now and in the future? While toys can be enjoyable and fun individually and for the family, they can cause havoc on budgets and other more important long-term goals when not purchased properly. How will you ensure that goals are kept in their proper perspective?

What are your plans and strategy for adult toys, i.e., boats, RVs, ATVs, etc.? Do you have these? How will you ensure these do not take over more important areas of your budget such as saving for retirement, missions, and education?

Learning Tools

The following Learning Tool may be helpful:

Lease versus Buy Analysis (LT22)
This spreadsheet closely approximates the costs of buying a vehicle versus leasing a vehicle. It includes most of the lease costs and shows how they are calculated.

Review Materials

Terminology Review

Average Amount Borrowed. This is the average amount borrowed over the life of the loan. In leasing, it is the (Net capitalized cost + residual)/2.
Average Monthly Interest Rates. This is the Annual Percentage Rate (APR) divided by 12.
Capitalized Cost Reduction: Any reductions in capitalized cost, such as rebates, down payment, dealer incentives, trade-in, etc.
Capitalized cost: The cost to which you agree or negotiate when purchasing a vehicle.
Interest or finance costs. This is the average amount borrowed times the monthly interest rate. In calculation form, it is the (Net capitalized cost + residual value) / 2 times your average interest rates which is the APR/12.
Lease Cost: The total cost of a vehicle's lease. It has three parts:

1. *Usage* (also called *depreciation*): The amount of the value of the vehicle that is used over the lease life. (Net capitalized cost – residual value).
2. *Interest* (also called *finance costs*): The average amount borrowed times the monthly interest rate. (Net capitalized cost + residual value) / 2*average interest rates : APR/12.
3. *Taxes* (also called *government costs*): (Usage + Interest)*tax rate.

Lease Term: The number of months the vehicle is leased.
Lease: A contractual arrangement calling for the lessee (user) to pay the lessor (owner) for the use of an asset.
Money Factor: A way of expressing interest rates, calculated by taking the APR and

dividing it by 24.
MSRP: The price the manufacturer hopes to get for the sale of a product.
Net Capitalized Cost (also called **adjusted capitalized cost**): The final amount paid. Found by taking the capitalized cost and subtracting capitalized cost reduction.
Residual Value: Expected value of a vehicle at term end. Often used as purchase price after a lease has ended.
Taxes (also called government costs). It is the tax on the usage and interest in a lease. It is calculated as (Usage + Interest) times your tax rate.
Usage (also called depreciation). This is the amount of the value of the vehicle that is used over the lease life. It is calculated at the Net capitalized cost – residual value.

Case Studies

Case Study #1

Data

Maxine negotiated the price of a car with a dealer and now wants to decide whether she should lease or buy the car.

Manufacturers Suggested Price (MSRP)	$25,000
Negotiated cost/Capitalized cost	22,000
Down Payment	2,000
Lease Term and residual	3 Years, 55%
Fees: Acquisition $500, Registration $150, License $35, Documentation $200, Termination $300	
Rent charge and Loan rate (APR)	8.35%
Sales tax	6.25%

Calculations

Help her decide based solely on costs. She will pay cash for the down payment, taxes on down payment, and fees but will finance the remainder (including other taxes). Assume the value at term end is the residual value

Case Study #1 Answers

Solution: Cost of Leasing

Down Payment and fees	$2,000
Taxes on Down Payment (2,000*.0625)	125
Fees (Acq + Reg + Lic + Doc+ Term)	1,185
Total Paid Outside the Lease	$3,310
Total Lease Payments:	
1. Usage: [20,000 – 13,750 (55% of MSRP)]	$6,250
2. Interest: (Average outstanding * average rate) [(Net Cap. Cost + Residual) * Money Factor] (20,000 + 13,750) / 2 * .0835/12 * 36 months)	4,227
3. Taxes: (6,250 + 4,227)*.0625	655

Total lease payments of	$11,132
Total Cost of Leasing (DPF+LP)	$14,442
Monthly lease cost: 11,132 / 36 =	$309.22

Solution: Cost of Buying

Down Payment and fees	$2,000
Taxes on down payment	125
Upfront Fees (Reg. + License + Doc.)	385
Total Paid Outside the Loan	$2,510
Remaining Amount	$20,000
Remaining taxes (20,000)*.0625	1,250
Total Amount to Finance including taxes	$21,250
Total Payments over holding period	
-21,250 PV, 8.35%, 36 N, PMT=669.33*36	24,096
Total Cost of Vehicle (Financed + DP + fees)	$26,606
Market value of car at end of the loan (residual)	(13,750)
Total Cost of Buying DP+UF+TP+T-MV	$12,856
Monthly Purchase Payment	$669.33

Maxine wants to make this decision based only on costs:

They are:

Cost to lease	$14,442.01
Monthly Cost	309.22
Cost to buy	$12,856.03
Monthly Payment	669.33
Cost savings from buying	
$14,442.01 - $12,856.03 =	$1,585.98

Lease versus Buy Analysis (LT22)

Updated 2019-02-26

This tool helps to compare leasing versus buying as a potential method of acquiring a vehicle. The lease interest charge is a close approximation. This example assumes that down payment, taxes on down payment, and fees are paid outside of the monthly lease payments. Below it gives the reason why either lease or buy is cheaper.

tual and Negotiated Costs:			Finance Charges and Residual :		
Manuf. Silly Retail Price (MSRP)	25,000.00		Interest Rate (rent charge)	8.35%	
Capitalized/Negotiated Cost	22,000.00		Sales Tax	6.25%	
Other Taxable Fees/Options	-		Lease Period (months)	36	
Gross Capitalized Cost	22,000.00		Residual Value in %	55.0%	
Cap. Cost Reduction. (Down Paym	2,000.00		Residual Value in $	13,750.00	
Cap. Cost Reduction. (Rebates/Other)			Taxable Fees		
Trade In Allowance			Acquisition/Termination	800.00	
Balance Owed on Trade In (-$)			Document Fee	200.00	
Remaining Amount (Net Cap. Cost)	20,000.00		License & Registration	185.00	

Lease Analysis (DP & Fees paid outside the lease)			uy Analysis (DP, Tax on DP & fees paid outside the loa		
Costs:	**Overall Costs**	**Monthly Payments**	**Costs:**	**Overall Costs**	**Monthly Payments**
Gross Capitalized Cost	$ 22,000.00		Negotiated Cost with Fees/Op	$ 22,000.00	
Cap. Cost Reductions (CCRs)	2,000.00		Cap. Cost Reductions (CC	2,000.00	
Net Capitalized Cost	20,000.00		Net Capitalized Cost	20,000.00	
Taxable Fees/Options	-		Taxable Fees/Options	-	
Tax on Down Payment	125.00		Tax on Down Payment	125.00	
Fees:			**Fees:**		
Acquisition/Termination	800.00		Document Fee	200.00	
Document Fee	200.00		License & Registration	185.00	
License & Registration	185.00		Total Paid Outside Loan:	2,510.00	
Total Paid Outside Lease:	3,310.00		**Total Amount to Finance:**	20,000.00	
Total Amount to Finance (NCC):	20,000.00		Taxes on Net Amount	1,250.00	
Note: Residual Value	13,750.00		Total Amount to Finance	21,250.00	
Lease Payments:			**Loan Payments:**		
Depreciation: (NCC-RV)	6,250.00	173.61	PV = $21,250, I = 8.35%,	24,096.03	$669.33
			N = 36, P/Yr = 12, PMT = ?		
Interest (NCC+RV)*MF*LP	4,227.19	117.42	Note: Loan Interest Paid	2,846.03	1,381.16
Taxes	654.82	18.19	Note: Taxes Paid	1,250.00	(595.18)
Total Lease Costs	11,132.01	309.22	Total Loan Costs	24,096.03	
Fees Paid outside the Lease	3,310.00		Fees Paid outside the Lease	2,510.00	
Total Lease Costs	14,442.01		Total Buy Costs	26,606.03	
			Less Residual Value	(13,750.00)	
Total Payments (inc. Trade in):	$ 14,442.01	309.22	**Total Payments:**	$ 12,856.03	669.33
			Savings of buy over lease:	Buy beats Lease by $1,586	

Case Study #2

Data

Andrea is considering the costs of owning a vehicle valued and sold for $30,000. Auto Loan Amount: $30,000, Duration: 4 years, APR: 8.65%
Property taxes: 2% of the vehicle value per year
Sales Taxes: 3% of the sales price
Title and Tags: $40 per year
Maintenance and Usage Costs: $1,500 per year
Insurance: $2,000 per year

Calculations

Calculate the total first year cost of ownership.

Case Study #2 Answer

$30,000	4 years APR 8.65% will have payments of $741.58 x 12 =
$8,898.91	Payments in year 1
$600	Property Tax
$900	Sales Tax
$40	Title/tags

$1,500	Maintenance/usage
$2,000	Insurance
$13,938.91	for the total cost for the first year

Note: If you include your sales tax in the loan, the payment is $30,000 * (1.03) = PV = $30,900, N = 48, I = 8.65, PMT ? = $763.82 * 12 = $9,165.87

Case Study #3

Please note that this section was originally in the text, but I rarely had enough time to get to this topic. As such, I have included it here in the problem section.

Bill is thinking about getting a used car. What questions you should he ask before he buys a used car? What advice can you give on each of the questions?

Case Study #3 Answers

- Can I afford this car?
- Will this car fit into my monthly budget?
- Is this car a want or a need?
- Does this car meet my current driving needs?
- What type of driving do I do?

Make sure you are shopping for a car that will meet not only your current needs but also your future driving needs. Consider how you will feel about this car a year from now or several years from now. Will your family be growing or shrinking? What extra features do you want your car to have? What about gas mileage? Do you want two doors or four doors? What safety features are important to you?

While the process of shopping for a used car is similar to the process of buying or leasing a new car, this next chapter will address additional aspects of purchasing a used vehicle: locating, evaluating, negotiating, and financing the vehicle.

Locating Used Cars

Good sources of used cars include private owners, new- and used-car dealerships, rental car companies, auctions, and auto brokers.

Private owners: Many used cars are sold by private parties. Often, these cars are the most reasonably priced, but they don't have warranties. Do your research. Ask friends, neighbors, and relatives about used cars they know are for sale. If you buy from people you know, you should be able to find out more about a vehicle's history. Watch for cars with "for sale" signs in the windows. Look at newspapers, classified ads, and bulletin boards. Keep in mind that cars that are closer to your geographical location are generally easier to inspect and evaluate. Use Internet sites, such as www.autotrader.com, www.classifieds2000.com, and www.usedcars.com to help

you. Follow the procedures for buying a new car listed above, including getting a Carfax report on vehicles you are thinking of buying.

New- and used-car dealerships: New-car dealerships may also be a source of used cars. Dealerships often keep trade-in vehicles on their lots if they think they can resell them. Dealerships may be an attractive option for buying a used car because they sometimes offer special deals or warranties that are not available from private sellers.

Rental car companies: Other used-car lots are run by rental companies that are trying to sell vehicles that have just come off leases. Some of the cars sold on these lots may be backed by warranties as well. For newer used cars, part of the manufacturer's warranty may still be in effect.

Auctions and auto brokers: For those who know how to evaluate vehicles, auto auctions are options for purchasing vehicles for a reasonable amount. The risk with auto auctions and auto brokers is that once a vehicle is purchased, there is no warranty or guarantee. The rule of thumb is *caveat emptor,* or "Buyer beware."

You may also want to look into purchasing a used car through auto brokers, who for a fee (usually around $500) will find the make, model, and year of car you are looking for and purchase it at an auto auction.

Evaluating Used Cars

Contacting the seller: Call the seller before you go to see a car. Create a list of questions before calling and then use those questions to decide whether you want to see the car. Ask for the price, because it may have been lowered since the date of the advertisement. Ask about the mileage, the number of previous owners, and how often the oil has been changed. Before you buy, ask to see receipts for oil changes and other major services. If the car doesn't fit your criteria or the seller seems uneasy answering questions, skip the visit and keep looking for other vehicles.

Verifying the vehicle history: Ask for and verify information about previous owners. With a $30 two-month subscription to Carfax (www.carfax.com), you can determine how many previous owners a particular car has had and where each owner was located. To obtain this information, you must input the vehicle's VIN number on the site. Carfax will then give you a detailed vehicle history, including mileage listed on the odometer and a title check, to make sure the vehicle was not stolen. Check out the vehicle history of every potential purchase.

Determining a fair price: Know the blue book price, or recommended price, for the car you are calling about (pay attention to the specific year and the specific options you want). If possible, come to an agreement with the seller on the quality of the vehicle (fair, good, or excellent) before you go see the car. Coming to this agreement will allow you to determine a fair price beforehand.

Examining the vehicle: When you see the car, note your first impressions. Does the car appear

to be well cared for? Although you are probably not a mechanic, you should look for potential problems anyway. The following is a list of some of the things you should look at as you evaluate a used vehicle:

Exterior:

- Look for rust.
- Examine the paint. New paint may be a cover-up for serious damage.
- Look for dents, mismatched paint areas, or poorly fitting parts.
- Check for ripples in door panels. Ripples may indicate previous accidents.
- Check for body filler, which is a plastic used to fix dents. It can be painted over, so use a refrigerator magnet to test suspicious spots.
- Check the underside of the car for evidence of fluid leaks. Coolant is a greenish color, oil is black, transmission fluid is pink, and gasoline is clear and can be identified by its smell.
- Wipe the inner surface of the tail pipe with a rag—white or gray dust is normal. A thick greasy film means the car burns a lot of oil, which can be a serious problem.
- Check the shock absorbers. Bounce the car up and down at each corner of the car. When you release the car, you should not feel the car bounce back more than twice.
- Examine the tire treads. A tread that is unevenly worn may indicate poor alignment or balance. All tires should be the same size, especially on a four-wheel-drive vehicle.
- Check the CV joint boots on the ends of the front axles. CV joint boots are expensive to replace.
- Push the top of one rear tire toward the car. If it moves too much, there may be bearing problems.

Under the Hood:

- Check for mismatched bolts or offset paint. These mismatches may indicate a front-end accident.
- Look at the underside of the hood. A black film on the underside usually means there is an oil leak.
- Check the levels of oil, brake fluid, and transmission fluid. Levels should be adequate, but if it looks like all the fluids have just been changed, this may indicate there is a problem with the car. A low oil level may indicate either a leak or that the owner didn’t have the oil changed regularly.
- Take out the transmission dipstick and smell the fluid. Does the fluid smell burned? With a well-maintained transmission, the fluid should not have a burnt smell.

Interior:

- Look inside the car for wear and tear on the seats and pedals. Make sure the amount of wear looks consistent with the mileage on the odometer.
- Start the car: it should start right away. Listen for any unusual noises.

- Verify that all gauges report information accurately.
- Examine the emergency lights. Make sure no emergency lights are on when the engine is running.
- Test all lights—brake lights, headlights, reverse lights, turn signals, and so on.
- Check for play in the steering wheel, clutch, and brakes. Play is the amount a part can move before it engages.
- Hold the brake pedal down as far as possible for 45 seconds. If the pedal doesn't hold firm, there may be a leak in the brake fluid. There should be very little play in the pedal.
- Look for a jack and lug wrench in the trunk. If they aren't there, ask the seller to provide them with the vehicle.

Test drive:

- Test-drive the vehicle personally. Notice how the vehicle feels and fits you.
- Evaluate how quickly the car accelerates from a complete stop. Does the car hesitate, or does it accelerate as it should?
- Listen to the engine while accelerating. Is it smooth or rough?
- Check for hill-climbing power, braking power, cornering, suspension, and seat comfort.
- Check for rattles and squeaks from interior controls.
- Play the radio and CD player.

Qualified mechanic inspection: If you are interested in buying the car, take it to a qualified mechanic for a more complete inspection. Choose a mechanic who regularly works on the type of car you are considering; such a mechanic can generally be found at a dealership that sells that particular make and model. Mechanics that do not specialize in the specific vehicle you wish to buy may be only guessing about potential problems. Dealers may also have the car's history on their computers, which is also helpful.

Have the mechanic do an engine compression check and look for oil leaks and other fluid leaks. For cars with automatic transmission, take the car to a transmission specialist to have the transmission examined.

Negotiating for Used Cars

Once you are comfortable with the idea of buying a vehicle, negotiate a deal. If you plan to pay in cash, let the seller know this. Cash can do wonders for an agreement.

Know the fair value of the car beforehand. Negotiate politely. If you think the price is too high, make a persuasive case to support your argument. For example, you could point out that the vehicle needs some work, that the body or paint doesn't justify the price, or that you have seen lower prices elsewhere. If you want to test the price, you can explain that the car isn't exactly what you're looking for, but at a lower price, you might be interested. You can also let

the seller know that the car is worth the price but that you can only afford a lower price because of budgetary constraints. Make an opening offer that is low but in the ballpark of the seller's asking price—do not be unrealistic. Expect to spend about an hour negotiating. Don't be afraid to walk away if you're not getting anywhere: you don't have to buy the car.

Only enter into negotiations with a salesperson who makes you feel comfortable and who can make a deal. Before you go to see the vehicle, decide how much you can spend and walk out if the seller cannot meet this price. Leave if you get tired or hungry or if you feel pressured. Don't be hurried into a decision. Don't be distracted by pitches for related items. Expect the salesman to try to improve the deal before you reach a final price.

Close the deal at the dealership. At a dealership, the person who deals with financing and insurance will probably try to sell you a number of additional products, including service warranties and other dealer-installed options. Most, if not all, of these products are unnecessary. Review the contract thoroughly before signing. Ask questions about anything that dramatically increases the price. You will be asked to provide proof of insurance before you drive away in your car. Finally, you should inspect the car before you take possession of it. If any work is required or any repairs have been promised by the dealer, get the promise in writing in the form of a due bill—a written acknowledgement that the dealer will provide service at a future date.

Close the deal with a private owner. Before any money changes hands, make sure you will be able to register the car in your name. No registration means no deal. Request the title, sometimes called the pink slip, and have it signed over to you. No title also means no deal.

If the seller has not paid for the car in full, the lender still owns the title to the car. One way to deal with a seller who still owes money on the car is to close the sale at the office of the lender, where the title is held. Once all of the paperwork is complete, relax and begin enjoying your new purchase—a good used car.

Financing Used Cars

If you must finance your used car (I don't recommend doing this), get your financing approved before you look for cars. There are several different lenders who can provide funding for a used-car loan. Banks and credit unions usually offer lower rates than dealerships do, so don't use in-house financing unless you get a special deal or unless the in-house interest rate is very competitive. Also, make sure your credit is approved before you leave the dealership. Banks and credit unions will usually finance a car only if it is less than five years old; however, auto dealerships will finance basically any car.

When looking for a lender, it is important to consider the maximum length of the loan. The good news is that most banks offer 60-month programs for late used car models, or cars that are less than five years old. However, the older the vehicle, the less likely it is to run without problems for the full 60 months. In general, banks offer shorter length loans for older vehicles because older vehicles are not good collateral for loans.

Regardless of which lender you choose, make sure you understand exactly what you are getting into before you sign a loan contract. Once you have signed, you have committed yourself. Once again, you should know your credit score before you attempt to get a loan. If you know whether or not you have a good credit score, a dealer will not be able to insist that you need a higher interest rate because of your poor credit. Knowing your credit score will give you greater freedom to choose a lender that offers a lower interest rate.

Final Thoughts on Used Cars

Even if you follow the pattern explained above when buying a used car, there is still a good chance you will have to make some repairs you did not anticipate. Repairs are one of the risks of buying a used car. However, the more closely you adhere to the process outlined in this chapter, the less likely it is that you will have major problems with your vehicle.

18. Investing 1: What to Do Before You Begin Investing

Introduction

The previous chapters have helped you put personal financial management into perspective. These chapters have taught you about living on a budget, keeping track of where your resources are going, managing your cash and cash equivalents, protecting yourself from loss by owning insurance, and making big-ticket purchases wisely. Now we will begin a discussion on long-term investing.

Please be aware that this course approaches the subject of investments differently than do other textbooks. Most books take an asset-based approach—they talk about stocks, bonds, mutual funds, and other assets. Such assets change over time as new assets are developed and sold. Instead, I take a principle-based approach to discussing investments because the principles will not change over time.

The most critical part of investing is having a plan—an Investment Plan. These chapters in this course on investing all relate to putting together an Investment Plan, often called an investment policy statement. This Investment Plan describes what kind of an investor you are, what your risk and return requirements are, how you will invest, where you will invest, how you will get money to invest, and how you will evaluate your investments. These are all critical areas of the investment process.

Learning about investments is really learning how to answer six important questions:

1. **What are financial markets and how do they operate?** It is important that you learn the basics of financial markets and financial market operations before you begin investing.

2. **What are the major financial instruments or assets, and what are their advantages and disadvantages, i.e., risks?** Learning about financial assets is important since that is what you will be investing in.

3. **What are the asset classes and why are they important?** Asset classes (i.e., stocks, bonds, cash, etc.) have different risk and return characteristics. Understanding asset classes is critical since investment returns are largely the result of an investor's asset allocation, or the allocation of resources between the different asset classes.

4. **What is your asset allocation and how will it change over time***?* Your asset allocation is the way you allocate your investment dollars to different asset classes.

5. **What is your Investment Plan and how will you invest?** Your Investment Plan should include clear objectives, guidelines, and constraints. These factors will influence both how and where you invest and will help you become a better investor.

6. **How will you build your portfolio and how will you monitor it?** Once you invest, you will follow this process to build, monitor, evaluate, and rebalance your portfolio.

I have divided this course on investments into nine different chapters. Investments 1: Before You Invest discusses principles of successful investing and gives a basic history of asset-class performance over the last 80 years. It will also help you develop your preliminary asset-allocation targets. Investments 2 discusses investment objectives, constraints, and policies needed to prepare an Investment Plan or an Investment Policy Statement. Investments 3 discusses financial markets and how they operate. Investments 4, Investments 5, and Investments 6 delve into a deeper discussion on the major asset classes and financial assets. Investments 7 and Investments 8 discuss how you build your portfolio and how to choose financial assets. Finally, Investments 9 discusses how to monitor and rebalance your portfolio.

Objectives

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

A. Know what to do before you invest.
B. Recognize the principles of successful investing.
C. Understand the major asset classes and their risk and return history.

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.

Know the Steps to Take Before You Invest

The following are important questions to ask yourself before you start investing:

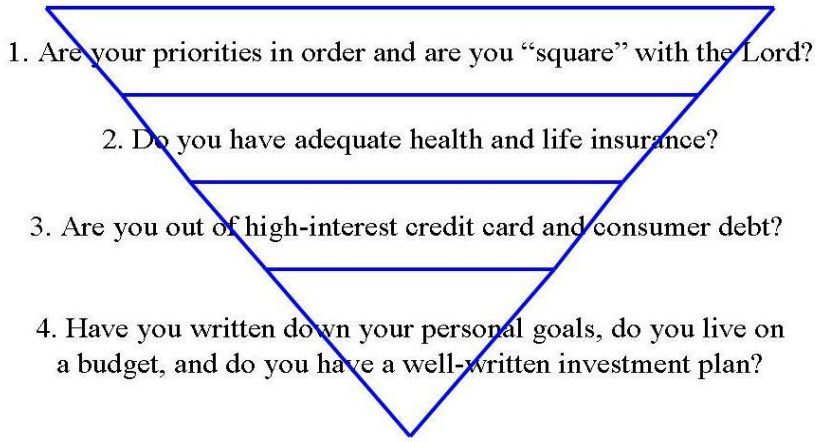
- Is there a priority to paying your bills? Do you consider some of your bills more important than others? Which bill do you consider more important?
- Are there certain products or services you feel you should never do without? Should you have health and life insurance before you begin investing?
- 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 high-interest items 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 vision, 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. This chapter will focus on the top of the investment hourglass. The hourglass is designed to help you prioritize. 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 agree with each of the statements listed in the top of the hourglass, you are ready to invest (see Chart 1). If you cannot agree with any of these statements, you have important steps to take before you begin investing.

Chart 1. Top of the Investment Hourglass—Before You Invest



Before you even think about investing, you should be sure you've paid your bills. First and foremost, your most important priority is being "square" with the Lord, who is your most important creditor. Before you invest, ask yourself if you have paid your tithing, a generous fast offering, and other contributions as you feel inclined.

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.

If you can answer yes to each of the statements 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.

Recognize the Principles of Successful Investing

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, your personal goals, and your Investment Plan. The key to successful investing is to understand the principle and know yourself and what you are trying to accomplish.

To understand how most equity investors have done in investing, you must compare their returns to their benchmarks. Each year, DALBAR puts out an annual survey called *Quantitative Analysis of Investor Behavior* (www.dalbar.com), which discusses how the average investor in equities, fixed income, and asset allocation funds has done compared to his or her benchmarks over the past 20 years. Interestingly, most investors have not had very high returns in comparison to their benchmarks (see Tables 1–3).

As the saying goes, "If you do what everyone else does, you will get what everyone else gets." Based on the DALBAR study, it seems that whatever people are doing regarding investing is not working well for equity investors (see Table 1), fixed income investors (see Table 2), or investors using asset allocation (see Table 3). Is there a better way to help investors achieve higher returns than what they have in the past, perhaps returns closer to the benchmarks? I believe so. Is there one right way to invest? I think not. Likewise, there is not just one right way to teach investing.

I believe the best way to teach investing is to first teach the principles of wise investing. While assets may change, the principles should not. Joseph Smith's admonition, "I teach them correct principles and they govern themselves,"[1] applies today in this area as well.

If you understand the "correct principles" that relate to successful investing, you will be able to "govern," or manage, your investment portfolio well. 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.[2]

Table 1. Historical Analysis of Equity Investor's Return (Dalbar 2015-2019)

Year	Investor Period	Investor Returns	Benchmark Returns	Difference
2015	1995–2014	5.2%	9.9%	-4.7%
2016	1996–2015	4.7%	8.2%	-3.5%
2017	1997–2016	4.8%	7.7%	-2.9%
2018	1998–2017	5.3%	7.2%	-1.9%
2019	1999–2018	3.9%	5.6%	-1.7%

Table 2. Historical Analysis of Fixed Income Investor's Return (Dalbar 2015-2019)

Year	Investor Period	Investor* Returns	Benchmark Returns	Difference
2015	1995–2014	0.8%	6.2%	-5.4%
2016	1996–2015	0.5%	5.3%	-4.8%
2017	1997–2016	0.5%	5.0%	-4.5%
2018	1998–2017	0.4%	4.6%	-4.2%
2019	1999–2018	0.2%	4.6%	-4.4%

Table 3. Historical Analysis of Asset Allocation Investor's Return (Dalbar 2015-2018)

Year	Investor Period	Investor Returns*	Benchmark Returns**	Difference
2015	1995–2014	2.5%	8.4%	-5.9%
2016	1996–2015	2.1%	7.0%	-4.9%
2017	1997–2016	2.3%	6.6%	-4.3%
2018	1998–2017	2.6%	6.2%	-3.6%
2019	1999–2018	2.9%	9.7%	-2.3%

* DALBAR 2015– 2019 ** Estimate of 60% equity and 40% fixed income

Whatever you decide to invest in, and whatever phase of investment you are in, it is critical that you adhere to the following ten principles. If you build your portfolio according to these principles, you will be most likely to have a successful portfolio.

1. Know Yourself, your goals, vision and plans. 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.

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.

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. [3]

You must be wary of having overconfidence when trading online as well. 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.[4] While online trading may appear to give you more control, it can result in lower overall returns if it leads to more frequent, overconfident trading.

3. **Seek, receive and act on the Spirit's guidance**. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received. Carlos E. Asay said,

> When the Spirit is with us, we can think thoughts we've never thought before, we can say words we've never said before, we can perform beyond our natural abilities. That power is related to truth, to the scriptures, to the stirring of the Spirit within. And the power won't come unless we're actively courting the influence of the Holy Ghost.[5]

3. Understand the key areas of investing and especially risk. Risk is inherent in all investment activities. Some risks include inflation, business, interest-rate, financial, market, political and regulatory, exchange-rate, call, and liquidity risks. The key to managing risk is to understand the different types 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 test is included in the Learning Tools section of the website A Risk-Tolerance Test (LT16).

4. 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 asset class 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 Historical Return Simulation for Asset Classes (LT23).

5. 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 taxes.

6. Invest for the Long Term. Invest for the long run; this is how you will achieve your goals. There are no "get-rich-quick" schemes that work, and short-term investing is expensive in terms of time, transaction costs, and taxes.

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.[6]

7. Use Caution If You Are Investing in Individual Assets. If you must 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 another's 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.

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.

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.

8. 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." [7]

How can you know if your investments are doing well 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 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' performance against the benchmarks you have set (after taxes). If the return on these assets is consistently lower than the benchmarks, consider investing in no-load (no sales charge), low-fee (low expense ratios) index funds, which are discussed later in this course. The returns on index funds generally match the performance of selected benchmarks more consistently than actively managed funds.

9. 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 gaining 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 and money and access to more databases than you have.

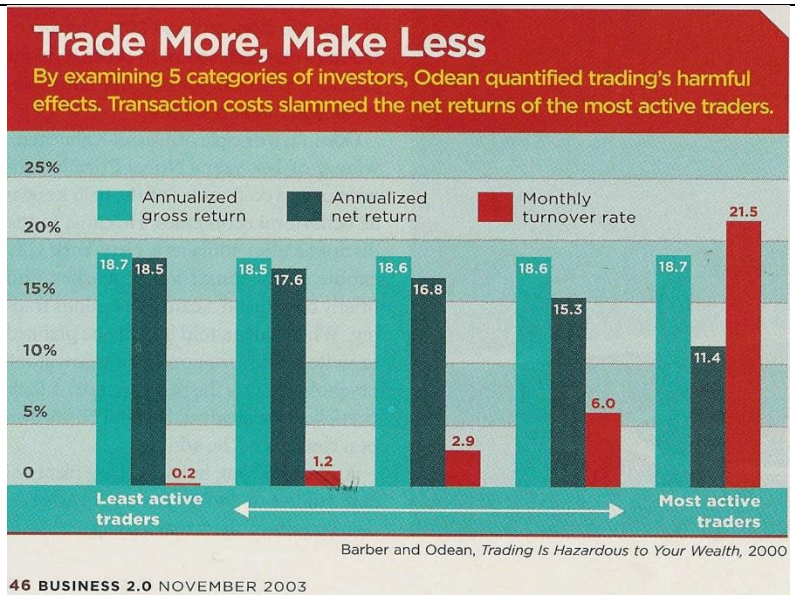
If you want to try to beat the market, try for a short period of time and compare your returns after taxes to your benchmarks. Do not waste too much time and energy because you will be able to match the market return with little or no effort through no-load, low-fee index mutual funds or exchange traded 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 deferred or eliminated when you take the money out at retirement.

10. 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.

Use the best resources available to help you invest, but be aware of how 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.

Chart 2. Trade More, Make Less



11. 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 evaluation methodology. For an example of an Investment Plan, see Investment Plan Example Template (LT05A).

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.

Finding Balance

As you work on understanding and developing your Investment Plan, finding balance among doctrines, principles and application is important in helping you become better investors. We have shared some ideas for principles, although you can find others. Below are a few ideas for doctrines on which the principles are based. As you strive to increase your ability and effectiveness in investing wisely, I recommend you study and ponder the doctrines and principles supporting this application.

Principles	Doctrines
Know yourself, your goals, vision and budget	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Understand risk – there is lots of it	Stewardship
Stay diversified	Accountability
Invest low-cost and tax efficiently	Stewardship
Invest long-term	Stewardship
Know what you invest in	Accountability
Monitor performance versus benchmarks	Accountability
Don't waste time trying to beat the market	Stewardship
Invest with good people and firms	Stewardship
Develop a good Investment Plan (IPS) and follow it	Stewardship

Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with our liquid assets, which is an application. From a higher perspective, or increased vision,

> We are children of a Creator (identity), striving to live worthy of the Spirit (obedience), striving to understand ourselves and our risk tolerance (agency), and learning to understand financial markets and instruments (accountability). We are developing our investing talents carefully (stewardship), so we can invest our resources carefully and wisely (agency), to earn the return we are expecting (stewardship), and accomplish our personal missions and individual and family vision and goals.

Understand the Major Asset Classes

Investment is similar to an amusement park. At an amusement park, people go on rides that appeal to them; likewise, in the area of investment, people invest in areas that suit them. High-risk investments are similar to a roller-coaster ride—they require a stronger stomach, but the thrill and returns are generally much greater than with other investments. Low-risk investments are similar to the merry-go-round—while fun, they may be too sedate for some investors. The key is to find out which investment "rides" you like based on your age, your goals, your budget, and, for some, your medical history.

Asset classes are broad categories of investments with specific and similar risk and return characteristics. Asset classes are distinguished by the unique characteristics of particular groups of securities, including the type of financial instrument, market capitalization, maturity, and geographic location. There are three major asset classes most investors should include in their portfolios: cash and cash equivalents, fixed-income investments (bonds), and equities (stocks). Each asset class has its own risks and benefits—the more familiar you become with each type of asset class, the stronger your overall investment portfolio will become.

Cash and Cash Equivalents

The main goal of cash and cash-equivalent investments is to preserve capital. Cash investments include certificates of deposit, money market funds, Treasury bills, and short-maturity commercial papers (see the chapter on Cash Management). Cash investments offer a fixed rate of return, most checking and savings accounts are insured by the Federal Deposit Insurance Corporation (FDIC), and Treasury securities are backed by the taxing ability of the U.S. government. Short-term, interest-bearing investments include Treasury bills, U.S. savings bonds (loans to the U.S. government), and commercial paper (loans to corporations).

Some of the benefits of cash and cash-equivalent investments include their liquidity and their generally stable principal. These investments are low-risk because the borrowers have good credit and the loans are for short periods of time. They are especially good investments for money you plan to use in less than five years or money or for your emergency fund.

However, the risk of cash investments is that they are unlikely to keep up with inflation and taxes. This makes them less attractive options for medium-term or long-term investments (longer than five years). Use cash investments for the purpose of your emergency fund, to maintain liquidity and to diversify your portfolio, but realize that this asset class will do little to improve your portfolio's overall performance.

Fixed-Income Investments (Bonds)

The main goal of fixed-income investments is to provide income and to earn returns in excess of inflation. There are two main categories of fixed-income assets: taxable bonds and tax-free bonds. Taxable bonds include U.S. Treasury bonds, corporate bonds, and U.S. government agency issues such as Fannie Mae (Federal National Mortgage Association or FNMA) and Freddie Mac (Federal Home Loan Mortgage Corporation or FHLMC). Tax-free bonds include

revenue bonds or general-obligation bonds and may be issued by state or local governments. Such bonds are generally exempt from federal taxes and may be exempt from state taxes as well. Bond mutual funds which hold these assets enjoy the same tax advantages.

There are several different types of fixed-income investment assets, including short-term bond funds, intermediate bond funds, and bond mutual funds.

Short-term bond funds invest in bonds that mature in less than five years, making them less vulnerable to interest-rate risk than long-term bonds. Although the return on these investments is not as attractive, they are generally considered to be appropriate for anyone who needs a dependable stream of income from interest or dividends.

Intermediate-term bond funds have an average maturity of 3 to 10 years; another option is long-term bond funds, which have an average maturity of 10 or more years. These long-term bonds are much more vulnerable to interest-rate volatility because the principal is at risk for a longer period of time.

Bond mutual funds allow you to buy and sell bonds before they mature; therefore, there are tax implications for investors (see **Chapter 20: Bond Basics**). Investing in a bond fund means you are buying a share of many different bonds in a changing portfolio rather than purchasing a single bond.

Income from fixed-income bond funds fluctuates as mutual fund investors buy and sell bonds. The market value of the fixed-income bond funds changes depending on whether investors are selling bonds at a loss or a gain, and length of maturity also affects the income. Looking at the average maturity of the bonds in your bond fund will provide a clearer picture of the volatility of that fund regarding interest-rate fluctuations. The longer the average maturity of the bonds, the more dramatically the principal will gain or lose value as the interest rates change.

The benefit of fixed-income assets is that they offer a greater potential return than cash investments, though they do involve greater risk. Fixed-income assets are a good diversification tool for a long-term stock portfolio because bonds generally behave differently than stocks do. Other risks of fixed-income assets are that the returns have historically been lower than the returns on stocks and that fixed-income assets are susceptible to interest-rate changes and other risks.

Generally, fixed-income assets often do not provide enough growth to beat inflation over long periods of time—therefore, they are not good long-term investments by themselves but should be part of an overall diversified portfolio.

Stocks or Equities

The main goal of stock investment is to provide growth and to earn returns in excess of inflation. Historically, the stock market has been the only investment that has consistently outpaced

inflation. For the past 85 years, large-capitalization stocks have earned slightly less than 10% per year, while small-capitalization stocks have earned slightly more (see Table 4). When you buy a share of stock, you are buying ownership in a business's earnings and assets. You therefore receive a proportionate share of the profits through dividends and benefits that stem from increases in the company's share price. Mature companies are typically a better source of dividends, since rapidly growing companies often prefer to invest profits.

Equity asset classes are mainly classified by three factors: market capitalization, type of company, and geographic location.

Market capitalization is one way of measuring the size of a company. It is calculated by multiplying the market price of the stock by the number of shares or the number of ownership pieces outstanding. Market capitalization is used to separate companies into specific ranges of company size and to determine certain classes of companies, including large-capitalization (large-cap) companies, middle-capitalization (mid-cap) companies, and small-capitalization (small-cap) companies.

Large-cap stocks are generally defined as stocks from companies with a market capitalization that is greater than U.S. $10 billion (this amount is smaller for international companies). Large-cap stocks generally come from large, well-established companies that have a history of good sales and earnings as well as a notable market share. Although large-cap stocks have traditionally been synonymous with dividend-paying companies, this classification is no longer standard. Nevertheless, large-cap stocks do generally entail mature corporations with long track records and a steady growth of dividends.

Companies that offer mid-cap stocks have a capitalization that is roughly between U.S. $2 billion and U.S. $10 billion. These stocks tend to grow faster than large-cap stocks and are generally less volatile than small-cap stocks. Mid-cap stocks generally perform in a similar manner to the small-cap asset classes. For asset allocation purposes, mid-cap stocks are not generally considered a major asset class.

Companies that offer small-cap stocks generally have a market capitalization of less than U.S. $2 billion. They are small (or sometimes newer) U.S. and global companies that are still developing, so they have a smaller market share than their large-cap counterparts. Small-cap companies are subject to greater volatility in stock price and tend to fail more frequently than larger companies; however, they are generally expected to grow faster than larger companies.

Type of company: Within the large-, mid-, and small-capitalization stock categories, there are two separate types of stocks, growth stocks and value stocks. Growth stocks are offered by companies whose earnings are expected to grow much more rapidly than the market. Value stocks are inexpensive stocks, at least in terms of low price earnings and low price-to-book value ratios when compared to their peers. These terms are explained in **Chapter 21. Stock Basics** of this course.

Location: International stocks are stocks whose primary listing is outside the United States. Global stocks are stocks that are either international or in the United States. Regional stocks are stocks from a specific region, such as Europe or Asia. Emerging market stocks are stocks from countries that are not considered developed. International investments involve additional risk, such as differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets.

Table 4. Asset Class Summary

Asset Class Summary 2019 MBA 620/Fin418/Fin200 Financial Planning (2/22/19)												
	Cash and Cash Equivalents		Fixed Income				Equity					
	Taxable or Tax-free		Taxable or Tax-free			Intl./Global	Domestic			International/Global		
Asset Classes:	CDs, MMA, MMMFs	Government Bills/Funds	Short-term Bonds/Funds	Intermediate Bonds/Funds	Long-term Bonds/Funds	International/ Global Funds	Small Cap/Funds	Mid Cap/Funds	Large Cap/Funds	International / Global Funds	Emerging Markets/Funds	Domestic/Intl. REITs/Funds
Description:	Short-term interest bearing investments from banks, mutual fund companies and public companies	Short-term interest bearing investments of the government, agencies, and municipalities	Bonds/funds which invest in short-term instruments with a maturity of < 5 years and can be either taxable or tax-free	Bonds/funds which invest in intermediate-term instruments with a maturity of 3 - 10 years and can be either taxable or tax-free	Bonds/funds which invest in long-term instruments with a maturity of 10 - 30 years and can be either taxable or tax-free	All maturity bonds/funds which invest in bonds of companies domiciled outside the US. Global includes both international and US bonds.	US stocks with a market capitalization less than $3 bn.	US stocks with a market capitalization of between $2 and $10mn, considered the up and coming companies	US stocks with a market capitalization of >$10 bn, considered the blue chip and larger companies	All capitalization stocks that are domiciled outside the US. Global includes both international and US stocks	All capitalization stocks that are domiciled in countries not considered Developed by the World Bank/IMF	All capitalization stocks that generally own and operate income producing real estate, ranging from offices and apartments to hospitals and shopping centers
Includes:	CDs, money market funds, commercial paper and funds which invest in these	Bonds and funds of Treasury bills, US Savings bonds, municipal bonds, etc.	Bonds and funds of short-term US Treasuries, US Savings, corporate, municipal and agency bonds	Bonds and funds of intermediate-term US Treasuries, US Savings, corporate, municipal and	Bonds and Funds of long-term US Treasuries, US Savings, corporate, municipal, agency and junk bonds	Bonds and Funds of al maturity international companies	Small cap value, growth, blend, and funds that invest in these types.	Intermediate cap value, growth, blend, and funds that invest in these types.	Large cap value, growth, blend, and funds that invest in these types.	All capitalization stocks and funds that invest in these types	All capitalization stocks and funds that invest in these types	All capitalization stocks and funds that invest in these types
Key Advantages	Good for liquidity and stability of principle	Good for liquidity and stability of principle	Provides income and returns generally in excess of inflation	Provides income and returns generally in excess of inflation	Provides income and returns generally in excess of inflation	Provides income and returns generally in excess of inflation	These stocks are generally smaller, less followed, and tend to grow faster than larger stocks	These stocks are generally larger than small-cap and smaller than large-cap, somewhere in between	Least risky of all equities. These stocks are generally larger, better run, and less volatile stocks	Returns can be enhanced through investing across borders--correlations are not as strong	Returns generally enhanced through investing across small country borders--lower correlations	Offers exposure to real estate without having to own any individual properties
Key Risks	Low returns, and little risk of losing principal since the borrowers have good credit and loans are for a short period.	Low returns and little risk of losing principal since the government can always print new money. More risk with agencies and municipalities	Lower returns and little risk of losing principle from non-government bonds as terms are generally short	Lower returns and risk of losing principle from non-government bonds as terms are still somewhat short	Interest rate and other risks as bond's principle is not fixed as bond price fluctuates with interest rates	Interest rate and other risks as bond's principle is not fixed as bond price fluctuates with interest rates	Because these stocks are smaller and less well-capitalized, they are considerably more risky than larger-cap stocks	Risk is generally between small and large-cap stocks	These are considered the least risky of all equities, although risks remain, particularly with individual stocks	Much risk can be diversified away due to investing across borders; however, still risky as subject to different risks	These tend to be among the riskiest of asset classes due to currency, interest rate and other domestic risks	Tends to move with real estate markets generally, very interest-rate sensitive
Taxes:	Interest is fully taxable and capital gains at preferential rates	Interest from Treasuries state tax-free, muni's Federal tax free, and muni's from your state are both state and federal tax-free	Interest from Treasuries state tax-free and muni's Federally tax free. Other interest is taxable at ordinary rates	Interest from Treasuries state tax-free and muni's Federally tax free. Other interest is taxable at ordinary rates	Interest from Treasuries state tax-free and muni's Federally tax free. Other interest is taxable at ordinary rates	Internation/global bonds are generally fully taxable, sometimes taxed both internationally and domestically	Fully taxable, with dividends and long-term capital gains at preferential rates	Fully taxable, with dividends and long-term capital gains at preferential rates	Fully taxable, with dividends and long-term capital gains at preferential rates	Fully taxable, with dividends and long-term capital gains at preferential rates.	Fully taxable, with dividends and long-term capital gains at preferential rates	Fully taxable, with dividends and long-term capital gains at preferential rates
Returns & Risk:	(ending 2018)											
10 Year Return		0.3%			4.3%		12.7%		12.7%	2.4%	2.0%	2.0%
10 year Risk		0.2%			14.1%		18.9%		13.6%	18.5%	22.7%	22.7%
25 Year Return		2.4%			7.0%		10.3%		8.9%	6.9%	8.0%	
25 year Risk		0.6%			11.6%		20.1%		14.4%	16.0%	22.4%	
How to Invest:	Banks, brokerage, mutual fund companies	www.treasurydirect.gov, banks, brokerage mutual fund companies	Banks, brokerage, or mutual fund companies	Banks, brokerage, or mutual fund companies	Banks, brokerage, or mutual fund companies	Banks, brokerage, or mutual fund companies	Banks, brokerage, or mutual fund companies	Banks, brokerage, or mutual fund companies	Banks, brokerage, or mutual fund companies	Banks, brokerage, or mutual fund companies	Banks, brokerage, or mutual fund companies	Banks, brokerage, or mutual fund companies

Stock mutual funds are funds that own stock in specific groups or types of companies. When you invest in a stock mutual fund, you are investing in multiple companies; this group of companies changes over time, depending on the fund manager. You are responsible for paying taxes on all distributions from the mutual fund, and these distributions are taxed at your level, not at the fund level. Mutual funds are generally delineated by investment objective and may include any of the asset classes discussed earlier.

The benefit of stocks is that they offer the highest potential return of any of the major asset classes. Growth stocks and value stocks tend to perform well in alternating cycles, so it makes sense to own some of both. Stocks are good for long-term investing: as mentioned earlier, this is

the only major asset class that has consistently beaten inflation over the long term.

The risks of investing with stocks are that they offer less stability of principal than other asset classes and that they are subject to short-term price fluctuations. These factors make stocks a big risk for short-term investments. If you are investing for less than five years, only invest a small portion of your money, if any, in stocks.

Stocks consistently yield the highest return of any asset class over long periods, but they also have the highest risk. Nevertheless, even though stocks can be volatile in the short-term, they continue to deliver returns that far surpass taxes and inflation over time. Through broad diversification, you can reduce some of the risks of this asset class and still receive the benefits of stock investment. For a summary of the major asset classes, see Table 4.

Understand the Risks and Benefits of the Major Asset Classes

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.

Note that there is a difference between investing and gambling. Investors are willing to assume risk because they expect to earn a risk premium when they invest; in other words, the odds are in the investor's favor because there is a favorable risk-return trade-off. Gamblers are different from investors in that they are willing to assume risk even when there is no prospect of a risk premium—in other words, the odds are not in the gambler's favor because there is no favorable risk-return trade-off.

Return on Investment

The return on an investment is the change in value of a financial asset or portfolio over a specific period of time; the return includes any interest, dividends, or distributions that were added to the asset or portfolio during that period of time.

The return on an investment measures how much your asset or portfolio has grown over a specific holding period. Once you have calculated your return, you can compare your asset or portfolio's performance to benchmarks. If you do not calculate your return for each of your assets, you will not be able to tell how well you are doing in your investing.

To calculate your investment return, subtract the investment's beginning price from the investment's ending price and then add the resulting amount to any dividends or distributions you received. Divide this amount by your beginning price. Calculating your return is important because your return is a measure of how much your asset or portfolio is worth. Your holding period return (HPR) is calculated as follows:

$$\text{HPR} = \underline{(\text{ending price} - \text{beginning price} + \text{dividends} + \text{distributions})} \,/\, \text{beginning price}$$

In this calculation, include all dividends and distributions received, including dividends and distributions that were reinvested into the portfolio. This "holding-period return" can be annualized to reflect the total amount of return over a year, depending on the holding period of the asset.

To calculate after-tax returns, you would deduct the taxes to be paid from your dividend and distribution amounts; you would include in your calculation only the amount of dividends you would get to keep after taxes.

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 2).

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." [8]

Chart 3. Asset Class Returns

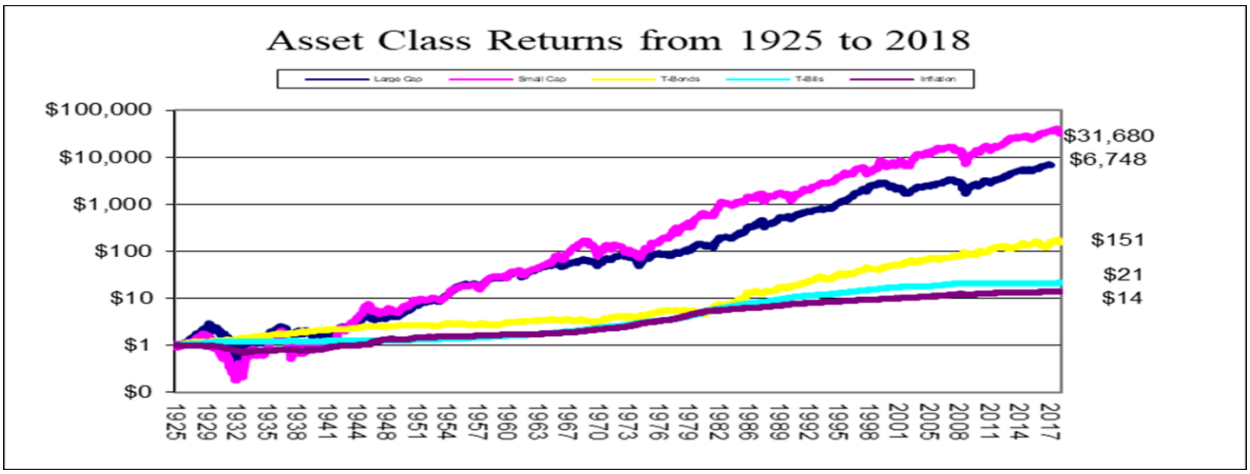
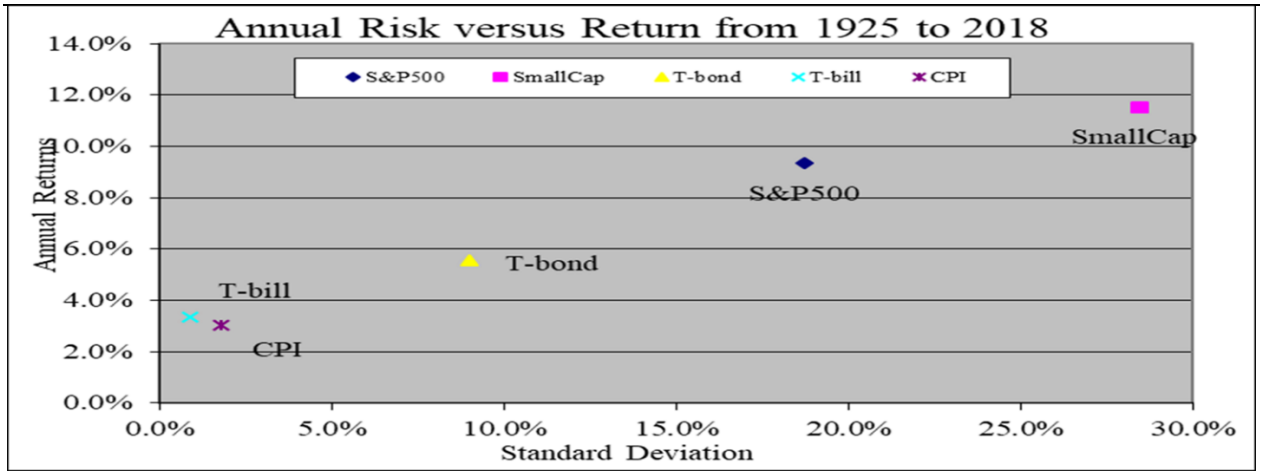


Chart 4. Annual Risk versus Return



What have been the characteristics of risk and return historically? Chart 4 and Table 4 show that from 1926 to 2018, large-cap stocks (as represented by the S&P 500) have yielded a return of over 9.0 percent per year and have a standard deviation of about 19 percent. Small-cap stocks have yielded a return of above 11.0 percent per year and have a standard deviation of approximately 29 percent. T-bonds have yielded a return of roughly 5.5 percent per year and have a standard deviation of 9.0 percent. T-bills have yielded a return of 3.3 percent per year and

have a standard deviation of about 0.9 percent. As a reference point, inflation over this same period has been 3.0% per year with a standard deviation of 1.8%. 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).

Chart 5. S&P 500 1 Year Annual Returns

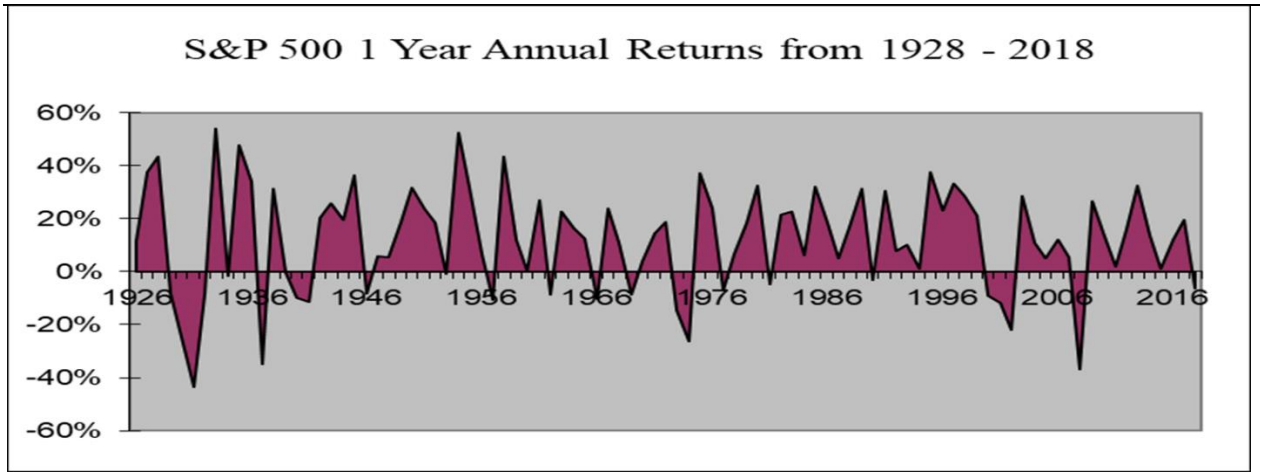


Chart 5, which shows the S&P 500 annual return since 1925, shows that the annual return appears to be very volatile—there are many years of high returns and many years of negative returns. However, looking at the return in terms of 5-year periods instead of 1-year periods shows that there are only a few major periods of time 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 return and risk, note that over 5, 10, 25, 50, 75, and 90 years, the return was volatile, yet over longer periods has been around 9 to 10 percent. The standard deviation has ranged from approximately 15 percent to 19 percent.

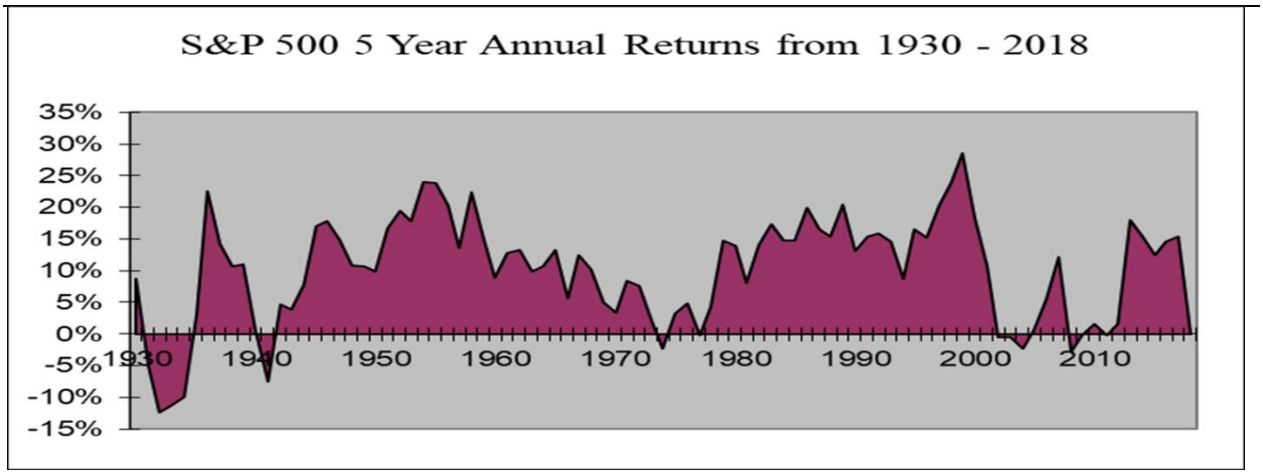
If you look at small-cap returns over the same periods of time, you will see that same volatility, particularly in recent years. Though over longer periods the return has been between 10 to 13 percent, notice that the risk levels of small-cap returns (the standard deviation) are between 20 percent and 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

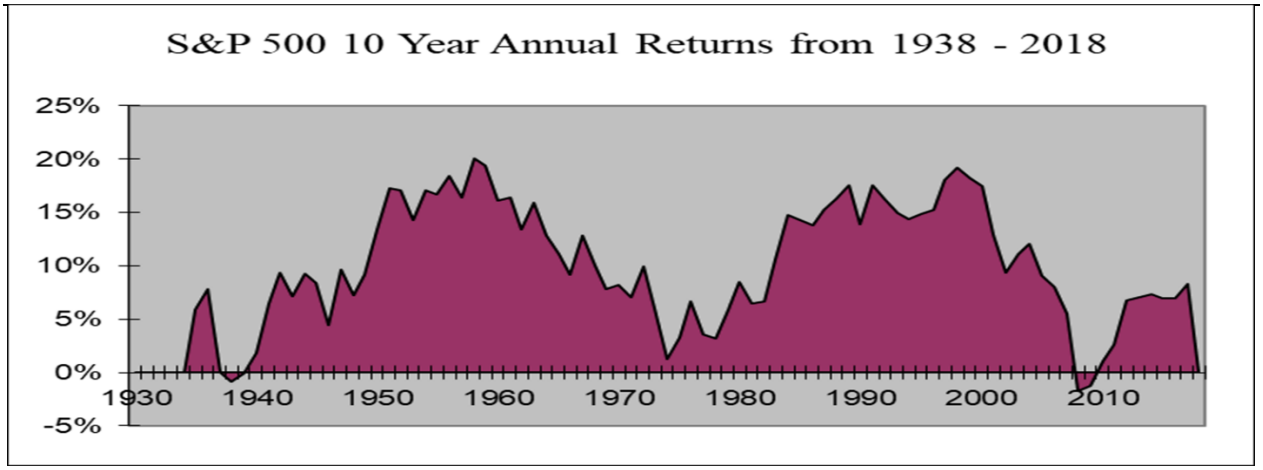
between 0.1 and 0.9 percent.

Chart 6. Five-Year Annual Returns



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.

Chart 7. 10-Year Annual Returns



Summary

There are several steps you should take before you invest. Remember the top half of the investment hourglass: God comes first, then family, then personal responsibility and accountability, and then investments. There is no better way to start investing than to have your priorities in order.

This principles-based approach to investing will not change over time because the principles of good investing do not change. These important investing principles, if followed, will result in a

quality Investment Plan and lead to a successful investment portfolio. The principles are the following:

1. Know yourself.
2. Understand risk.
3. Stay diversified.
4. Make low-cost and tax-efficient investments.
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.

Table 4. Geometric Return and Risk over Specific Time Periods

Total Returns For the Periods Ending December 31, 2018

	1 Year	5 Years	10 Years	25 Years	50 Years	75 Years	90 Years
S&P500							
Compound Return	-6.2%	7.6%	12.7%	8.9%	9.7%	11.2%	9.3%
Standard Deviation	14.7%	10.9%	13.6%	14.4%	15.0%	14.2%	18.7%
SmallCap							
Compound Return	-12.2%	3.5%	12.7%	10.3%	11.0%	13.6%	11.5%
Standard Deviation	18.5%	15.2%	18.9%	20.1%	21.2%	19.9%	28.5%
T-bond							
Compound Return	11.6%	6.2%	4.3%	7.0%	8.0%	5.8%	5.5%
Standard Deviation	21.7%	15.2%	14.1%	11.6%	11.3%	9.6%	9.0%
T-bill							
Compound Return	1.9%	0.6%	0.3%	2.4%	4.7%	3.9%	3.3%
Standard Deviation	0.1%	0.2%	0.2%	0.6%	1.0%	0.9%	0.9%
EAFE (International)							
Compound Return	25.6%	8.4%	2.4%	6.9%			
Standard Deviation	4.3%	11.7%	18.5%	16.0%			
Emerging Markets							
Compound Return	37.8%	4.7%	2.0%	8.0%			
Standard Deviation	6.7%	12.3%	22.7%	22.4%			
REITs							
Compound Return	5.1%	9.3%	7.4%				
Standard Deviation	6.8%	15.0%	39.1%				
CPI							
Compound Return	2.1%	1.5%	1.8%	2.2%	4.0%	3.6%	3.0%
Standard Deviation	0.0%	0.8%	1.0%	1.1%	1.3%	1.5%	1.8%

Source: Ibbotson Associates for large cap, small cap, T bond, T bill and Inflation up to 2014 with Bloomberg for 2015 and beyond, and Morgan Stanley Capital International for the remainder, 2015 and beyond.

In order to invest successfully, you must understand the risks and benefits of each of the major asset classes.

Asset classes broadly categorize investments with specific and similar risk and return characteristics. Asset classes are categorized by the characteristics that are unique to particular groups of securities, such as type of financial instrument, market capitalization, maturity, and geographic location. The major asset classes are cash and cash equivalents, fixed-income investments (bonds), and equities (stocks).

From Table 4, we note several important aspects of successful investing. First, each asset class has different return and risk characteristics, which should be accounted for when building your portfolio. As a general rule, the higher the return, the higher the risk. When you build your portfolio, you are not just trying to plan for a higher return but for a lower risk as well. Third, while stocks are volatile on a monthly basis, over time the bad periods are offset by the good periods. Generally, the longer the time period, the greater the likelihood of positive returns. Finally, if you want your portfolio to grow faster than taxes and inflation, you should consider making stocks an important part of your portfolio.

Assignments

Financial Plan Assignments

This section on investing is different from previous sections. Instead of vision and goals, these things are included (well mostly) in your Investment Plan, which we have prepared a template (Investment Plan Example Template (LT5A)). We then encourage you to change it to fit your situation. Because of the number of different and important parts to this Investment plan, we have chosen to give you more guidance.

Understanding yourself is a critical part of investing. It is important that you understand both your personal view of investing as well as your family view of investing—how you were brought up. Review the questions on investing from Family - Key Questions on Money and Relationships (LT21). Reviewing your past can help you gain important insights about the events that shaped your views on money.

Review the top of the investment hourglass. Where are you on the top of the hourglass? Determine where you are and determine the steps you must take before you begin investing.

When you have answered these questions, you are ready to start creating your Investment Plan.

> First, copy the sample Investment Plan template found in Investment Plan Example Template (LT5A). While you do not need to know the entire plan today, it is important that you read through it. For this course, you will complete this entire 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, take a risk-tolerance test such as A Risk-Tolerance Test (LT16) or any number of tests available on the Internet. This will help you understand what kind of investor you are. After taking your risk-tolerance test, fill out the type of investor you are in Section I.B. (we should do this in class to help you).

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 A Risk-Tolerance Test (LT16). Later, you will return to this section to determine your allocations within the stock and bond asset classes.

Learning Tools

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

A Risk-Tolerance Test (LT16)

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.

Family - Key Questions on Money and Relationships (LT21).

This document asks nine simple questions regarding how your views on money were shaped. The answers to these questions can help you gain important insights about the events that shaped your views on money.

Review Materials

Terminology Review

Asset allocation. This is the process of managing risk in your investment portfolio. Asset allocation is the process of allocating assets between various asset classes. It determines the risk of the portfolio and is the percentage allocated to each of the different asset classes.

Asset classes. Asset classes are broad categories of investments with specific (and similar) risk and return characteristics. Asset classes 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.

Blend stocks. These are stock that are a part of both value and growth.

Cash and Cash Equivalents. Cash and cash equivalents is an asset class whose major goal is liquidity and to preserve capital. Cash includes CDs, money market funds, T-bills, and commercial paper, etc. It also includes short-term interest-bearing investments such

as treasury bills and savings bonds, loans to the U.S. government, commercial paper, and loans to corporations. It is a good investment asset class for money you plan to use in less than 3-5 years and don't want to take risks. It is less attractive as medium-to-long-term investments (> 5 years) as returns on cash and cash equivalents are unlikely to keep up with inflation.

DALBAR. DALBAR is a private company that does research on investor returns. It puts out an annual survey in a book titles "Quantitative Analysis of Investor Behavior." It discusses how average equity fund investors have done versus benchmarks over the past 20 years in the equity, fixed income, and balanced categories.

Day trading. The process where someone with limited experience and minimal investment tools in the market trades on a daily basis with an expectation to outperform institutions with significant experience and tools. It is not investing, rather it is speculating.

Diversification. Diversification is the process of allocating your assets so they are not concentrated in a single asset class. It is "not putting all your eggs in one basket". Having a diversified portfolio in many different asset classes is your key defense against risk

Emerging Market stocks and emerging market mutual funds. These are stocks or mutual funds of companies that trade in the countries not considered develop by the IMF. These are often smaller companies in smaller markets. 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.

Equities (or Stocks). Equities are an asset class that provides growth and earns returns in excess of inflation. Over longer periods of time, the stock market historically has been the only major asset class to consistently outpace inflation. Equity ownership is ownership in a businesses' earnings and assets. Equity asset classes are delineated by market capitalization (which is shares outstanding multiplied by the stock's current market price), type of company (growth versus value), and geographic area. The benchmarks for equity asset classes can be generally defined as capitalization: Large, mid, and small; type: Growth, blend, and value; or geographic area: US, international, global and emerging markets. Equities have offered the highest return of the major asset classes historically and have been a good investment for long-term investing—they have consistently beat inflation over the long-term. However, they offer less stability of principal than other asset classes, and are subject to short-term price fluctuations (very risky for short-term investments).

Financial assets/instruments. These are different types of securities that are sold in financial markets.

Financial markets. Markets in which financial securities or assets are bought and sold.

Fixed Income. Fixed income is an asset class that attempts to provide income and to earn returns in excess of inflation. There are two different types of fixed income assets: Taxable bonds. 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. Fixed income includes short-term bonds/bond funds, intermediate-term bonds/bond funds, and long-term bonds/junk bonds/bond funds issued by governments or corporations. Fixed income offers greater returns than cash, but with greater risk. It offers good diversification tool when holding a long-term stock portfolio, as bonds move differently than stocks. However, returns have been historically lower than stocks, they are very susceptible to interest rate and other risks, and 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.

Global stocks and global stock mutual funds. These are stocks or mutual funds of companies that contain a mixture of U.S. and foreign or international holdings. 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.

Growth stocks. These are fast-track companies whose earnings are expected to grow very rapidly. Frequently these are companies developing new technologies or new ways of doing things.

International stocks and international mutual funds. These are stocks or mutual funds of companies based entirely outside the U.S. These can be of any size (small-cap, large-cap), any type (value, growth) and from any part of the world outside the US. 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.

Large-cap (capitalization) stocks. Large caps are stocks with a market capitalization greater than roughly $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. These are generally mature corporations with a long track record of steady growth and dividends.

Market capitalization. It 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. Market capitalization is used to weight companies in various benchmarks and to determine certain classes of companies, i.e. large-cap, mid-cap, small-cap, etc.

Mid-cap or mid-capitalization stocks. These are stocks with 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 similar to the small-cap asset class. For asset-allocation purposes, mid-caps are generally not considered a major asset class.

Risk. Risk is the possibility of having a return different from what was expected, whether it is losing all your money, losing principle, or not achieving a specific rate of return. There are many different types of risk including: inflation, business, interest rate, financial, market, political and regulatory, exchange rate, call, and liquidity risk.

Small-cap or small capitalization stocks. Small-cap 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.

Taxable bonds. Taxable bonds include U.S. Treasuries, corporate bonds and agency issues (bonds issued by U.S. government agencies, like Ginnie Mae).

Tax-free bonds. 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.

Value stocks. These are inexpensive (in terms of low PE and low P/BV ratios), companies that have potential for good long-term return through both appreciation and dividends.

Review Questions

1. What is the most critical part of investing?
2. What are the 10 principles of successful investing?
3. What are asset classes? What are the three major asset classes?
4. What is the difference between investors and gamblers?
5. What is the main goal of cash and cash-equivalent investments? Fixed-income investments? Equities?

Case Studies

Case Study 1

Data

Bill wants to know how much he will need to save at the end of each year to have $1 million in savings when he retires in 30 years.

Calculations

Assuming Bill can earn an 8.5 percent return on his investment, how much must he save each year?

Application

What assets would you recommend Bill use to save?

Case Study 1 Answers

Calculations

Set your calculator to 1 payment per year (annual).

N = 30, I = 8.5%, PV = 0, FV = $1,000,000

Solve for Bill's annual payment.

Bill would need to save $8,050.58 annually to reach his goal.

Recommendations

Bill could use any number of investment assets, including stocks, bonds, cash, mutual funds, etc. Since Bill is just starting out, I would encourage him to consider the use of inexpensive, no-load index mutual funds as investment assets.

Excel Financial Calculator (LT12)		
The Payment is -$904.01		
Present Value =	PV	
Years/Periods* =	N	30.00
Payments/Year =	P/Yr	12
(Compounding: Ann. = 1, Mon. = 12, Qrtly. = 4)		
Annual Interest =	I_{real}	6.50%
Ann. Nom. Rate =	I_{nom}	6.50%
Ann. Inflation =	I_{infl}	
12 Period Rate =		0.54%
Future Value =	FV	$1,000,000
Payments =	PMT	($904.01)

Case Study 2

Data

Last year Kim purchased 100 shares of MSAM Corporation for $40 per share. Over the past 12 months, MSAM's price has gone up to $45 per share, and she received a dividend of $1 per share.

Calculations

What was Kim's total rate of return on her investment in the MSAM stock?

Case Study 2 Answer

Calculations

This can be solved either on a total portfolio basis or on a per share basis.

Total Portfolio

(($45 × 100 − $40 × 100) + 1 × 100) / $40 × 100 = ?

Kim's total rate of return is 15%.

Per-share basis

(($45 − $40) + 1) / $40 = ?

Kim's total rate of return is 15%.

Excel Financial Calculator (LT12)		
The Interest Rate is 15.00%		
Present Value =	PV	($40)
Years/Periods* =	N	1.00
Payments/Year =	P/Yr	1
(Compounding: Ann. = 1, Mon. = 12, Qrtly. = 4)		
Annual Interest =	I_{real}	15.00%
Ann. Nom. Rate =	I_{nom}	15.00%
Ann. Inflation =	I_{infl}	
1 Period Rate =		15.00%
Future Value =	FV	$45
Payments =	PMT	$1.00

Case Study 3

Data

Kim's investment in MSAM stock was so successful that she decided to hold it for five more years. Remember, she purchased 100 shares for $40 per share. Unfortunately, the price of MSAM stock has not risen any further—in fact, it is back to where it was when she purchased it. The good news is that she earned $1 per share for five years.

Calculations

What was Kim's annualized total rate of return?

Application

Compared to a bank account earning 2.25% over this same period, how did Kim's stock do?

Case Study 3 Answers

Calculations

Kim's annualized rate of return is her return for the total period, annualized, or taking the geometric return.

Kim's total return for the five-year period is:

(($40 × 100 − $40 × 100) + 5 × 100) / ($40 × 100) = 12.5%

Taking that return and annualizing for five years gives the following annual

returns:
Geometric return = $(1 + .125)^{(1/5)} = 2.38\%$
Average return = 12.5% / 5 = 2.5%
Using either method, Kim's stock performed better than the bank account.

Excel Financial Calculator (LT12)		
The Interest Rate is 2.50%		
Present Value =	PV	($40)
Years/Periods* =	N	5.00
Payments/Year =	P/Yr	1
(Compounding: Ann. = 1, Mon. = 12, Qrtly. = 4)		
Annual Interest =	I_{real}	2.50%
Ann. Nom. Rate =	I_{nom}	2.50%
Ann. Inflation =	I_{infl}	
1 Period Rate =		2.50%
Future Value =	FV	$40
Payments =	PMT	$1.00

Case Study 4

Data
Sam recently purchased a bond with a 10-year maturity for $1,000, which pays annual interest of $100.

Calculations
What interest rate is Sam receiving?
If interest rates for 10-year bonds today are 5 percent, how much can Sam sell his bond for today?
How much could he sell the bond for tomorrow if interest rates move up to 12 percent?
Applications
Based on your calculations, what is the relationship between interest rates and the value between bonds?

Case Study 4 Answers

Calculations

The bond's current yield is $100/$1000 = 10%.
At 5% Sam can sell his bond for:
N = 10, I = 5%, PMT = 100, FV = 1,000, solve PV?
$1,386.07
At 12% Sam can sell his bond for:
N = 10, I = 12%, PMT = 100, FV= 1,000, solve PV?
$887.00
This implies a negative relationship between bond prices and interest rates. In other words, as interest rates increase, bond prices fall, and when interest rates decrease, bond prices rise.

Excel Financial Calculator (LT12)		
The Present Value is -$1,386.09		
Present Value =	PV	($1,386)
Years/Periods* =	N	10.00
Payments/Year =	P/Yr	1
(Compounding: Ann. = 1, Mon. = 12, Qrtly. = 4)		
Annual Interest =	I_{real}	5.00%
Ann. Nom. Rate =	I_{nom}	5.00%
Ann. Inflation =	I_{infl}	
1 Period Rate =		5.00%
Future Value =	FV	$1,000
Payments =	PMT	$100.00

Excel Financial Calculator (LT12)		
The Present Value is -$887.00		
Present Value =	PV	($887)
Years/Periods* =	N	10.00
Payments/Year =	P/Yr	1
(Compounding: Ann. = 1, Mon. = 12, Qrtly. = 4)		
Annual Interest =	I_{real}	12.00%
Ann. Nom. Rate =	I_{nom}	12.00%
Ann. Inflation =	I_{infl}	
1 Period Rate =		12.00%
Future Value =	FV	$1,000
Payments =	PMT	$100.00

Case Study 5

Data

Ryan is 35 years old and took the Risk Tolerance Test from A Risk-Tolerance Test (LT16). He determined that he was "moderate" in terms of risk.

Application

Based on the rule of thumb for his age in bonds, which of the following most likely represents Ryan's preferred asset allocation (assume his emergency fund is included in cash and bonds)?

- Portfolio A: 35% cash, 40% large-cap, 25% bonds
- Portfolio B: 25% cash, 35% large-cap, 25% small-cap, 15% international
- Portfolio C: 10% cash, 25% bonds, 50% large-cap, 15% small-cap
- Portfolio D: 15% bonds, 30% large-cap, 30% small-cap, 25% international

Case Study 5 Answer

Ryan's preferred allocation would likely be Portfolio C.

Portfolio A has too much exposure to cash and bonds.

Portfolio B has too large an allocation to international and small-cap (40 percent), which involves much more than a moderate risk exposure.

Portfolio C is more consistent with Ryan's risk-tolerance level: 35 percent in bonds and cash and some (limited) exposure to small-caps.

Portfolio D has too little exposure to bonds and cash and too much small-cap and international.

Case Study 6

Data

Assume the same information from Case Study 5 but change Ryan's Risk Tolerance Test result to "aggressive."

Application

A. Based on the same rule of thumb, which of the following most likely represents Ryan's asset allocation?

- Portfolio A: 35% cash, 40% large-cap, 25% bonds
- Portfolio B: 25% cash, 35% large-cap, 25% small-cap, 15% international
- Portfolio C: 10% cash, 25% bonds, 50% large-cap, 15% small-cap
- Portfolio D: 15% bonds, 30% large-cap, 30% small-cap, 25% international

B. What would his allocation be if his results were "very aggressive"?

Case Study 6 Answer

A. The preferred allocation for "aggressive" would be Portfolio B.

Portfolio A has too much exposure to cash for his risk level.

Portfolio B is consistent with Ryan's risk-tolerance level; it has a larger allocation to international and small-cap (40 percent) and a lesser allocation to bonds and cash.

Portfolio C has too much (35 percent) in bonds and cash and likely not enough of

the riskier assets.

Portfolio D has too little exposure to bonds and cash, and likely too much small-cap and international.

B. The preferred allocation for "very aggressive" would be Portfolio D.

Portfolio D has less exposure to bonds and cash and much more small-cap and international (55 percent), which is consistent with a "very aggressive" risk-taker.

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[1] *Presidency of The Church of Jesus Christ of Latter-day Saints*, 6 vols., [1965–75], 3:54.
[2] "Brother's Keeper," *Ensign,* Nov. 1986, 20.
[3] Carla Fried, "The Problem with Your Investment Approach," *Business 2.0,* Nov. 2003, 146.
[4] Carla Freid, "The Problem with Your Investment Approach," *Business 2.0*, Nov. 2003, 146.
[5] Carlos E. Asay, "Scriptures and Sunday Classes," Ensign, January 1986.
[6] Chart 2; Carla Fried, "The Problem with Your Investment Approach," *Business 2.0,* Nov. 2003, 146.
[7] In James R. Moss, "Sheep, Shepherds, and Sheepherders," *New Era,* June 1977, 20.
[8] "Reach with a Rescuing Hand," *New Era,* Jul. 1997, 4.

19. Investing 2: Understanding and Creating Your Investment Plan (IPS)

Introduction

Once you have put your finances in order and know what to do before you invest, you are prepared to invest. Like a good road map, a good Investment Plan (or Investment Policy Statement) helps you know where you are and where you are headed. A good financial road map helps you know your goals, your budget, and your risk tolerance; it also helps you avoid hazardous detours, such as get-rich-quick schemes, which may delay or stop your progress. A good financial road map helps you decide where you want to go in terms of your personal and family goals and helps you get there by making wise choices regarding investment and savings programs. A good Investment Plan is key to achieving your financial goals. The purpose of this chapter is to help you write your personal Investment Plan.

Objectives

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

A. Understand the importance of financial goals and how to set them
B. Know the importance of your Investment Plan and how to prepare it
C. Identify and be aware of get-rich-quick schemes and how to avoid them.

Understand the Importance of Financial Goals and Know How to Set Them

Not every personal goal is a financial goal, but many personal goals require some money to be accomplished. Certain personal goals cannot be accomplished without meeting specific financial targets, such as saving for the down payment on a house or saving for a child's education. If you do not calculate and plan for the costs of many of your personal goals, it is likely that you will not be able to accomplish them.

The processes for setting personal goals and setting financial goals are the same:

1. Catch your vision, identify your goals and write them down.
2. Prioritize your goals, and list them in order from most important to least important.
3. Calculate the financial costs of each goal that requires financing.
4. Set a completion date for each goal and record the total amount needed to complete the goal.
5. Determine how much you must save each month (and which accounts you will use to save that money) to meet your goals.

6. Begin saving now.
7. Periodically evaluate your progress toward achieving your goals.

There are several important questions you should ask yourself about each of your financial goals to see if you are really committed to attaining them.

First, how important is the goal to you? How much you are willing to sacrifice to pursue the goal? Most goals require sacrifice to achieve. If you are not willing to make the sacrifices necessary to achieve a particular goal, it is likely not important to you and will be difficult for you to achieve.

Some of the goals on your list may really just be wishes—things you dream of having or achieving but are not really committed to working toward. So ask yourself, is this truly a goal, or is it just a wish? Wishes do not count—eliminate them from your list.

Second, how much money do you need to accomplish the goal? Once you have calculated the financial cost of each goal, determine whether the amount you need is before taxes or after taxes, and whether it is before inflation or after inflation. This is important to determine because the differences between these amounts may be substantial. Do not let inflation or taxes keep you from achieving your goals.

Finally, when do you need the money? Is the goal feasible with your current financial plan? Good financial plans require you to sacrifice—to stretch—but they are also reasonable for your individual financial situation.

Understand the Importance of your Investment Plan and How to Prepare It

The most important financial-planning document you will prepare, besides your list of personal and family vision and goals, is your Investment Plan. In finance terms, your Investment Plan is also known as your investment policy statement (IPS). An Investment Plan is important because it creates a framework for every investment activity in which you will participate. It states what you will invest in, how you will invest, why you will invest, what percentage of your money you will invest, and so on. In short, your Investment Plan significantly affects your investment returns. Write this plan well and then follow it carefully. An example of a good Investment Plan is found in the Learning Tools directory of the website under Investment Plan Example Template (LT05A). Your Investment Plan is a detailed description of all the major components of your investment strategy. It will help you to do the following:

1. Represent yourself: It explains your personal investment characteristics, such as your risk tolerance and your personal constraints, and how those relate to your asset allocation and targets.

2. Articulate what you will and will not do: This plan clearly states what you will and will not invest in and how you will invest. It also includes investment guidelines that

will help you invest your money wisely and achieve your goals.

3. Provide an investment framework and guidelines for making wise investment choices. If you clearly think through and plan how you will invest now that you have few assets (and are not influenced by fear and greed), you will have an investment framework and guidelines to help you reason through decisions that could have a major impact on future financial goals and retirement. If followed carefully, your plan will help you avoid poor investment decisions that could have major repercussions for your financial life. But you must write your Investment Plan carefully and then follow it.

Your Investment Plan is divided into four separate categories:

1. Risk and return objectives
2. Investment guidelines and constraints
3. Investment policies, plans and strategies
4. Portfolio monitoring, reevaluation, and rebalancing

1. Risk and Return Objectives

This category describes your expectations for returns on your investments. These expectations will, to a large extent, determine your asset-allocation decisions. In other words, these expectations will determine how you will distribute your investments among different asset classes. This category also addresses your expectations for risk and outlines how much risk you are willing to accept.

Expected returns. You should not invest without specific goals in mind. For your first goal, you should decide what return you expect your total portfolio to make over a specific time period. You cannot know with certainty what the actual returns will be before you invest. However, you can estimate an expected return, or a goal you hope to achieve during a certain period of time (such as a week, a month, or a year). Be aware that your expected return will have a major impact on what your portfolio looks like.

- An expected annual return of 1 to 2 percent will likely be the result of a diversified, very low-risk portfolio.

- An expected annual return of 3 to 4 percent will likely be the result of a well-diversified, low-risk portfolio.

- An expected annual return of 5 to 6 percent will likely be the result of a well-diversified, moderate-risk portfolio.

- An expected annual return of 7 to 8 percent will likely be the result of a less-diversified, high-risk portfolio.

- An expected annual return greater than 9 percent will likely be the result of an undiversified, very high-risk portfolio that is heavily dependent on high-risk assets.

Note that you will determine your expected returns for two periods of time: before retirement and during retirement.

There are several ways to estimate your expected returns. To give you an idea of how to estimate your expected returns over a period of time longer than one year, it may be helpful to look at the long-term history of the asset classes you have selected. Look at Historical Return Simulation for Asset Classes (LT23).

Expected risk. Since a higher expected return requires you to accept more risk, it is important that you know your risk-tolerance level, or your willingness to accept risk. Where you are in your life, as represented by your age, will likely have a big impact on how much risk you are willing to take. In general, when people are younger, they are more willing to accept risk because their investments will have more time to grow and overcome losses. As people grow older, they usually become less willing to accept risk because they will need their investment funds sooner for retirement and other purposes. Investors that have a low tolerance for risk should typically devote the majority of their portfolios to bonds and cash because these investments are the least risky of all asset classes; however, these investments also have the lowest returns. Investors that are willing to accept more risk may allocate more of their portfolio to U.S. and international stocks versus investments in bonds and cash. The challenge of wise investing is to balance your risk and return expectations with your situation in life and your personal goals.

Defining risk in your portfolio is a challenge. Professional investors usually state an annual standard deviation as the acceptable risk level for their portfolios—for example, 12 percent. From a financial standpoint, this means that 66 percent of the time the investor's risk will be within one standard deviation (plus or minus 12 percent) of his or her mean or average return. If an investor's average return is 8 percent, this means there is a 66-percent chance that the investor's returns will be between –4 percent (8 percent – 12 percent) and 20 percent (8 percent + 12 percent). While using a standard deviation to define risk may be helpful for some, this method will not work for everyone. I would like to propose a more simple way of defining risk: using investment benchmarks.

Instead of defining your risk-tolerance level in terms of a standard deviation, you can simply define it by deciding that you are willing to accept the risk of the benchmarks you have chosen for your portfolio. You can determine how risky a particular asset is by looking at your investment benchmark. If you have a small-capitalization stock mutual fund or asset that has had a return of 6.5 percent over the last 10 years and a standard deviation of 19.3 percent, you can compare this asset to an investment benchmark for small-cap stocks. From Table 4 in the previous chapter, note that small-cap stocks have yielded a 7.2 percent return over the past 10 years with a 20.6 percent standard deviation. Your mutual fund or asset has a slightly lower return than the benchmark (6.5 percent versus 7.2 percent), but with slightly lower risk than the benchmark (19.3 percent versus 20.6 percent).

You can also determine a portfolio's risk level by comparing the portfolio to weighted individual benchmarks. For example, if you choose a portfolio that is made up of 50 percent U.S. stocks, 20 percent international stocks, 25 percent bonds, and 5 percent real estate (all percentages should add up to 100), then your risk is equal to the risk defined by the benchmarks of each of these asset classes. In this case, your risk would be equal to the benchmarks of each element in a portfolio that contains 50 percent U.S. stocks (as measured by Standard and Poor's 500 Index, a major benchmark for large-capitalization stocks); 20 percent international stocks (as measured by MSCI Europe Australia, Far East Index (EAFE), a major benchmark for international stocks); 25 percent bonds (as measured by the Barclays Aggregate Index, a major benchmark for bonds); and 5 percent real estate (as measured by Standard and Poor's REIT Index, a major benchmark for real estate investment trusts). A list of the major benchmarks for a portfolio can be found in the Learning Tools directory of the website under Possible Benchmarks for Investment Plans (LT15) and Expected Return Simulation and Benchmarks (LT27). Asset class performance over the past 1, 5, 10, 25, 50, 75, and 85 years can be found in Table 4 in the previous chapter of this manual.

2. Investment Guidelines and Constraints

The second category of your Investment Plan is investment guidelines and constraints.

Investment guidelines. Your investment guidelines are the road map for how you will invest over your lifetime. These guidelines and constraints explain the ways in which you will invest differently at different phases in your life. Generally, most individuals have three stages of their financial life cycle. Most investors who are younger than age 55 are in stage one, or capital accumulation and growth. Investors who are approaching or in retirement are typically in stage two, where the main goal is investment preservation, or maintaining the value of investments. The choice of the number of stages is arbitrary. You can add more stages if you choose.

Your investment guidelines should provide you with a general road map for investing money at different stages of your financial life cycle. These guidelines should integrate all of your financial goals to give you a complete financial perspective.

Investment constraints. Once you have decided on your investment guidelines, you should identify your investment constraints. Your Investment Plan should address a number of important constraints: liquidity, investment horizon, tax considerations, and any special needs.

Liquidity is the speed and ease with which an asset can be converted into cash. As you create your plan, consider how important it is for you to have the option of turning your assets into cash quickly. Ask yourself how much money you will need at different times in your life and how quickly that money needs to be available. Examples of liquidity constraints include paying for graduate school, making a down payment on a house, and sending a child to college. To pay for these expenses, you will need to convert assets into cash.

Investment Horizon is the amount of time you are planning to keep an asset to save for a

particular purchase. Consider how soon you will need to use the funds from a particular investment. Examples of short-term investment horizons include saving for a new car or making a down payment on a house. An example of a long-term investment horizon would be saving for retirement or saving for your children's college educations.

Tax considerations take into account your current tax bracket and your current tax rates. Consider your tax position: are tax-free or tax-deferred investments more advantageous than taxable investments? You cannot simply compare the stated returns of particular assets; you must compare assets by taking into account that certain investments eliminate federal or state taxes and those other investments are tax-free. For example, if you are comparing government I and EE savings bonds versus corporate bonds, you must take into account that government I and EE savings bonds are state tax-free (and federal tax-free if principal and interest are used for college tuition costs), while corporate bonds have no tax advantages.

Special-needs are constraints related specifically to your family, your business, and other areas of life that are important to you. Do you have a child with a disability? This may impose specific requirements on your Investment Plan because you will likely need life insurance to provide funds for a disabled child in case of your death. Is a large part of your wealth tied up in your company? This imposes constraints such as the decision of how much you should invest in your company's employee stock-ownership plans. You may have other special constraints that will influence your investment decisions. It is critical that you understand your special needs before you begin investing.

3. Investment Policies, Plans and Strategies

Your Investment Plan also includes your investment policy, which is a written statement of what you will and will not invest in, how you will allocate your investments, and how you will distribute your assets. Your investment policy is divided into six sections:

- Acceptable and unacceptable asset classes
- Investment benchmarks
- Asset allocation
- Investment strategy
- Funding strategy

Acceptable and unacceptable asset classes. It is important that you decide which assets you will invest in before you begin investing so that others will not be able to convince you to invest in asset classes that are not suitable for you at your stage in the financial life cycle. Invest where you have a particular expertise or where the odds are in your favor. You should plan to invest in asset classes that have a history of delivering long-term returns, not just high returns over very short periods of time. For example, I recommend that investors invest in stocks, bonds, mutual funds, and cash and cash equivalents; I do not recommend investing in futures, options, foreign currencies, or precious metals. The investments I have recommended have long-term histories of consistent performance, while the investments I do not recommend lack a history of consistent

performance.

Review the historical performance of various asset classes to roughly estimate future performance. After reviewing the historical performance of the various asset classes, it is likely you will decide to invest in stocks and mutual funds, bonds and cash equivalents, and real estate.

Once you have identified which asset classes you will invest in, you must also determine which asset classes you will not invest in. Asset classes on this list may include those in which you do not have expertise or those in which the odds are against you. For example, most investors should probably not invest in asset classes such as foreign currencies. The foreign currency trades are controlled by large international banks, which employ hundreds of very experienced men and women with PhDs in finance. These banks have billions of dollars invested in computers and computing power as well as real-time databases to alert them immediately to economic changes that may affect currencies. The odds are not in your favor: investing in foreign currencies is known as a "zero sum game." This means that for every winner, there must be a corresponding loser. You do not want to be that loser. Other asset classes that typically require a great deal of expertise include commodities (especially commodity futures contracts, which have very high levels of implicit debt), precious metals, and art. Be cautious of investing in these areas unless you have specific expertise to support your investment decisions.

Investment benchmarks. These are hypothetical investment portfolios that show how a specific set of assets performed over a specific period of time. These portfolios can help investors evaluate how their investments are performing versus how the benchmark is performing over the same time period. Unless you have a benchmark by which you can judge your investments' performance, you cannot know how your investments are doing. For example, if you invest in a mutual fund of large-cap stocks and your annual return is 6 percent for 2016, how do you know if this is a good or bad return? You cannot know if you do not have anything to compare this information with. But if you know that your benchmark for large-cap stocks, the Standard and Poor's 500 Index, rose 12 percent during 2016, then you know that your investment underperformed in that year. Your investment was up 6 percent for the period versus a 12 percent return for the benchmark.

Investors select benchmarks based on asset classes, size or capitalization, geography, issuer, and investment style. Investment benchmarks are covered more thoroughly in later sections of this course.

Asset allocation. Asset allocation is the process of determining how much you will invest in each specific asset class in your portfolio. Research has shown that the decision of how to allocate your assets is the most important factor affecting your portfolio's performance.[1] As you write this section of your Investment Plan, you should answer these questions:

- How much will you invest in each asset class?
- What percentage of your total investments will you invest in each asset class?
- What is the minimum allocation of funds you will invest in an asset class at any point in time?

- What is the maximum allocation?
- What is the target allocation?

Your target asset allocation will probably vary throughout your life. Again, the younger you are, the more likely it is that you will be willing to invest in riskier asset classes. Likewise, the older you are, the less likely it is that you will be willing to invest in riskier asset classes.

In general, the first decision you should make when determining your asset allocations is between stocks and bonds. One time-tested way to decide how much you should invest in bonds is to use your age as the percentage for the allocation. The logic behind this starting point is that the older you are, the more you should invest in bonds because bonds are less risky than other investments. The remainder of your portfolio would be allocated to equities.

The second step you should make when you are determining your asset allocations is to understand your risk tolerance. I recommend that you take a number of different risk-tolerance tests to help you decide how to make allocations in your portfolio. One example of a risk-tolerance test is found in A Risk-Tolerance Test (LT16) in the Learning Tools directory of the website. Based on the results from this test, you may either decide to increase your equity allocation above the time-tested approach if the test indicates you are an "aggressive" investor or reduce your equity allocation if the test indicates you are a "conservative" investor. The amount you increase or reduce for different allocations should be based on your individual tolerance for risk.

After you have decided on your portfolio's allocations, you should add different types of stocks and bonds to deepen your portfolio. You might add some small-cap stocks or some international stocks if you want to take on more risk. Or you might add some federal tax-free municipal bonds or state tax-free Treasury bonds if you want to reduce the risk of your portfolio. You can then broaden your portfolio by adding additional asset classes, such as real estate, emerging markets, and inflation-linked bonds.

Once you know the asset classes you want to invest in, it is important that you decide on a minimum allocation, maximum allocation, and target allocation for each asset class. Having a set minimum allocation preserves diversity in your portfolio. Diversification is an important tool for reducing risk. Since your allocations will change over time, reaching your maximum allocation will be a signal that it is time to rebalance your portfolio back to your target, or ideal allocation, based on your current expectations and the current market conditions.

When you are determining minimum, maximum, and target allocations, you should take into account where you want to be throughout your entire investing life. It is likely you will have to make different allocations for the different stages of your financial life cycle—for example, newly married, kids in college, retirement, and so on.

Investment Strategy. Your investment strategy describes how you will invest your money. It clarifies how you will manage, prioritize, and fund your investment; it also describes how you

will evaluate new investments. The following paragraphs explain some of the questions you should answer about your investment strategy.

Will you use active management or passive management? Active management is a strategy in which you try to outperform your benchmarks by actively buying and selling stocks and bonds. This strategy requires considerable time and expense to maintain. Passive management is a strategy in which you invest in index funds, or exchange-traded funds, instead of trying to beat your benchmarks: index funds, or exchange-traded funds, simply mirror the performance of your benchmarks. This strategy is much cheaper in terms of time and costs, and it is often more tax-efficient as well.

You may also choose to use a combination of active and passive management for your portfolio. For example, you may choose to use active management for your tax-deferred accounts (these accounts do not require you to pay taxes until retirement, when you withdraw the money) and passive management for your taxable accounts (these accounts require you to pay taxes each year). Your choices will depend on your goals, your objectives, and your investment style.

Will you invest in mutual funds or individual assets? Mutual funds are professionally managed portfolios that are composed of similar assets. Mutual funds offer the benefits of diversification and economies of scale. Investing in individual assets, such as stocks and bonds, allows you to control what you invest in and when you will realize capital gains. While it is much more exciting to invest in individual assets, these assets also involve much more risk and instability. You may choose to invest in a mix of assets: a combination of mutual funds and individual stocks or bonds.

Will you use leverage in your investing? Using leverage is the process of borrowing either money or securities for your investment activities. Using leverage is not recommended. While leverage increases the potential for return on an investment, it also magnifies the potential for loss. Many investors have lost significant amounts of financial assets by using leverage. There are two types of leverage used by a few individual investors: buying on margin and short selling.

Buying on margin is borrowing to purchase a stock. The amount of borrowing you use is referred to as your “leverage.” For example, you are sure the value of a stock you do not currently own will go up soon. You invest $10,000 of your own money and invest another $10,000 that you borrow from your broker—buying on margin. If the value of the stock goes up, you make a larger profit because you used leverage to invest more. However, if the value of the stock goes down, you incur a larger loss because you invested more, and you must still pay back the $10,000 you borrowed, regardless of the price of the stock. With leverage you can lose considerably more than the amount you put up of your own money.

Short selling is another type of leverage in which you borrow stock and then sell it immediately. For example, you are positive the value of a stock will go down. Before the stock goes down, you borrow a hundred shares of that stock from your broker and sell them. Again, you are borrowing, but this time you are borrowing stock instead of money. If the stock price goes down,

you will be able to buy the shares back at a lower price; you make a profit by selling the borrowed shares at a higher price and buying them back at the lower price to replace the stocks you borrowed. However, if the value of the stock goes up, you will have to use your own money to buy back the more expensive shares; you must also repay any dividends paid during the period you borrowed the shares.

Using leverage is risky because you can lose much more than you originally invested. Do not take the chance. Joseph F. Smith stated the following:

> If there is anyone here intending to go into debt for speculation . . . I would advise him to hesitate, pray over it, and carefully consider it before he obligates himself by borrowing money and going into debt. In other words, keep out of debt if you can. Pay your debts as soon as you can.[2]

Finally, how will you handle new investments? You need to decide the maximum percentage you will allocate to any new investment. Most experts advise that this amount should generally not be more than 10 percent of an investor's assets. Too often, people lose a great deal of money by putting all of their investments into one company or product that they think is a sure thing. There are no sure things. To avoid falling into this trap, decide now on the maximum amount you are willing to invest with a single investment: in other words, decide how much you would be willing to lose with a single investment.

You should also decide on the maximum amount of your company's stock that you will include in your 401(k) or other retirement account. For most people, this amount should not be more than 5 to 10 percent of the funds in their retirement account. Remember the principle of diversification. If your company does well, your job is secure and your retirement portfolio is strong. If your company does poorly, you may lose your job, and your retirement portfolio may be reduced substantially as well.

Funding strategy. You cannot invest without having the funds to invest, and you should not invest with borrowed money. Where will you get the funds for your investments? In a previous section, I recommended that you always pay the Lord first—that you pay tithes and other offerings before anything else—and then pay yourself a minimum of 10 percent, hopefully more (20 percent).

Most financial planners recommend that you save a minimum of 15 percent when you are young, and they recommend that this amount should increase as you get older. Once you have set aside the recommended 10–20 percent each month, invest this money wisely according to your personal Investment Plan. In this manual, I recommend that you save 20 percent of every dollar you earn after college.

How will you manage the funds for your various financial goals? One way to save for different financial goals is to set up different investment vehicles for each of your financial goals. You can use a 401(k) plan to save for retirement, a taxable account to save for your children's weddings,

and 529 funds and Education IRAs to save for your children's educations. You can also set up investment accounts to save for an emergency fund, a house down payment, or a car fund. If you pay yourself at least 10 percent (hopefully more), you can divide this money among your financial goals; for example, you could allocate 5 percent to your 401(k) plan, 4 percent to your investment fund, and 1 percent to your 529 funds.

4. Portfolio Monitoring, Reevaluation, and Rebalancing

The final part of your Investment Plan is describing how you will monitor, reevaluate, and balance your portfolio. Monitor and compare the performance of each of your assets against benchmarks on a monthly, quarterly, and annual basis. How did your assets perform? Which assets had returns that were greater than their benchmarks, and which assets had returns that were less than their benchmarks?

Setting goals is not a one-time event. You should continually review and reevaluate your goals. Has your situation in life changed? Which goals need to be changed to accommodate your situation?

Finally, has your portfolio shifted away from your target asset allocations because of time or because of the performance of your assets? How will you rebalance your portfolio to regain your target allocations, while at the same time minimizing the tax effects of rebalancing? We will discuss the topic of rebalancing in more detail in later sections.

Final Thoughts on Your Investment Plan

To conclude our discussion on investment plans, I would like to offer a few final suggestions. First, develop a good Investment Plan and stick to it. This plan is your road map to attaining your financial goals. Think it through, write it well, and follow it closely. An example of a good Investment Plan can be found in Investment Plan Example Template (LT05A). Feel free to copy this plan and personalize it based on your views of risk, return, constraints, investment policy, and portfolio monitoring and rebalancing. Instructions on filling this plan out are found in Investment Plan Example Instructions (LT5B).

Second, compare the performance of your assets to your chosen benchmarks on a monthly, quarterly, and annual basis. No one will watch your portfolio like you will.

Third, beware of following the investment crowd. It is unlikely that last year's best-performing asset classes will be this year's best-performing asset classes. In my experience with investing, I have found that winners rotate. Avoid chasing last year's winners.

Finally, remember that there are tax consequences for selling—try to minimize those tax consequences as much as possible. Beware of churning, or buying and selling too often. Rebalance your portfolio annually—perhaps even less often.

Identify and Beware of Get-Rich-Quick Schemes

Get-rich-quick schemes are investment methods in which you can supposedly make a lot of money in a short amount of time without having any knowledge or incurring any risk. If a promise seems too good to be true, it usually is. No one can guarantee a consistently high rate of return. Markets are unpredictable and so are returns. "Guaranteed high returns" are typically neither guaranteed nor high. The way to make money in the stock market is the old-fashioned way: saving and investing in a diversified portfolio for many years.

M. Russell Ballard stated the following about get-rich-quick schemes:

> 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.[3]

There are many types of get-rich-quick schemes. The paragraphs below discuss some of the most common schemes.

In **day trading,** an individual with little or no training in investing spends all of their free time in an attempt to outperform the market's benchmarks (and other investment professionals) after taxes and other fees. Most day traders make very little money and waste a lot of time at the expense of their families and often their regular jobs. Few, if any, day traders beat the market consistently over time and after taxes. While day traders may make money when the market is going up, day trading is not a viable long-term strategy.

For many, day trading is a form of entertainment, not investment. As long as you consider day trading to be entertainment, and as long as you only speculate with a small percentage (less than two percent) of your overall portfolio, it can be entertaining and fun. But it is not investing.

Trading rules are recommendations generated by individuals or computers for buying and selling stocks, mutual funds, and other assets. An example of a trading rule would be you would buy a stock when the 15 moving average crosses up through the 30 day moving average, and sell it when it crosses down through the 30 day. Marketers insist you will be able to beat the market by using these rules. Do not be fooled by these "trading" rules." Think about the marketers' motives. Ask yourself, if this trading rule is so great, why are they telling me? If the rules were useful, the sellers would just use them to get rich; they would not sell them to others. Be aware that all trading rules have major flaws. The biggest flaw is that they do not work consistently.

Stock market secrets are shortcuts, or secrets, that supposedly only the professionals know; marketers are willing to share these secrets with you—for a price. Again, look at the marketers' motives. Ask yourself, if this secret is so good, why don't the marketers invest their own money, make millions of dollars, and retire to an island in the Pacific? If the shortcut were useful, the

marketers would use them to get rich. They would not share them. In investing, it is critical to use time-tested information about markets, instruments, and trading; taking supposed shortcuts is usually hazardous to your wealth.

Outright lies are the promise of high and consistent above-market returns without risk. Don't get sucked in. If it seems too good to be true, it usually is. No one can guarantee a consistently high specific rate of return. Markets and returns are volatile. Guaranteed high returns are never guaranteed or high. The way to make money in the market is the old-fashioned way—to invest in a diversified manner for many years.

Insights on Get-Rich-Quick Schemes

There are no get-rich-quick schemes that work consistently. Following are four general tips to help you identify and avoid get-rich-quick schemes:

1. *Beware of the amount of time, energy, and money the suggested strategy requires*. I recommend you spend time with your family and work, and keep your money for yourself and invest it.

2. *Beware of the agency problem*. Ask yourself what a person wants to be given in exchange for his or her rules and secrets. If the answer is money, keep the money for yourself and invest it wisely.

3. *Beware of the "you can do it too" pitch*. Ask yourself if they really did it. Most sellers of get-rich-quick scheme are very selective as to the information they will supply. They only reveal selective bits of information about their success (and in some cases the information is wrong). They comment on "selective performance" when the method actually made money; "selective funds," the funds that actually made money; and "selective time periods," the time periods when the method worked. Most sellers have not even tried the strategies they suggest.

4. *Beware of the hidden costs of trading*. When sellers tell you about potential returns, they usually have not accounted for transaction costs, taxes, and other trading costs; these costs will substantially reduce your annual returns.

Summary

Certain personal goals cannot be accomplished without meeting specific financial targets, such as saving for the down payment on a house, or saving for a child's education. If you do not calculate and plan for the costs of your personal goals, it is likely you will not be able to accomplish them.

The most important financial planning document you will prepare, besides your list of personal and family goals, is your Investment Plan. An Investment Plan is important because it creates a

framework for every investment activity in which you will participate. It states what you will invest in, how you will invest, why you will invest, what percentage of your money you will invest, and so on. Write this plan well and then follow it carefully.

We have discussed the importance of creating a personal Investment Plan that can help you achieve your financial goals. Remember that your personal Investment Plan is your road map to successful investing: it will help you achieve your goals and avoid dangerous get-rich-quick schemes. The following are some final thoughts to consider before you invest:

1. Learn and follow the principles of investing. Avoid taking shortcuts.
2. Make investing an automatic part of your lifestyle. Strive to reach a point where you do not have to think about investing, you just do it.
3. Let others help you save. Take advantage of employee benefits and federal and state tax advantages. Use tax-deferred and tax-eliminated investment vehicles as much as possible.
4. Institute barriers that limit your access to your savings. The harder it is to liquidate your investments, the less often you will use your investment assets for everyday purchases.
5. Invest bonuses and other money you receive unexpectedly to help you achieve your financial goals more quickly.

Finally, get-rich-quick schemes are investment methods in which you can supposedly make a lot of money in a short amount of time without having any knowledge or incurring any risk. If a promise seems too good to be true, it usually is. No one can guarantee a consistently high rate of return. The way to make money in the stock market is the old-fashioned way: following the principles of successful investing and doing it consistently for many years.

Assignments

Financial Plan Assignments

Open your copy of your Investment Plan Investment Plan Example Template (LT05A). Make sure you understand the terminology related to investment plans. I will discuss many aspects of this plan in upcoming sections.

First, you will not have only one portfolio for your investments; you will likely have many portfolios, all of which are important parts of your Investment Plan. Review your vision and goals. What are you trying to accomplish individually and as a family through investing? Think through your general investment guidelines in Section IIA for both Stage 1 and Stage 2, and fill in those sections.

Using Expected Return Simulation and Benchmarks (LT27) , input your stock and bond allocations from your work you have done in the previous section.

There are four different asset classes for equities or stocks that I have data for. *Large-cap stocks*

are the largest and biggest companies, generally with market capitalization (or shares outstanding multiplied by share price) of over $10 billion dollars. *Small-cap stocks* have market capitalization generally between $250 million and $2 billion dollars. *International stocks* are those registered on exchanges outside the United States. And *emerging market stocks* are stocks of companies listed outside the U.S. and outside the major developed markets.

In bonds and cash, there are two different asset classes. Treasury bonds are long-term government securities, which are government debt with maturities generally one year or more. Treasury bills are government debt with maturities less than one year.

Real Estate Investment Trusts (REITs) are neither stocks nor bonds but have components of both.

Using the dropdown boxes in Expected Return Simulation and Benchmarks (LT27), try to come up with a preliminary target asset allocation. This is not your final target but just a preliminary pass.

Second, determine your investment constraints. When will you need money from your investments and why? Now is a good time to think about these needs. Fill out the constraints on Section II.B.1-4. on liquidity, time horizon, taxes, and unique needs. Your average and marginal tax rates should also be added and will come from your section on Tax Planning.

Finally, determine your policies. I recommend you make a first pass at your policies and then refine them as you learn more about investments. Major policies include:

> **III.A.1. Acceptable asset classes:** Decide now what you will invest in and what you will not invest in. I recommend against asset classes where you have no discernible advantage.
>
> **III.A.2. Total assets:** What is the maximum amount you will invest in any single asset? Remember the principle of diversification.
>
> **III.A.3. Short selling or buying on margin:** Decide if you will use debt to invest. I recommend against it. Do not invest with borrowed money.
>
> **III.A.4 Un-acceptable asset classes:** What asset classes will you not invest in? Make the decision now. I recommend against foreign currencies, options, futures, derivatives, and collectibles and other
>
> **III.B.1-2. Investment benchmarks:** Determine your investment benchmarks for each of your asset classes. I strongly recommend a minimum of four asset classes, so you will have at least four investment benchmarks. Suggestions for benchmarks for the various asset classes can be found in Expected Return Simulation and Benchmarks (LT27).
>
> **III.C.1-2. Asset allocation strategy**: Determine your target and minimum and maximum

allocations for your two different stages.

III.D.1. Investment strategy: Determine how you will invest. Will it be mutual funds or individual stocks? I strongly recommend mutual funds, at least initially, when your assets are few.

III.E. Funding strategy: Determine your funding strategy. How will you save money for investing and saving? What is your goal to save each week or each month? How will you keep your priorities in order?

III.F.1. New investments strategy: What is the maximum amount you will invest in new investments? I recommend not investing more than 5 to 10 percent in any new investment (except for broad-based mutual funds with more than 50+ assets).

III.F.2. Investments in company stock: Think about the maximum you will have in your retirement fund in investments of your company's stock. I recommend no more than about 10 percent due to diversification concerns.

III.F.3. Unlisted investments: Finally, what is the maximum amount you will include in unlisted investments, i.e., investments that are not listed on a recognized stock exchange? While I recommend you not invest in assets that are not listed, it is your choice.

Learning Tools

The following Learning Tools may also be helpful as you prepare your personal Investment Plan:

Investment Plan Example Template (LT05A)
: You are encouraged to copy this Investment Plan template and change the investment goals, objectives, allocations, and other areas to make them consistent with your personal goals, objectives, return and risk requirements, asset allocation targets, and other investing parameters.

Investment Plan Example Instructions (LT5B)
: These are instructions for preparing your Investment Plan.

Expected Return Simulation and Benchmarks (LT27)
: This spreadsheet helps you see the impact of various investment strategies as well as the volatility of different asset classes. It also shows you the historical impact of different asset-allocation decisions.

Possible Benchmarks for Investment Plans (LT15)
: This document give ideas for possible benchmarks for your different asset classes.

Review Materials

Terminology Review

Active management. Active management is the process of trying to beat market returns by the active buying and selling of mutual funds and stocks.

Buying on margin. Buying on margin is borrowing money to invest. You borrow money from your broker and use it to purchase financial assets. If the stock goes up and you sell the stock, you make a profit due to leverage. Be careful as you can lose much more than your original investment.

Day trading. It is the process of an individual giving up all his spare time in an area in which he has little or limited competence, in an attempt to consistently beat the market and other professionals after taxes, costs and fees.

Financial Goals. Financial goals are personal goals with a cost attached.

Investment Benchmarks. An investment benchmark is the standard by which to judge your asset performance. You never choose an asset without choosing an investment benchmark. Use your investment benchmark to determine how well you are doing.

Investment Constraints. These are specific needs you have which will constrain how you will invest your portfolio.

Investment Guidelines. Your investment guidelines are the general road map on how you will be investing your assets over your life cycle. It integrates your personal goals and your financial goals into a complete financial perspective.

Investment Horizon. This is when will you sell the investment.

Investment Plan (also called and Investment Policy Statement). Your Investment Plan is the most important document you will prepare in regards to your investing activities. It sets the plan and framework on every investing activity. It states what you will do: what you will and will not invest in, how you will invest, why you will invest, what percentages you will invest, etc. In short, it is the key document that will impact your investment returns most for the rest of your future.

Investment vehicles. These are tax-law defined vehicles which allow you to save tax-advantaged for specific goals, i.e., Retirement: 401k, 403b, Roth 401k, IRA, Roth IRA; Education: 529 Funds, Education IRA etc.

Leverage. The decision of using debt to invest. It is not recommended.

Liquidity. This is the speed and ease with which an asset can be converted into cash.

Mutual Funds. These are professionally managed portfolios of similar instruments which offer the benefits of economies of scale and diversification.

Passive management. Passive management is the process of accepting average returns through purchasing index funds rather than trying to beat the market. It is much cheaper and more tax efficient.

Short-sell. Short-selling is borrowing shares from your broker, selling those shares, and hoping the price of the shares will decline to you can rebuy them at a lower price. Be careful as you can lose much more than your original investment. Don't risk it!!

Stock Market Secrets. These are supposed short-cuts or secrets that only the professionals know, but they will share them with you for a price. Don't get taken.

Tax Considerations. These are how taxes will impact your investment decisions, including your tax position, specifically your marginal and average tax rate; and how tax-free investments may fit into your plan, i.e. municipal versus corporate bonds.

Unique Needs. Unique needs are special needs that may impact your investing decisions.

Review Questions

1. How are your financial goals related to your personal goals?
2. What is the difference between a goal and a wish?
3. What is an Investment Plan? Why is it important?
4. What are the four categories of an Investment Plan?
5. What is an investment benchmark? How do they help an investor? What is the consequence of not having a benchmark to follow?

Case Studies

Case Study 1

Data

Last year Anne sold short (this is another term for short selling) 400 shares of stock at $90 per share. Six months later the stock fell to $45 per share and she covered her short, i.e., she bought back shares to replace the shares she sold short. Over the six-month period, the company paid out two dividends of $1.50 per share. Her total commission cost for buying and selling the shares came to $125.

Calculations

A. Determine Anne's profit or loss from this transaction.

B. What would her profit or loss have been if the stock had rallied to $250 per share and she had to cover her shares sold short?

Case Study 1 Answers

A. Profits are made on short selling as the market price of a stock goes down. In this example, the stock fell to $45 per share. To determine Anne's profit or loss, use the following calculation:

Total value of the shares sold short at $90 * 400		$36,000 credit
Repurchase cost of the shares ($45 * 400)		–$18,000 purchase
This is the purchase cost to cover the shares she borrowed and sold.		
Gross Profit		$18,000
Dividends	(2 *$1.50 x 400)	–$1,200

Since Anne sold these shares, she must pay back the dividends the owners would have received if they didn't lend her the stock.

This is your commission cost	–$125 commissions
Net profit	$16,675

This is Anne's profit if the stock price declined from $90 to $45 after she sold the shares short and covered the shares at $45.

B. Profits are made on short selling as the market price goes down. In this example, the stock's price went up to $250 per share. To determine Anne's loss, use the following equation:

This is the sale of the shares at $90 (* 400)	$36,000 credit
Purchase cost to cover borrowing ($250)	–$100,000 purchase
Net profit	–$64,000 loss

Dividends (2 * $1.50 x 400) –$1,200 dividends

Since Anne sold these shares, she must pay back the dividend.

Commissions –$125 commissions

Net profit –$65,325 net profit

This is Anne's loss if the stock price increased from $90 to $250 and she was forced to cover the shares at $250.

Case Study 2

Data

Bill is one of the 8,400 Utah victims of the 12DailyPro Internet fraud, where investors were supposed to receive a 12 percent return per day without any products or services.

Application

A. What advice would you give to Bill regarding purchasing products of this type in the future?

B. Which principles of investing did this fraud violate?

Case Study 2 Answers

A. 12DailyPro was a Ponzi scheme, where new investors' money was the "return" to investors who got into the scheme before later investors. Investors had no idea how the firm made money but were only concerned that they made money. It seemed too good to be true, and it truly was.

B. 12DailyPro violated two main principles: (1) Principle 6: Know what you invest in and who you invest with and (2) Principle 9: Invest only with high-quality individuals and institutions.

Case Study 3

Data

Kim just purchased 1,000 shares of NS corporation at $15 per share, and 50 percent was purchased on margin (i.e., she borrowed 50 percent to buy the shares). She held the shares for six months and sold them. Interest on her margin loan was 12 percent annually.

Calculations

A. Assuming the price increased to $30 per share and Kim sold the shares, what is the total profit of her investment after paying back the loan with interest? Profit = total revenues – total expenses. Assume the money she invested is part of her expenses.

B. Assuming the price decreased to $5 per share and she sold the shares, what is the total value of her investment after paying back the loan with interest?

C. Generally, should an individual buy on margin?

Case Study 3 Answers

A. Kim's purchase at $30 $30,000 ($30 * 1,000 shares)

Interest –450 ((6 months /12 months) * 12% * $7,500)

Loan amount –7,500 (She borrowed 7,500.)

Her personal money –7,500 (She put up 7,500 of her money.)

Her profit is $14,550

B. Kim's purchase at $5 $5,000 ($30 * 1,000 shares)

Interest –450 ((6 months /12 months) * 12% * $7,500)

Loan amount –7,500 (She borrowed 7,500.)

Her personal money –7,500 (She put up 7,500 of her money.)

Her profit –$10,450

C. No. Buying on margin is a bad idea and should be avoided at all costs.

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[1] Robert G. Ibbotson and Paul D. Kaplan, "Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance?", *Financial Analyst Journal*, Jan./Feb. 2000, 2633.

[2] Conference Report, Oct. 1911, 128–29.

[3] "Keeping Life's Demands in Balance," *Ensign*, May 1987, 13.

20. Investing 3: Understanding Securities Markets

Introduction

Once you have your priorities in order, understand your personal and financial goals, and have written a thoughtful Investment Plan, you are ready to learn about securities markets, both physical and electronic, where financial or real assets are traded. What are the different types of securities markets in which you might invest? Who can help you achieve your goals? What are these individuals' motivations, and how are they paid? How do you buy and sell securities, and what kind of help do you need? How do you choose someone to help you in the investment process? These and many other questions regarding securities markets will be addressed in this section.

Objectives

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

A. Recognize the different types of securities markets.
B. Be aware of the basics of brokers and investment advisors and how to buy and sell securities.
C. Understand how to choose a broker or an investment advisor.
D. Know the uses and types of investment benchmarks.

Recognize the Different Types of Securities Markets

Securities markets are the markets in which securities, or financial assets, are traded. There are two different types of securities markets. The first is known as the primary market, which is used for trading newly issued securities. The second type is known as the secondary market, which is used for trading securities that have already been issued. Primary markets and secondary markets are generally used for trading equity securities.

Primary Markets

Primary markets, or primary financial markets, are where new financial assets are issued. There are two main types of primary-market issues. The first type of issue is known as an initial public offering (IPO). These issues are the very first shares a company offers to the public. Investment bankers serve as underwriters for these issues: they facilitate the process of selling them.

The second type of issue is known as a seasoned new issue. These issues are new shares that are issued by a company that already has publicly traded shares on existing stock exchanges. A seasoned new issue is the way a company sells more shares to the investing public.

Secondary Markets

Secondary markets, or secondary financial markets, trade existing securities (previously owned shares of stocks, bonds, and other financial assets). Secondary markets consist of both organized exchanges, such as the New York Stock Exchange (NYSE), and over-the-counter or electronic markets, such as National Association of Securities Dealer Automated Quotation System (NASDAQ).

Organized stock exchanges are markets that are used to facilitate the trading of financial instruments. The main organized stock exchanges are the New York Stock Exchange and the American Stock Exchange. There are also regional stock exchanges, such as the Pacific, Chicago, Philadelphia, Cincinnati, Intermountain, Spokane, and Boston Stock Exchanges, but these are very small.

The largest stock exchange in the United States is the NYSE. This stock exchange is more than 200 years old, and it is still limited to 1,366 seats (the number of individuals/institutions who can trade), which is the same number of seats it has had since 1953. NYSE includes over 3,000 listed companies. Generally, 80 percent of the daily trading volume in the United States is done on this stock exchange.

Over-the-counter (OTC) market is an electronic network of dealers that allows investors to execute trades without going through specialists or intermediaries. There is no single physical location where stocks are traded; rather, these trades are executed through NASDAQ, which links various dealers and brokers through a computer- or telephone-based system. Usually the bigger companies are traded on an exchange rather than OTC. These trades are also executed through the National Market System, a system under the sponsorship of the National Association of Securities Dealers (NASD), which trades stocks of specific sizes, profitability, and trading requirements. NASD also trades "pink sheets," or lists of small companies not listed on any exchange; these stocks are traded by brokers through a network of phone and computer systems and may be significantly more risky.

Secondary bond markets: An organized exchange for individual retail investors to trade bonds does not exist. This may be because there is little demand for bonds among individual investors; this may also be because the transaction costs to trade bonds are so small. Generally, individuals must work with a broker who buys or sells bonds through a bond dealer.

Government bond trading is dominated by investment houses, commercial banks, and the Federal Reserve. Some bonds, such as Series EE and I Bonds and some Treasury securities, can be purchased online at www.treasurydirect.gov.

International stock markets are domestic stock exchanges in developed countries and in many emerging or developing countries. Most nations have securities exchanges; these markets trade more than $25 trillion in assets. In the U.S. stock markets, investors can often trade American Depository Receipts (ADRs), which are receipts for shares that are held on deposit by foreign

banks and represent ownership of companies that have their primary listing on exchanges outside the U.S. Buying an ADR is very similar to buying the underlying domestic share from the issuer's home or domestic market, except you get your dividends in U.S. dollars and your annual report information in English. Another way to invest in international shares is to invest in mutual funds; many mutual funds invest internationally.

Understand the Basics of Brokers and Investment Advisors and How to Busy and Sell Securities

A stockbroker is a person who is employed by a commission house or merchant to solicit business for these institutions. An investment advisor is a person or organization that makes the necessary daily decisions regarding an investor's portfolio. Both stockbrokers and investment advisors want to be responsible for making investment and trade decisions because they earn commissions and fees as they help investors buy and sell securities.

How Stockbrokers and Investment Advisors Are Paid

Stockbrokers and investment advisors are generally paid in three different ways:

Commissions. Investors may be charged a commission on the trades they make. This commission requires investors to pay a percentage of every order. For example, the commission might be 80 basis points per trade (0.8 percent of each trade) or a specific charge per trade, such as $29.99 for a trade of 1,000 shares.

Assets under management. Investors may be charged a percentage of the value of assets that are under management. For example, if you have a $500,000 portfolio, and the advisor's fee is 1 percent per year, you will pay the advisor $5,000 per year for helping you manage your portfolio.

Combination pay. Stockbrokers and financial advisors may charge fees that are a combination of both commissions and assets under management.

Regardless of who you work with, it is important that you know how the individual or institution is compensated. If individuals or institutions are unwilling to share this information with you, find someone who will. There are many excellent, qualified brokers and investment advisors who make compensation arrangements a part of every meeting with clients.

Generally, you must work with brokers or investment advisors if you are buying and selling stocks, bonds, and some mutual funds with loads, or sales charges. If you wish to purchase stocks, bonds, or load mutual funds, you will need to work with a broker.

If you only want to purchase no-load mutual funds and Treasury bonds, you can buy most of these directly from the mutual fund company without cost or from some brokers also without cost. You can buy some U.S. Savings bonds and Treasury securities directly from the U.S. Treasury at www.treasurydirect.gov.

Types of Brokerage Firms

Full-service brokers offer a complete range of tools, research, and advice to help you trade assets and invest money. These are the most expensive type of brokers, but they offer the most services and research.

Discount-service brokers perform only the trading portion of investment management, but their services usually cost 50 to 75 percent less than full-service brokers.

Deep-discount brokers are even less expensive than discount-service brokers because they specialize in only one area. Like discount-service brokers, these brokers do trading only, but they often cost as much as 90 percent less than full-service brokers.

Online-discount brokers are similar to deep-discount brokers and offer support for online trading. These brokers are often less expensive than discount-service brokers, and they offer low-cost immediate trading and other services.

There are two additional categories of brokers: captive and independent. This delineation is generally made when investors are considering purchasing mutual funds.

Captive brokers' firms own part of a mutual fund company. Because of the ownership connection with this company, these brokers are often encouraged to sell the firm's mutual funds rather than the mutual funds from other companies. Investors should be aware of this connection and make sure that a broker's investment recommendations are in the investor's best interest instead of the broker's best interest.

Independent brokers are not part of a major chain and do not own a captive mutual fund company. These brokers may be more inclined to give unbiased advice because they do not sell specific mutual funds from a parent company.

Types of Brokerage Accounts

Cash accounts require you to leave money with the broker; this money is used to pay for purchases and to generate more money from the selling of securities. In trading, a specific amount of time is allowed between the notification of purchase and the deadline for payment. Therefore, having a cash account with a broker is a good idea in many cases because this account ensures that cash will be available for immediate payment upon the receipt of securities.

Discretionary accounts are accounts in which a broker or investment advisor is authorized to make trades for you. Exercise extreme caution in using this type of account; the broker can buy and sell securities at will, but you are responsible for paying all taxes and commission costs. Before you set up a discretionary account, make sure the broker has thoroughly read and understands your Investment Plan and your list of investment goals.

Margin accounts allow you to borrow money from the brokerage firm to purchase financial assets. Since this type of account involves debt, it amplifies both gains and losses. Because the broker assumes a greater amount of risk with margin accounts, the broker requires you to maintain a specific maintenance margin in your account at all times; in other words, you must maintain a specific percentage of the value of the assets that have been purchased on margin. Currently, the maintenance margin is 50 percent. Should the value of the securities purchased on margin decline below this percentage, you will get a "margin call." A margin call requires you to either put more money in your margin account or sell some of the assets you have purchased on margin to reduce the amount of money you owe. Rules for margin lending are federally regulated. I strongly suggest you do not buy on margin because you have the potential to lose more than the amount of your original investment. Buying on margin is a high-risk activity.

A broker is an intermediary between buyers and sellers of stock. An investor places orders with brokers, either indirectly by phone or fax, or directly through the Internet. The broker takes the orders to the securities exchange. If the broker is successful in finding a counter-party to the trade (i.e., a buyer is found when you want to sell a security, or a seller is found when you want to buy a security), the trade is executed on the exchange. The broker then notifies the investor that the trade has been made, and funds and securities are exchanged on the specified trade date (See Chart 1).

Types of Broker's Orders

You can place orders to buy and sell securities with a broker in many different ways:

Buy-and-sell orders are directions you give to a broker to purchase or sell a specific number of shares at the market price or when the share reaches a specific price.

Market orders are directions to buy or sell a specific number of shares at the current market price. A benefit of this type of order is that it is the easiest to execute. A disadvantage is that the price may be significantly higher (for a buy) or lower (for a sell) than you had planned.

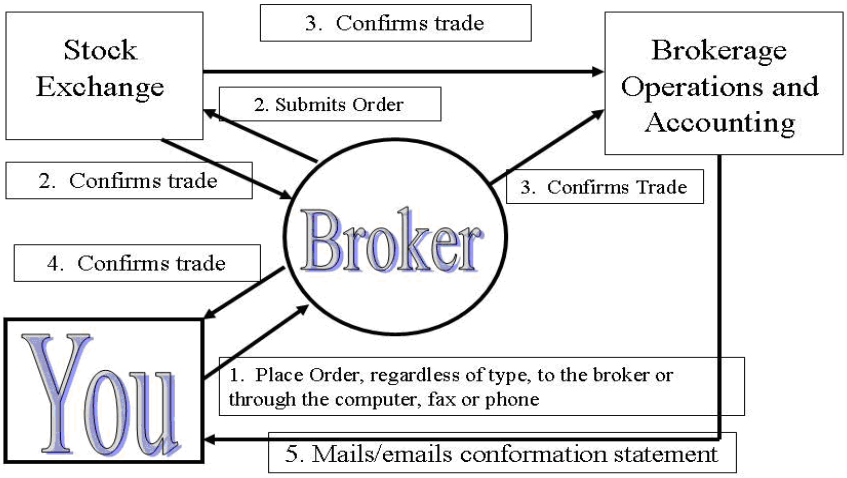
Limit orders are directions you give to a broker to buy or sell a specific number of shares at a specific price (or a better price, if possible). An advantage is that you may get the limit price or better. A disadvantage is that you may not get any shares at all if the market moves against you.

Day orders are buy-and-sell orders that are valid only until the end of the trading day. A benefit of this type of order is that at the end of the day you know everything you bought or sold. A disadvantage is that unfilled orders are automatically canceled.

Open orders, or good-till-canceled (GTC) orders are valid until they are filled or canceled. An advantage is that you can keep open orders for long periods of time, which may be helpful when dealing with securities that are thinly traded. A disadvantage is that if you fail to cancel these orders, they could be unexpectedly filled at a later date. If this happens, you are responsible for paying any fees related to the order.

Fill-or-kill orders must either be filled or canceled immediately. Most often, these are market orders at the current market price. An advantage of this type of order is that you will know immediately whether you have purchased or sold the shares. A disadvantage is that your trade may not be executed.

Chart 1. The Trading Process for Stocks and Bonds



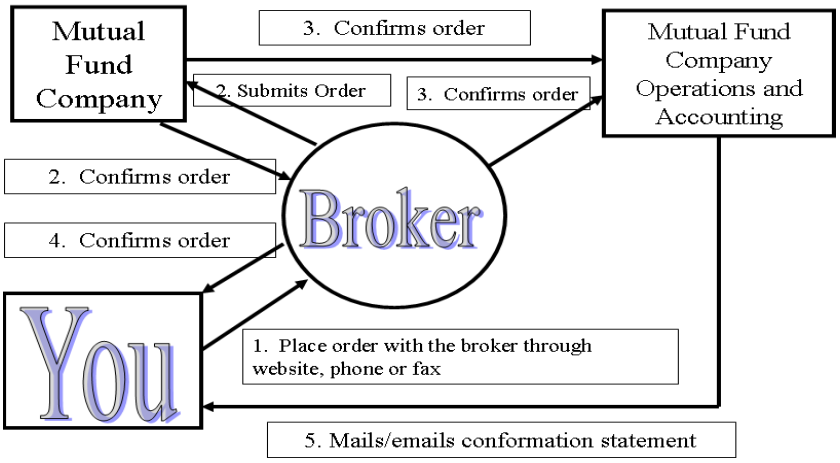
Stop orders and stop-loss orders are directions to either sell a specific number of shares if the stock price falls below a certain level or to buy a specific number of shares if the stock price rises above a certain level. Use care when you set stop prices to safeguard against major fluctuations. An advantage of this type of order is that you can minimize loss if the market price of a security falls. A disadvantage is that the brokerage house may not be able to sell the asset at the stop-loss price if the market falls too quickly.

When you trade, use wisdom in your decisions. I generally recommend using limit orders, which are only good for one day; this way you are sure you will get the price you want (or nothing at all), and you are sure that at the end of every day, your orders will have all been canceled. I also recommend that you try to buy and sell shares in round lots. Round lots (orders of 100 shares or multiples of 100 shares) are easier to sell than odd lots (orders of 1 to 99 shares). You will get better execution and a better price if you sell and buy round lots.

Share Registration

Financial assets can be registered in a number of different forms, as is the case with most assets. Street name registration is where the shares of the stock remain in the broker's custody and under the broker's name. Joint accounts are where shares are jointly owned with a spouse or partner. Joint tenancy is where shares are owned with a partner who has the right of survivorship. Tenancy in common is where shares are owned with a partner; however, when one shareholder dies, the shares of the deceased become the property of an heir, not the partner.

Chart 2. The Trading Process for Mutual Funds with a Load, or Sales Charge (or Load)



Understand how to Choose a Broker or an Investment Advisor

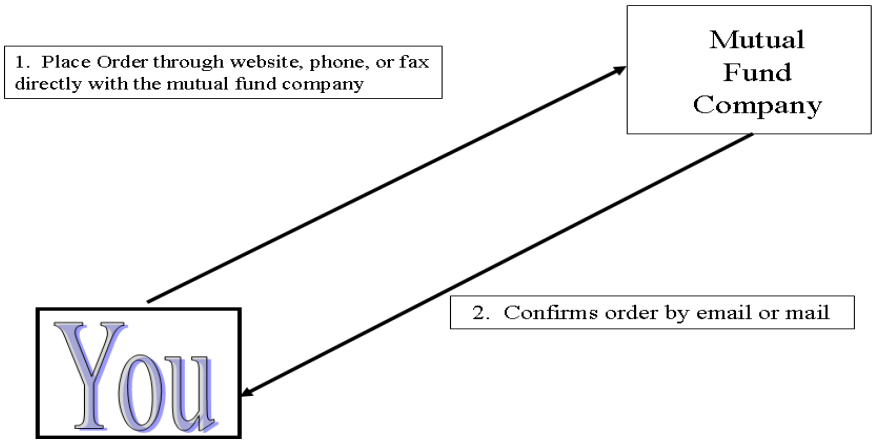
How do you choose an investment advisor or stockbroker? The key is to decide what kind of assistance you need and to get quality help from the best individuals and institutions. Whichever institution or individual you choose, remember that this individual or institution must be registered and licensed to sell the assets you are interested in buying or selling. While the terms "advisor" and "broker" are often used interchangeably, the difference is largely based on what type of assets each advisor has recommended historically.

You should base your decision about a broker or investment advisor on what you are buying or selling, how much help you want with the investment process, and how much you are willing to spend.

What you are buying? If you are buying stocks and bonds, you must use either a broker or an investment advisor who works with a broker. If you are comfortable making investment decisions yourself and you just need help executing your stock and bond trades, you might decide to use a discount-service broker or an online-discount broker. A discount-service broker will charge lower commissions on trading but will not provide investment advice. If you work with a discount-service broker, you will determine what to buy and sell, and you will give the orders to buy and sell. A discount-service broker executes your orders at a reduced price.

If you are not comfortable making your own investment decisions and would like someone to help you decide what to buy and sell, you may want to think about using a full-service broker or an investment advisor. A full-service brokerage firm provides a variety of services to its clients including research and advice, retirement planning, tax tips, and much more. The full-service broker helps you decide what to buy and sell, executes trades for you, and keeps you informed about changes in the market. These services come at a price, however; commissions for full-service brokers are much higher than commissions for discount-service brokers.

Chart 3. The Trading Process for No-Load Mutual Funds



If you invest only in mutual funds and make all of your asset allocation decisions yourself, you may not need a broker or investment advisor at all. You can buy many of your funds directly from the mutual fund family (the company that owns the mutual fund) or from a mutual fund supermarket that sells mutual funds from many different mutual fund families. Most of these purchases can be made directly without sales charges or loads (a fee charged to the purchaser for the privilege of purchasing the mutual fund and is generally used to compensate the broker for the work done to sell the mutual fund) or 12b-1 fees (fees charged to new investors to help cover the costs of selling the mutual fund to other investors). Be aware that the amount of your investment must meet a minimum investment requirement: many mutual fund families charge a fee if your account falls below the minimum required investment.

Help in the investment process. If you are comfortable making your own investment decisions, you may still appreciate some outside advice regarding your investments, or you may want to have someone to review your Investment Plans. If this is the case, consider talking with an investment advisor. A full-service broker or investment advisor can provide helpful advice about retirement planning, taxes, and other aspects of finance. You can negotiate for an up-front fee to pay for the specific amount of time you talk with the advisor or broker, or you can agree to make specific trades through the advisor to compensate for the advice.

How much you are willing to pay? If you are concerned about costs, you can purchase mutual funds directly from a mutual fund family, generally without fees. If you are buying or selling stocks or bonds, you can work with a discount-service broker or an online-discount broker so that you will pay the lowest costs possible.

Working with a Broker or Advisor

When working with a broker or advisor, remember that you are working with *your* money. Do your homework and take responsibility for your money. No one will watch it like you will.

Brokers and investment advisors offer specialized knowledge to help you in the investment process. However, if you do not need their services, you should not pay for them. Save money by using a discount-service broker or consider using no-load mutual funds if you feel comfortable making investment decisions yourself. Using alternatives to full-service brokers can greatly reduce your costs, especially because these alternatives may not charge transaction costs.

Keep transaction costs and taxes to a minimum. A percentage saved in cost is a percentage earned in return. Try to keep your trading to a minimum to reduce transaction costs and taxes. Likewise, if you buy mutual funds that have low turnover, you can reduce the amount of taxes you will have to pay each year due to mutual fund distributions. You may also be able to reduce costs by using index funds and applying a buy-and-hold strategy. Regarding bonds, you can work with a broker or buy direct. If you go through a broker or advisor, you will generally have to pay transaction costs.

Trusted Financial Advisor (TFA) versus Salesperson

Look for brokers or investment advisors that have your best interest in mind. Make sure trading is to achieve your goals—not theirs. Make sure they have the necessary expertise and licenses in the financial areas you think are important. If they don't have the licenses, they cannot sell you the securities. Make sure they don't trade a lot, or "churn" your portfolio. It's not what you make but what you keep after all costs, taxes, and inflation that makes you wealthy.

Look for brokers with integrity, intelligence, and efficiency. Make sure they are upfront regarding all costs and commissions. If they will not tell you their commission, go somewhere else. Look for brokers with experience in both up and down markets. Generally, you will not find this type of experience in someone who cold-calls you on the phone. Make sure your broker listens. Ensure he or she will spend the time with you to know your investment philosophy and read your Investment Plan. If not, go somewhere else. Finally, choose a broker that has a reputation for allowing customers to say "no" without pressure. If you ever feel pressure to make a trade, get another broker.

There is a difference between a trusted financial advisor (TFA) and a salesperson. A trusted financial advisor has your best interest at heart, while a salesperson has his or her best interest at heart. The following are a few differences you should be aware of:

- A TFA follows a process to help you create a comprehensive financial plan. A salesperson has a technique for making a sale and placing a trade.
- A TFA is interested in the things that are important to you. A salesperson is interested in making small talk, making you feel comfortable, and then making the sale.
- A TFA requires you to bring all financial data to the first meeting but does not require you to disclose information you are not comfortable sharing. A salesperson does not require you to do anything but show up and asks probing, personal questions that are designed to make you feel uncomfortable so you will buy the products he or she recommends.

- A TFA expresses interest in you and frequently refers to the work you have done so far in your financial plan; a TFA makes an effort to understand you and your goals. A salesperson refers to the possibility of your impending demise, the need to protect your family, and so on in an attempt to scare you into buying a product.
- A TFA meets in a professional environment with all of the financial decision-makers. A salesperson will meet with anyone, anytime, anywhere for "convenience."
- A TFA will not allow you to talk him or her into selling you a product that is not appropriate for you, even if you insist. A salesperson will sell you anything you want to buy or will redirect you to a preferred product that gives him or her a higher commission.
- A TFA works with you even during times when you are not doing much trading. A salesperson only works with you if you are generating commissions.

As you review your experience with brokers or financial advisors, you can come to understand the type of advisor you were working with. The key is to work with a trusted financial advisor, whether that person is registered as a financial advisor or a broker.[1]

Choosing a Broker or Advisor

The best brokers and investment advisors are those that have your best interests in mind. They have expertise in the financial areas that are important to you, they make you feel comfortable, they have read and understand your Investment Plan, and they do not trade a lot. They are looking out for number one—you.

There are a number of important areas you should consider if you are thinking about hiring a broker or advisor. Some of these areas are listed below and include some of the basic questions you should ask before hiring anyone to help you manage your finances.

1. Are you a full-time broker/registered investment advisor (RIA)/financial planner (FP)?

Work with brokers/RIAs/FPs who work full time at their business. This gives you greater assurance that they are knowledgeable about the products you need.

2. What is your education and what licenses do you have?

Many financial advisors have had little or no financial training. There are no required courses for someone who wants to be called a financial advisor. If you are paying for help, get the best help you can. I recommend you stick with advisors that have trained and qualified for specific designations, such as certified financial planners (CFPs), chartered financial analysts (CFAs), and certified public accountants (CPAs).

Make sure you choose licensed financial planners. If you require stock and bond assistance, they should have their CFA or Series 7. If they are RIA, they should have their Series 65 and 66. If they are financial planners, I recommend they be CFPs.

3. How long have you been a full-time broker/RIA/financial planner?

Work with someone who is experienced and established.

4. Are you working as a fiduciary or an advisor?

Fiduciaries are required to recommend products that are in the best interests of their clients. Some fee-based advisors at brokerage firms are held to a lower standard that only requires that they recommend products that are a reasonable choice for their clients. **I recommend that you work only with advisors that will commit to acting as fiduciaries on your behalf, and that will act only in your best interests.**

5. Do you offer only investment advice or full financial-planning services?

Many advisors only offer investment advice. But taking into account what you have learned from this course, you must realize that there is much more to comprehensive financial planning than choosing financial assets. I recommend you work with someone who will help you in those other areas as well, including goals, budgets, mortgages, insurance, taxes, retirement planning, and so on.

6. What companies do you represent?

There is a trade-off here between captive and independent brokers/RIAs/FPs. If they work with multiple companies, they may be able to offer more competitive products. If they only work for one company, they may be limited (or biased) in what they recommend.

7. How are you compensated?

Many advisors earn money by collecting commissions on the investments they sell. While they are compensated for the time they spend, there is no additional incentive for them to watch your investments after you have purchased them because they make no additional fees. In addition, there is the potential for conflict of interest, as well as for excessive trading. Remember that every dollar in commissions you pay reduces your returns, and every time you sell a security, you create a taxable event that may require you to pay more taxes. You want to make sure the broker/RIA/FP is working on your behalf. By knowing the commission on various policies, you may be able to avoid investments that are more of a benefit to the broker than to you.

8. Tell me about your proposed assistance:

A. Trading commissions: How much will it cost to buy stocks or other securities? Are there different prices for market and limit orders? What are those prices? Does your firm offer both safekeeping and recordkeeping services?
B. Other fees: What are your annual maintenance or custody fees? Are there inactivity

fees if you're not a frequent trader?
C. Minimum initial deposit: What is your minimum initial deposit? What is the monthly fee for going below this minimum?
D. Customer service: How good is your customer service? Do you have references? Do you have an 800 number for transactions and quotes?
E. Traditional banking services: Do you offer traditional banking services? Can I write checks on my account?
F. Research: Do you provide objective, independent security analysis? Do I have to pay for reports?
G. Mutual funds: Do you have access to high-quality, low-cost fund families outside the funds sold by the broker, such as Vanguard/Fidelity? If not, what is the cost for me to invest with these fund families?
H. Investment product selection: Do you have certificates of deposit, bonds, options, and so on? (List the items you may want to invest in.)
I. Insurance: Is my account insured by the Securities Investor Protection Corporation (SIPC) to $500,000?
J. Other methods of trading: How do you make trades if your computer is down or you're away from home? Can you trade via phone?
K. Other perks: Do you have any special deals that would make it more attractive for me to work with you? Do I receive interest on idle cash in your account?

9. Do you have any clients who are willing to recommend you?

Your broker should either supply you with names of satisfied clients or share testimonial letters from others. You should not consider a broker/RIA/FP without recommendations.

While it may be time consuming to find a good financial planner/broker/registered investment advisor, the correct choice can be very beneficial in helping you achieve your personal and financial goals.

Understand the Uses and Types of Investment Benchmarks

Now that you know about securities markets and the investment personnel that can help, it is important that you understand Principle 7: Compare Performance versus Benchmarks. This section will discuss benchmark basics, types, construction, weighting, and finding data.

Benchmark Basics

A benchmark (also called an index) is a measuring device that shows the average performance of a specific set of securities; benchmarks are used for comparison purposes. Benchmarks may be modeled after published indexes or customized to fit a specific investment strategy. Benchmarks are the standard by which you should judge the performance of individual assets in your portfolio; they also allow you to evaluate your portfolio as a whole. You cannot know how well your portfolio is performing unless you have a benchmark against which to compare that

portfolio. Comparing asset performance to benchmarks is Principle 7 of successful investing.

There are three primary purposes of benchmarks. First, benchmarks allow you to track the average returns of a specific asset class. Second, benchmarks allow you to compare different mutual fund managers in similar asset classes; benchmarks also allow you to monitor recommendations made by financial brokers. Third, benchmarks give you a framework for building new portfolios and exchange traded funds (ETFs).

The following are a few questions you should ask yourself when choosing a benchmark:

- Does the benchmark represent the assets I am interested in?
- How broad is the benchmark?
- How many securities does the benchmark include?
- How is the benchmark constructed?
- How is the benchmark weighted?

Benchmark Types

Type. Benchmarks may be categorized by type of financial asset—stocks, bonds, and other asset classes. Stock benchmarks are subdivided by market capitalization, geography, industry, and investment style. Bond benchmarks are subdivided into corporate bonds, government bonds, convertible bonds, agency bonds, municipal bonds, junk bonds, and so on. Each asset class defines its own benchmarks: for example, real estate investment trusts (REITs), currencies, commodities, derivatives, gold, and hedge funds each have their own benchmarks.

Geography. Global benchmarks measure the performance of assets in several developed market countries, including the United States. Examples of global benchmarks include MSCI World and MSCI All Country Free. International benchmarks measure the performance of assets in developed countries outside the United States. An example of an international benchmark is the MSCI Europe, Australia, and Far East index (EAFE). Emerging markets benchmarks measure the performance of less-developed markets in Asia, Latin America, emerging Europe, and Africa. Examples of emerging markets benchmarks include the S&P/IFC Emerging Markets Free index and the MSCI Emerging Markets Free index. Regional benchmarks measure the performance of assets in a specific region of the world. Examples of regional benchmarks include MSCI Europe, MSCI Asia, Dow Jones Asia, and Dow Jones Latin America. Country benchmarks measure the performance of assets in a specific country. Examples of country benchmarks include the S&P 500, Russell 5000, Dow Jones, MSCI Argentina, S&P/IFC Chile, and Japan TOPIX.

Asset size. Market capitalization is the most common division within this category. Market capitalization benchmarks measure the performance of assets with a specific market capitalization range. Large-cap stocks generally have a market capitalization of greater than $10 billion, mid-caps are between $2 billion and $10 billion, and small-caps are less than $2 billion. Micro-cap stocks, a less common benchmark, generally have a market capitalization of less than

$250 million.

Industry. Industry benchmarks (also called sector benchmarks) measure the performance of assets in a specific industry, such as telecommunications or retail. Industry benchmarks may also be subcategorized by geography; for example, there are industry benchmarks specifically for the Japanese automotive industry, the European telecommunications industry, and the Asian cement industry.

Investment style. Investment-style benchmarks measure the performance of stocks with different values. Value benchmarks measure the performance of stocks that are considered to be undervalued by the market; in other words, their price-earnings and price-book ratios are lower than the average price-earnings and price-book ratios for all companies. Growth benchmarks measure the performance of stocks that are expected to have accelerated growth caused by increased earnings, a dominant market position, or other factors; in other words, the price-earnings and price-book ratios for these stocks are higher than the average price-earnings and price-book ratios for all companies. Blend benchmarks measure the performance of all stocks in that asset class, both value and growth stocks.

Maturity. Long-term benchmarks measure the performance of bonds that will mature in more than 10 years. Intermediate-term benchmarks measure the performance of bonds that will mature in 2 to 10 years. Short-term benchmarks measure the performance of bonds that will mature in less than two years.

Benchmark Construction

There are a number of different ways that benchmark returns are calculated. The price return method calculates only the price appreciation of the underlying assets. The total return with gross dividends reinvested method uses both the price return and the dividend return to calculate the total return. However, the gross dividends method does not account for the impact of withholding taxes on dividends, which may be required for international investing.

The total return with net dividends reinvested method uses both price and dividends to calculate the total return. The total return with net dividends reinvested method accounts for the impact of international withholding taxes on dividends. Thus, benchmarks that use this last method of calculating returns will report a smaller return compared to the amount of return reported by methods that base calculations on the gross dividends; however, the total return with net dividends reinvested method will better represent the amount of return an international investor will actually receive.

Benchmark Weighting

Assets are weighted in a variety of ways, depending on the benchmark:

Market-value weighted. If assets are market-value weighted, they are weighted according to

their market capitalization. An asset's market capitalization is found by multiplying share price by outstanding shares. This method assumes that market capitalization is a viable representation of asset size. Market-value weighting is the primary way most benchmarks weigh assets. Indexes that are market-value weighted include the S&P 500; NASDAQ; and most MSCI global, country, and regional benchmarks. These benchmarks give a higher weighting to stocks with a greater market capitalization.

Price weighted. Benchmarks that use price weighting assume that the weight of a stock should be related to the price of the stock. In other words, a stock that trades at $10 is considered twice as important as a stock that trades at $5. Price-weighted benchmarks base the weight of an asset on the price of the stock. Examples of price-weighted benchmarks include the Dow Jones Industrial Average and Japan's Nikkei index.

Equal weighted. Equally weighted benchmarks consider all stocks to have the same weight. These benchmarks place the same value on a stock with a market capitalization of $50 billion as they do on a stock with a market capitalization of $250 million. Examples of equally weighted benchmarks include the Value Line index and the MSCI Equal Weighted index.

Float weighted. Benchmarks that use float weighting assume that asset weightings should be based on both market capitalization and the amount of float outstanding. The amount of float outstanding refers to the number of shares that are actually available to investors (usually international investors); the amount of float outstanding does not include shares that are held by insiders or shares that are available only to local country investors. Examples of benchmarks that use this weighting system include the S&P/IFC Emerging Markets Free index and the MSCI Emerging Markets Free index. These benchmarks give a higher weight to companies that have more shares in the marketplace and companies that do not limit foreign ownership.

Finding Data on Benchmarks

You can find data on benchmarks in a number of places. Data on several benchmarks are accessible through the Internet on financial sites such as CNN Money or Yahoo! Finance. These free benchmarks do not typically account for dividends, so make sure you take this into account when looking at index performance.

Proprietary data providers, such as Morgan Stanley and Standard & Poor's, have their own benchmarks. They will also design custom benchmarks for a fee; the MSCI Emerging Markets Free ex-Malaysia index is one example of a custom benchmark. Other data suppliers include NASDAQ, Bloomberg, and Reuters.

Key Characteristics of Benchmarks

The purpose of a benchmark is to reflect the performance of specific asset classes or funds. Any benchmark you choose should have the following five characteristics:

1. The benchmark should be constructed according to objective rules, not subjective judgments. There should be specific reasons for why each asset is included in the benchmark.

2. The benchmark should consistently weight its holdings according to its chosen weighting method. Choose benchmarks that use a weighting method you agree with.

Table 1. Key Benchmarks for the Major Asset Classes

Asset Class	Benchmarks
Domestic Equities	
Large-Cap Stocks	S&P 500
Small-Cap Stocks	Russell 5000
Micro-Cap Stocks	Wilshire Micro-Cap
International Equities	
Global	S&P Global 1200, MSCI & DJ World
International	EAFE (Europe, Australia, and the Far East)
Emerging Markets	S&P/IFCI Emerging Markets Free, MSCI Emerging Markets Free
Corporate Bonds	
Short-Term	DJ Corporate Bond
Intermediate-Term	Barclays Intermediate
High-Yield	Salomon Smith Barney High Yield
Mortgage-Backed	Barclays MBS
Yankee	Merrill Lynch Yankee
Treasury Securities	
Intermediate-Term	Barclays Intermediate Treasury
Long-Term	Barclays Long-Term Treasury
Real Estate	
Real Estate Investment Trusts	S&P REIT MSCI US REIT

3. The benchmark should feature overlapping buffer zones at the cutoff points between large-, mid-, and small-capitalization holdings. It is a bad sign if many holdings in the benchmark are considered small-cap stocks one day and mid-cap stocks the next day due to changes in the market.

4. The benchmark should use a variety of factors to determine whether a stock is a growth stock or a value stock. The benchmark should have buffer zones to prevent assets from changing their status daily.

5. The benchmark should gradually and carefully rebalance its holdings to reflect market changes. This rebalancing should take place infrequently—once a year at most.

Key Benchmarks

Some key benchmarks are found in Table 1.

Summary

There are two different types of securities markets. The first type is known as the primary market and is used for trading newly issued securities. The second is known as the secondary market and is used for trading securities that have already been issued. Primary markets and secondary markets are generally used for trading equity securities.

A stockbroker is a person who is employed by a commission house or merchant; stockbrokers solicit business for these institutions. An investment advisor is a person or organization that makes the necessary daily decisions regarding an investor's portfolio. Both stockbrokers and investment advisors want to be responsible for making investment and trade decisions because they earn commissions and fees as they help investors buy and sell securities. Stockbrokers and investment advisors are generally paid in three different ways: commissions, assets under management, or a combination of commission and assets under management.

There are a number of different types of brokerage firms. There are three main types of accounts: cash accounts, discretionary accounts, and margin accounts.

A broker is an intermediary between buyers and sellers of stock. An investor places orders with a broker, either indirectly by phone or fax or directly through the Internet. The broker takes the orders to the securities exchange. If the broker is successful, the trade is executed on the exchange. The broker then notifies the investor that the trade has been made, and funds and securities are exchanged on the specified trade date (See Chart 1).

Orders to buy and sell securities can be placed with a broker in many different ways. Buy-and-sell orders are directions that tell a broker when to purchase or sell a specific quantity of a security at either a pre-determined price or the market price. There are a number of different types of orders, and each type has specific advantages and disadvantages. Types of orders include market orders, limit orders, day orders, good-till-canceled (GTC) orders, fill-or-kill orders, and stop or stop-loss orders.

It is important to work with good people and institutions. Working with brokers and financial advisors can be challenging. You must understand what you want to accomplish, what you expect from the broker or advisor, and how the broker or advisor will be paid. You should be paying brokers and advisors to add value to your portfolio—you should not be paying them to do what you could do for yourself.

Finally, if you decide you need help, it is important to work with qualified, licensed, and

appropriate institutions and individuals. Work with a trusted financial advisor, not just a salesperson, who is acting in your interests as a fiduciary.

A benchmark (also called an index) is a measuring device that shows the average performance of a specific set of securities: benchmarks are used for comparison purposes. Benchmarks may be modeled after published indexes or customized to fit a specific investment strategy. Benchmarks are the standard by which you should judge the performance of individual assets in your portfolio; they also allow you to evaluate your portfolio as a whole. You cannot know how well your portfolio is performing unless you have a benchmark against which to compare that portfolio. Comparing asset performance to benchmarks is a principle of successful investing.

Assignments

Financial Plan Assignment

Continue to work on your Investment Plan. As you do, it is important that you understand the environment in which you are investing. Understanding the key components of this environment is critical. Decide whether you can invest on your own or whether you will need help. When assets are small, you can often make important decisions on your own. As the size of your assets increases, it may be a good idea to get help with your investment decisions.

First, be familiar with the major players in the investment world. Come to understand the strengths and weaknesses of each of the different providers of financial advice. Make sure they are operating in your best interests as fiduciaries, not just as brokers.

Second, think through the importance of diversification as you put your Investment Plan together. Fear and greed are typical feelings that affect us all. In order to minimize the problems of fear and greed, determine investment policies to help you as you work to achieve your goals. What is the maximum amount you will invest in any single investment? We are not talking about mutual funds, index funds, or ETFs, but single investments. Most institutions have a maximum between 5 and 10 percent. Include your maximum total in Section III.A.2.

Third, determine whether you will use leverage to invest. Leverage is debt. I encourage you to not short-sell securities or buy on margin, but you can include your guidelines in Section III.A.3. Also, do not invest with borrowed money.

Finally, determine your investment benchmarks. Investment Principle 7 advises you to monitor portfolio performance. This means you must choose an appropriate benchmark for each of your asset classes and for each of your assets. If you would like help, I have included recommended benchmarks for each of the asset classes in Expected Return Simulation and Benchmarks (LT27). When you select the asset classes in the spreadsheet you will receive three recommendations for asset class benchmarks. Include these benchmarks in Section III.B.1. and III.B.2. You will not include the allocations yet, but you should add the benchmarks.

Review Materials

Terminology Review

Assets under management. This is another way an investment advisor is paid. It is calculated as a percentage of your assets under management, i.e., if you have $500,000 with an advisor and their fee is 1.0% per year, you will pay them $5,000 per year.
Captive brokers. These are brokers whose company is part of a group which owns a mutual fund company. These brokers may be encouraged to sell company mutual funds which may not be the best fit for the investor but are in the interest of the company.
Cash accounts. This is money with the broker which you use to pay for purchases or receive any cash. There is a specific time between notification of purchases and when the purchases must be paid.
Commissions. Commissions are the way a broker or investment advisor is paid. It is either a percentage of every buy or sell order (e.g., 20 bps per trade), or a specific charge for a trade (e.g., $9.99).
Day orders. These are orders to buy and sell securities which are good only until the end of the trading day.
Deep-discount and On-line brokers. These are brokers who are even cheaper than discount brokers. They do only trading, but at a 90% discount to full-service brokers. On-line can even be cheaper with other services.
Discount-service brokers. These are brokers who only perform trading, but usually at a 50% to 70% discount to full-service costs.
Discretionary accounts. These are accounts where you authorize a broker or investment advisor to make trades for you and your account. Exercise caution with this as the broker can buy and sell securities at will and you are responsible for all taxes and commission costs.
Fill or kill orders. These are orders which must be either filled or canceled immediately. Most often these are market orders.
Full-service brokers. These are brokers who will give you all the tools, research and other advice to help you trade and invest.
Independent brokers. These are brokers whose company is not part of a major chain or who own a captive mutual fund company. They may be inclined to give unbiased advice as they do not sell specific mutual funds.
Initial public offerings (IPOs). These are the very first shares ever issued by a company. Investment bankers serve as underwriters or intermediaries for these IPOs
Investment advisor. A person or an organization that helps makes the day-to-day decisions regarding a portfolio's investments for investors.
Limit orders. These are orders to sell or buy a specific number of shares at a specific price or better. This is generally the best method in working with brokers.
Maintenance margin. This is money you put up to buy on margin. If your maintenance margin falls below a specific level, you will be required to put up more money. If not, your position will be closed out.
Margin accounts. These are accounts where you borrow from the brokerage firm to

purchase financial assets. This is debt, and can amplify both gains and losses.
Margin call. This is a call by the broker to put up more money when your margin declines below a certain level. I recommend you do not buy on margin. It is using debt to invest and you can lose more than your original investment doing this.
Market orders. These are orders to sell or buy a specific number of shares at the currently available or market price. Be careful as the market can move quickly and dramatically between when you place the order and order execution time.
Open orders (GTC: good till canceled, GTD: good till date specified). These are orders which are good until filled or canceled. Be very careful with open or GTC /GTD orders. If you fail to cancel specific orders, you might have orders filled that you forgot to close out.
Organized Exchanges. These are areas used to facilitate trading of financial instruments.
Over-the-Counter (OTC) Market. This is an electronic network of dealers used to execute trades without specialists or middle-men.
Primary markets. These are markets for trading newly issued securities.
Seasoned new issues. These are new shares being issued by a company that is already publicly traded.
Secondary markets. These are markets for trading already issued securities. Secondary markets trade previously owned shares of stocks, bonds, and other securities. Secondary markets consist of organized exchanges and over-the-counter or electronic markets where existing shares are traded.
Securities markets. Securities markets are where securities, i.e., financial assets, are traded. The two different types of securities markets are primary and secondary markets.
Stockbroker. A stockbroker is a person who is employed by and solicits business for a commission house or merchant.
Stop (or stop-loss) orders. These are orders to sell a specific number of shares if the stock price falls below a certain price or buy a specific number of shares if the stock price rises above a certain price. These are used to set prices to safeguard against major fluctuations.

Review Questions

1. What are securities markets?
2. What are the two types of securities markets? What role does each play in the securities market?
3. What are organized stock exchanges? What are the two main organized stock exchanges?
4. What is a stockbroker? Investment advisor? In what three ways are they usually paid?
5. What are the five questions you should ask before hiring a financial advisor?

Case Studies

Case Study 1

Data

After studying the fundamental trends in CHKP Company's annual report and doing a lot of research, Steve decided to purchase one round lot of the firm's stock on the open market. On Monday morning he calls a stockbroker and asks for the price of CHKP stock. The broker indicates that CHKP is bidding at $45.12, with an asking price of $45.19.

Calculations

A. Assuming Steve wants to place a market order to purchase shares, how much will he most likely pay (assume there are no major moves in the stock price)?

B. What are the advantages and disadvantages of a limit order versus a market order?

Case Study 1 Answers

A. The asking price of CHKP, $45.19, is the amount Steve would most likely have to pay for each share of CHKP stock. So, assuming he purchased a round lot (100 shares), Steve would pay $45.19 x 100 = $4,519 (assuming there were no commissions).

B. The advantage of a limit order is that it is not executed unless the stock reaches the specified price or better. The disadvantage is that it may not be executed if the market rises.

Case Study 2

Data

Steve's purchase of 100 shares of CHKP has been a good investment. Yesterday, the stock closed at $53.75 per share. In order to lock in his gains, Steve decides to employ a stop-loss order.

Application

A. Assuming Steve sets the stop-loss order at $53, what is likely to happen?

B. At what price would you recommend setting the stop-loss order? Why?

Case Study 2 Answers

A. Because the stop-loss order price of $53 is set so closely to the recent close of $53.75, it is likely the stock will be sold when it fluctuates around its closing price. When stop-loss orders are set too close to the market price, the chance of the price declining results in too much trading. This generates high commission costs and taxes for the seller. Steve should hold for the long term and put his stop-loss orders farther away from the current price.

B. Steve should set his stop-loss order to safeguard against a major fluctuation, not a minor fluctuation. A stop-loss price of $49 or $50 would be more appropriate; this price is 7 to 10 percent below the current market price.

[1] (Main ideas for this section were from Jason Payne, Payne Financial Management, Orem, UT; and Bill Bachrach; *Values Based Financial Planning;* Aim High Publishing; San Diego, CA, 2000).

21. Investing 4: Understanding Bonds

Introduction

The purpose of an investment portfolio is to help individuals and families meet their financial goals. These goals differ from person to person and change over time. For example, a student who recently graduated will have different goals than an executive who is near retirement.

In the previous chapter, you learned about stocks and how they fit into an investment portfolio. Some investors find that they need a portfolio that provides more immediate income and greater safety than a portfolio composed mainly of stocks and stock mutual funds can provide. One way to accommodate these needs for increased income and safety is to add bonds to a portfolio. This chapter will discuss some basic, helpful information about bonds.

Objectives

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

A. Explain the benefits, risks, terminology and types of bonds
B. Understand how bonds are valued and the costs of investing in bonds
C. Understand plans and strategies for bonds.

Explain the Benefits, Risks, Terminology and Types of Bonds

Bonds are a form of debt, and they are generally issued for longer than one year. Bonds are sold by national and local governments, municipalities, companies, and other institutions. When you buy a bond, you are lending money to the institution that is selling the bond. The seller of the bond agrees to repay the principal amount of the loan when the bond reaches maturity. For interest-bearing bonds, the seller also agrees to pay interest periodically, as specified in the loan contract.

Bonds are an important component of most investment portfolios. Bonds reduce the overall risk of a portfolio by introducing diversity. They also produce steady current income—income that investors receive each month. Bonds are relatively safe investments if they are held to maturity because it is possible to calculate exactly how much interest they will earn. Bonds are lower-risk investments than stocks; however, the returns on bonds are lower as well. Bonds are attractive options when the market anticipates lower interest rates. As interest rates drop, the value of existing bonds rises.

Although there are many advantages to investing in bonds, there are also several disadvantages. Bonds are less liquid than other types of assets: an investor may not be able to find a buyer or

seller for a bond. Another disadvantage is that bonds are often sold in large amounts—amounts that are larger than most investors can afford to invest. Bonds may also be "called," which means that the issuing company may force you to redeem your bond before you had planned to redeem it. This generally happens when current market interest rates are lower than market interest rates were when the company issued the bonds. The company will call the bonds and reissue new bonds at lower rates, which will save the company money on interest. Additionally, it may be difficult to find a good investment outlet for the interest yielded from your bonds, particularly if interest rates are declining.

Bonds and Risk: All Risk Is Not Equal

Bonds are susceptible to a number of risks, including the following:

Interest-rate risk. Interest rates may rise or fall at any time, resulting in a decline or increase in a bond's value. Rising interest rates require that future cash flows have a higher rate of return. Since future cash flows are fixed in bonds, the principal value of the bond must be decreased to compensate for a higher required return.

Inflation risk. A rise or decline in inflation may result in an increase or decrease in the value of a bond. For most bonds, a higher rate of inflation results in a less valuable bond. The inverse of this situation is also true.

Company risk. The bond price may rise or decline because of problems with the company that is offering the bond. The better the future prospects for a company, the lower the required rate of return by investors and the higher the present value of a bond. The inverse of this situation is also true.

Financial risk. Whether or not a company is viewed as a financial risk has the potential to affect the performance of the company's bonds. Companies whose cash flows are sufficient to meet their financial obligations are considered less risky and can usually borrow money at lower rates of interest; hence, these companies may have lower interest costs and likely higher earnings. The inverse is also true.

Liquidity risk. Investors take the risk that they may not be able to find a buyer or seller for a bond when they need one. Sometimes liquidity is related to current market conditions as well as the company's financial statements.

Political or regulatory risk. Unanticipated changes in the tax or legal environment may have an impact on a company. Since taxes and the legal environment affect the outlook for a company, any regulatory changes that improve a company's long-term prospects will generally result in a higher price for that company's bonds. The inverse situation is also true.

Exchange-rate risk. Changes in exchange rates may affect profitability for international companies. As exchange rates strengthen, the cost of domestically produced goods that are sold

overseas increases. The inverse is also true.

Understand Bond Terminology

To understand bonds, you must first understand the language of bonds. Below is a list of important bond terminology.

Bond Basics

Holder. The investor who owns the bond.

Issuer. The corporation or government agency that issues the bond.

Price. The price for which the bond could be sold.

Indenture. A document that outlines the terms of the loan agreement.

Par value. The face value of the bond, or the amount returned to the bond holder when the bond reaches maturity.

Coupon interest rate (interest rate). The percentage of the par value that is paid to the bond holder annually in the form of interest.

Call provision. A provision that allows the issuer to repurchase a bond before its maturity date. The price at which the bond may be repurchased is set in the indenture.

Deferred calls. A specification stating that call provisions cannot be exercised for a number of years. Deferred calls provide protection for the holder of the bond.

Redemption. The process of cashing in a bond.

Sinking fund. Money that is set aside annually by the issuer to pay off the issuer's bonds when they reach maturity.

Current yield. The total annual interest payment on a bond divided by the bond's current or market price.

Debt obligation. A term that is interchangeable with the term "bond."

Bond Maturity

Maturity date. The date on which the bond expires and the issuer must pay back the loan.

Short-term bond. A bond that matures in one year or less.

Intermediate-term bond. A bond that matures in 2 to 10 years.

Long-term bond. A bond that matures in 10 or more years.

Types of Bonds

Asset-backed bond. A bond from an issuer whose bonds are backed or collateralized by loans, leases, personal property, or receivables, but not real estate.

Bearer bond. A bond with an attached coupon that allows the bearer to claim interest payments upon surrender of the coupon.

Book-entry bond. A bond that is registered and stored electronically (similar to stocks).

Collateralized mortgage obligations (CMO). More complex, specialized versions of mortgage-backed bonds.

Debenture. A bond that is backed by the credit of the issuer and has no specific security or collateral.

Discount bond. A bond that is sold at less than its principal value or at a discount to its par value.

Junk bond (high-yield bond). A bond with a very low (or risky) bond rating, a higher interest rate, and a higher default rate. Junk bonds are almost always callable.

Mortgage-backed bond. A bond that is backed by a pool (portfolio) of mortgages that are carried by the issuer.

Zero-coupon bond. A discount bond that does not allow for a coupon payment and pays no interest until maturity.

Bonds with Conditions

Callable bond. A bond where the issuer can force the investor to redeem this type of bond before the bond's maturity date.

Convertible bond. A bond that gives the holder the option of converting the bond into company stock instead of obtaining cash repayment.

Floating-rate bond. A bond in which interest payments fluctuate according to a specific benchmark for interest rates and that varies with short-term interest rates.

Subordinated bond. A bond that will be paid only after the issuer's other loan obligations have been paid in the event of financial distress.

Bond Ratings

Bond rating. A measure of the default risk associated with a company's bonds. Ratings are done by a bond-rating company and may range from AAA for the safest bonds to D for the riskiest bonds. In general, the better the bond rating, the lower the interest rate the company will have to pay on its bonds.

Default risk. The risk that a company will be unable to repay a bond.

Bond-rating company. A private-sector company that evaluates the financial condition of a company that issues bonds—factors include the company's revenues, profits, and debts. Bond-rating companies usually rate only issues of companies and sovereign issuers that offer corporate and municipal bonds.

Downgrade. A situation in which a bond-rating company reduces the bond rating of a particular issue, usually because of a company's deteriorating financial condition. If a bond rating is downgraded, it is likely that investors who own the company's bonds will have to reduce the price of their bonds (resulting in a lower return for the holder and a higher yield for the issuer) to make up for the increased risk if the investor wants to sell.

Upgrade. A situation in which a bond-rating company improves the bond rating of a particular bond, usually because of a bond-issuing company's improving financial condition.

Describe the Major Bond Categories

While there are many different types of bonds, most can be grouped into one of six major categories: corporate bonds, U.S. Treasury debt securities, municipal bonds, agency bonds, international bonds, and U.S. Treasury savings securities. I will address the eight key areas for each of these types of bonds: issuer, par value, taxes, risk and return, ratings, trading, and call provisions.

Corporate Bonds

There are three main types of corporate bonds: secured corporate bonds, unsecured corporate bonds or debentures, and secured debt. Secured corporate bonds are bonds backed by company collateral, a mortgage, or other lien. Unsecured corporate bonds or debentures are bonds not backed by specific collateral, although the holder has the claim of a general creditor. These bonds are more risky; therefore, companies must pay a higher return on these bonds to sell them. Secured debt is debt that has claim on specific assets in the event of a default. The list below summarizes characteristics of corporate bonds:

Issuer: U.S. corporations.

Par value: $1,000 and greater.

Maturity: Varying. Generally, the maturity length on short-term corporate bonds ranges from 1 to 5 years, intermediate-term corporate bonds typically mature after 6 to 10 years, and long-term corporate bonds typically mature after 11 or more years.

Taxes: Corporate bonds offer no tax advantages to the holder and are subject to federal, state, and local taxes.

Risk and return: Riskier than government bonds, but they offer higher returns.

Ratings: Corporate bonds are generally rated by one or both of the major bond-rating companies (Standard & Poor's and Moody's).

Trading: May be purchased by brokers, either over the counter (OTC) or through an organized exchange.

Call provision: May be callable.

U.S. Treasury Debt Securities

The U.S. Treasury issues three main types of debt securities: Treasury bills, Treasury notes, and Treasury bonds. Treasury bills are short-term debt obligations; these bonds are issued at a discounted price and may be redeemed at par value upon maturity in 3, 6, or 12 months. Treasury notes are intermediate-term debt obligations that are issued at or near par value; interest is paid semiannually on Treasury notes. Treasury bonds are long-term debt obligations that are issued at or near par value; interest is paid semiannually on Treasury bonds. The list below summarizes characteristics of U.S. Treasury debt securities:

Issuer: The U.S. government.

Par value: Treasury notes are issued in amounts ranging from $1,000 to $5,000, and Treasury bonds are issued in amounts ranging from $10,000 to $1,000,000.

Maturity: Maturity length for U.S. Treasury debt securities ranges from three months (for Treasury bills) to more than 30 years (for Treasury bonds).

Taxes: Exempt from state and local taxes but not federal.

Risk and return: U.S. Treasury debt securities are government securities, so they are considered default-risk-free. However, because the risk on these bonds is lower, the returns are also lower.

Ratings: U.S. Treasury debt securities are issued by the federal government; therefore, they are not rated.

Trading: Newly issued bonds are traded at auction at the Federal Reserve. Outstanding

bonds are traded by brokers over the counter.

Call provision: U.S. Treasury debt securities are generally not callable.

Municipal Bonds

There are two major types of municipal bonds ("munis"): revenue bonds and general obligation bonds. Revenue bonds are backed by the revenues of a specific municipal project. General obligation bonds are backed by the taxing power of the issuer. The list below summarizes characteristics of municipal bonds.

Issuer: State and local governments.

Par value: $5,000 and greater.

Maturity: Varying. Generally, short-term municipal bonds mature in 1 to 5 years, intermediate-term municipal bonds mature in 6 to 10 years, and long-term municipal bonds mature in 11 or more years.

Taxes: Exempt from federal taxes but not necessarily from state and local taxes. Municipal bonds may be exempt from state and local taxes if the holder lives in the state where the bond was issued.

Risk and return: Returns may be higher than those on government bonds to compensate for increased risk, as government bonds are essentially default-free. However, returns are generally lower for municipal bonds than corporate bonds because municipal bonds are exempt from federal taxes.

Ratings: Most are rated by bond-rating companies.

Trading: Traded through brokers and over the counter.

Call provision: Sometimes callable.

Agency Bonds

Agency bonds (agencies) are issued by various federal, state, and local agencies that are authorized by Congress to do so. Examples of agencies that are authorized to sell bonds include the Federal National Mortgage Association (FNMA, also called Fannie Mae), the Federal Home Loan Mortgage Corporation (FHLMC, or Freddie Mac), and the Government National Mortgage Association (GNMA, or Ginnie Mae). The list below summarizes the characteristics of agency bonds.

Issuer: Various federal, state, and local agencies. These institutions have all received congressional authorization to sell agency bonds.

Par value: Generally issued in amounts of $25,000 and greater. Agency bonds usually require a higher minimum investment than other types of bonds do.

Maturity: Varying. Generally, short-term agency bonds mature in 1 to 5 years, intermediate-term agency bonds mature in 6 to 10 years, and long-term agency bonds mature in 11 or more years.

Taxes: Agency bonds offered by Ginnie Mae, Fannie Mae, and Freddie Mac are taxable.

Risk and return: Agency bonds are only somewhat more risky than Treasury bonds and consequently pay higher returns.

Ratings: Some agency bonds are rated by bond-rating companies.

Trading: Traded through brokers and over the counter but also directly through banks.

Call provision: Not callable.

International Bonds

There are three types of international bonds: international bonds, Yankee bonds, and Eurobonds. International bonds are issued by international companies and sold in various countries and currencies. Yankee bonds are issued by international companies and sold in the United States in U.S. dollars. Eurobonds are issued by U.S. companies and sold outside of the United States in U.S. dollars. The list below summarizes characteristics of international bonds.

Issuer: U.S. or international corporations.

Par value: $1,000 and greater. The par value may be in different currencies.

Maturity: Varying. Generally, short-term international bonds mature in 1 to 5 years, intermediate-term international bonds mature in 6 to 10 years, and long-term international bonds mature in 11 or more years.

Taxes: Subject to federal, state, and local taxes. Depending on where they are issued, international bonds may also be subject to foreign taxes.

Risk and return: Risk and return varies depending on the type of international bond. International bonds may be more risky than government and corporate bonds, depending on the issuer. However, they typically offer higher returns than those offered by corporate bonds because investors may also be susceptible to exchange rate or currency risk.

Ratings: Bond-rating companies rate both U.S. companies and large international companies.

Trading: International bonds are either traded by brokers over the counter or in an exchange. These bonds may also be traded in domestic bond markets of foreign countries, as well as in the Euromarkets (markets outside the United States where securities are traded in U.S. currency).

Call provision: Sometimes callable.

U.S. Treasury Savings Securities

U.S. Treasury savings securities come in many forms: the most common types are EE bonds and I bonds. EE and I bonds are sold at face value, and interest is paid at maturity. Both securities have variable interest rates. The list below summarizes characteristics of U.S. Treasury savings securities.

Issuer: The U.S. government. These bonds are not marketable (i.e., they cannot be resold to others), but they can be redeemed at local banks.

Par value: Issued in amounts of $25, $50, $100, $1,000, and $10,000. They can be purchased online at www.treasurydirect.gov without transactions costs.

Maturity: U.S. Treasury savings securities that are redeemed within five years usually charge a three-month interest penalty. Investors can hold U.S. Treasury savings securities for up to 30 years.

Taxes: U.S. Treasury savings securities are registered as bearer bonds, which are exempt from state and local taxes. Another benefit of this type of security is that the interest is completely tax-free if it is used to pay for qualified educational expenses. Other taxes are deferred until maturity.

Risk and return: Minimal risk. The return on EE bonds is variable and changes every six months. The return on I bonds is also variable: the rate of return changes every six months to account for a guaranteed return over inflation for six months, as well as a real-return component. The real-return component is a guaranteed return amount over and above the return on inflation.

Ratings: Not rated because they are government securities.

Trading: Cannot be traded. They can be purchased online and can be redeemed at local banks.

Call provision: Not callable.

Explain How Bonds Are Valued and the Costs of Investing in Bonds

Bonds are valued in a number of ways. Generally, the value of a bond is determined by the

present value of the bond's cash flow, which includes periodic interest payments and the repayment of principal. Three key factors affect a bond's price: the par value, the market interest rate and length of maturity, and the investor's discount rate.

Par Value

When a bond is sold for less than its par value, it is being traded at a discount; when a bond is sold for more than its par value, it is being traded at a premium. The terms "premium" and "discount" in this situation refer to the bond's current market value. For example, suppose the market interest rate is four percent and the coupon interest rate on a bond is six percent. Because this bond pays more interest than the market average, investors will be willing to pay a higher price for this bond; thus, the bond will trade at a premium.

Market Interest Rate and Maturity

A bond's value fluctuates according to changes in the market interest rate. A bond's coupon interest rate and par value are fixed over the life of the bond. If the market interest rate increases, the value of the bond will decrease because investors will require a higher return on the bond to make up for the fact that coupon payments are lower than the market return rate. Investors will pay less for the bond to make up for the lower expected return. If the market interest rate decreases, the value of the bond will increase.

The price of a bond is also affected by the bond's maturity length. The longer a bond takes to mature, the greater the impact of fluctuations in the market interest rate.

Investor's Required Rate of Return and Price

The value of a bond is related to the investor's required rate of return, which is the rate of return an investor requires to hold or invest in a bond. If the investor's required rate increases, the investor will require a higher rate of return on all cash flows. Since the interest rate on bond coupons is generally fixed, the only way an investor can increase a bond's cash flow is by paying a lower price for the bond. The less an investor is willing to pay for a bond, the more the value of the bond decreases. The reverse is also true. An investor's required rate of return can change for many reasons:

> **The investor perceives a change in the risk associated with the issuer of the bond.** As perceived risk of an issuer increases, investors require a higher discount rate to invest in the issuer's bond.
>
> **The investor perceives a change in the general market interest rate.** As the market interest rate increases, investors require a higher discount rate to invest in any bond.
>
> **The investor perceives a change in overall market risk.** As the perceived riskiness of the market increases, investors require a higher discount rate to invest in all asset classes.

Note that the investor's discount rate will vary from one investor to another.

Bond Yields

The bond yield is the total return on a bond investment; it is not the same as the coupon interest rate. The bond yield is affected by the bond price, which may be more or less than par value. The bond yield can be calculated in many ways; however, three common ways to calculate it are the current yield, the yield to maturity, and the equivalent taxable yield.

Current yield is the total annual interest payment divided by the bond's current market price.

Yield to maturity is the promised yield the holder receives if the bond is held to maturity; when this yield is calculated, it is assumed that all interest payments can be reinvested at the same interest rate as the coupon rate. Since this calculation involves cash flow, it is best solved with a financial calculator.

Equivalent taxable yield (ETY) is the yield you must receive from a taxable security to get the same return you would make on a tax-advantaged security. To solve for the equivalent taxable yield, use the following formula:

ETY = tax-free yield / (1 – marginal tax rate)

Remember, the marginal tax rate is a combination of both state and local taxes. To effectively calculate after-tax returns, you must know the tax benefits of each type of bond (for example, you must know that municipal bonds are free from federal taxes, and Treasury debt securities are free from state and local taxes). For help with calculating after-tax returns and equivalent taxable yields, see After-Tax, ETY, and Other After-Inflation Returns (LT26).

There are a number of costs you should be aware of before you invest in bonds. The costs of investing in bonds can be divided into three categories: explicit costs, implicit costs, and hidden costs.

Explicit Costs

Explicit costs are the costs you see (or should see) on your brokerage account statement. These costs include commission costs, markup, and custody fees.

All bond trades incur commission costs, which are fees that are paid to the broker who arranged a purchase or trade. Some newly issued bonds may be sold to the investor without commission costs if the issuer absorbs the commission costs; however, most trades incur commission costs. Costs can either be fixed (e.g., $15 per trade) or a percentage of the purchase or sale amount (e.g., 15 basis points, or .15 percent of the trade).

Custody fees (annual fees) are charged by the brokerage house to hold bonds in your account. These fees may be a specific amount for small accounts (e.g., $15 per year). For larger accounts, the custody fee may either be assessed as a specific charge per holding (e.g., 8 basis points per security, or .08 percent) or a percentage of your assets (e.g., 25 basis points per security).

Implicit Costs

Implicit costs are those you may not see until months after you sell a security. The most common implicit cost is taxes. It is critical that you account for taxes when you are valuing the true return of your portfolio. Implicit costs such as taxes are not noted on your monthly report, and most investors do not think about them until they have to pay them. Understand taxes before you begin paying them.

The interest you receive from bonds each period is taxed at your ordinary income rate. Interest is an expensive type of income.

The amount of your capital gains is equal to the difference between what you paid for a bond, or the principal, and what you sold the bond for. In other words, capital gains are the difference between what you paid for a bond and the par value of that bond if it is held to maturity. Short-term capital gains are made when you sell bonds you have owned less than one year, and they are taxed at your marginal tax rate. Long-term capital gains are made when you sell bonds you have held for more than one year. Long-term capital gains are taxed at between 0 and 27.6 percent, depending on your income level and how long you have held the bond (see Figure 1).

Hidden Costs

In addition to understanding explicit and implicit costs, you should be aware of the hidden costs involved in investing in bonds, including the following:

Account transfer fees: Costs for moving assets in or out of an existing account.

Account maintenance fees: Fees for maintaining your account.

Inactivity fees: Fees for not having any account activity over a certain period of time.

Minimum balance fees: Feeds for failing to maintain the required minimum balance in your account. Make sure you know what the minimum balance on your account is.

Interest on margin loans: Interest charged on money you borrow to buy securities.

Selling charges (loads): Commissions paid to a broker for helping you purchase certain securities, mainly load mutual funds.

Understand Plans and Strategies for Bonds

Following are a few ideas for your plans and strategies for bonds and bond mutual funds. These will be include in your Investment Plan. The numbers refer to specific parts of your Investment Plan (LT05A).

Plans and Strategies for Bonds

Overall Investment Plan

- We will invest in bonds/bond funds which are great at doing what they do well, adding stability to the portfolio
- We will always have a diversified portfolio that includes bonds, realizing that bonds generally will not give us the returns needed to grow your portfolio much above inflation
- We will compare our bond/bond funds to the Barclay's Aggregate Index (or other bond benchmark of your choice). Note that there are different benchmarks for the different bond asset classes, i.e., short-term, intermediate-term, long-term bonds, treasuries, etc.

General Investing

- While risk of individual bonds can be high, we will reduce that risk considerably by buying no-load and low cost bond mutual/index funds with different maturities
- We will invest at our risk level, which is doable due to the many different types of bonds and bond asset classes
- As we get closer to retirement, we will increase our allocation to bonds as they offer more stability of principle and income, and are generally less volatile than equities
- We will follow the principles of successful investing.

Summary

Some investors find that they need a portfolio that provides more current income and greater safety than a portfolio composed mainly of stocks and stock mutual funds can provide. One way to accommodate these needs for increased income and safety is to add bonds to a portfolio.

Bonds are a form of debt, and they are generally issued for periods of time longer than one year. When you buy a bond, you are lending money to the institution that is selling the bond. The seller of the bond agrees to repay the principal amount of the loan when the bond reaches maturity. For interest-bearing bonds, the seller also agrees to pay interest periodically, as specified in the loan contract.

Bonds are an important component of most investment portfolios. Bonds reduce the overall risk of a portfolio by introducing diversity. They produce steady current income—income that investors receive each month. This steady stream is important to some investors, depending on their current needs. Bonds are lower-risk investments than stocks; however, the returns on bonds are lower as well. Bonds are attractive options when the market offers low interest rates. As interest rates drop, bond values rise.

While there are many different types of bonds, most bonds can be grouped into one of six major categories: corporate bonds, U.S. Treasury debt securities, municipal bonds, agency bonds, international bonds, and U.S. Treasury savings securities.

Bonds are valued in a number of ways. Generally, the value of a bond is determined by the price an investor is willing to pay for the bond. Three key factors affect a bond's price: the par value, the market interest rate and length of maturity, and the investor's discount rate.

Assignments

Financial Plan Assignments

Continue to work on your Investment Plan. As you do, it your assignment is to review the history of both short-term and long-term bonds over the past 5, 10, 25, 50, and 75 years. How have bonds performed overall? What do bonds add to a portfolio? What disadvantages do bonds have? How can you minimize the disadvantages of bonds, while at the same time enjoying the advantages bonds offer?

Benchmarks: What are the major benchmarks or indexes that correspond with bonds? (See Possible Benchmarks for Investment Plans (LT15). It is likely you will include bonds in your diversified portfolio, so it is important you select the major benchmarks you will follow to help you understand how bonds perform.

Volatility: Generally, investors consider bonds less risky than stocks. To graphically see the volatility of bonds versus other asset classes, open Expected Return Simulation and Benchmarks (LT27). Go to the *Asset Class Data* tab and use the light-blue drop-down boxes to select your asset classes (or you can just use the asset classes listed). Use the dark-blue drop-down boxes to select your time period. Then go to the *Charts* tab. Push the *F9* button to see the impact of standard deviation.

This worksheet builds random portfolios with the expected return and standard deviation of the period and asset class chosen. It then assumes that each asset class builds 10 different portfolios and that those portfolios are run for 20 years. The differences between the 10 different portfolios are shown in the same colored lines. The more the lines move together, i.e., the more each of the random portfolios move together, the less risky or less volatile the asset class. The more the same colored lines diverge, the more risk or more volatile the asset class.

Returns: To see what the returns have been for various types of bonds, go to Expected Return Simulation and Benchmarks (LT27)**.** Go to the tab labeled *Returns and Risk*. Look for the 1-, 5-, 10-, 25-, 50-, 75- and 85-year returns for Treasury bonds (long-term government bonds with maturity of more than 10 years) and Treasury bills (short-term government bonds with maturities less than one year). How have these assets performed compared to equity or stock returns?

Learning Tools

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

Possible Benchmarks for Investment Plans (LT15)
This document shows possible benchmarks for most of the major asset classes.

Historical Return Simulation for Asset Classes (LT23)
This spreadsheet shows the impact of various investment strategies and the volatility for different asset classes. This spreadsheet will also show you the historical impact of different asset allocation decisions for several asset classes.

After-Tax, ETY, and Other After-Inflation Returns (LT26)
This spreadsheet calculates the after-tax return, equivalent taxable yield, and after-inflation return on various assets.

Expected Return Simulation and Benchmarks (LT27)
This spreadsheet shows a historical perspective on returns and standard deviation (risk) for the major asset classes over the last 1, 5, 10, 25, 50, 75, and 85 years. The spreadsheet also includes recommended benchmarks for some of the major asset classes.

Review Materials

Terminology Review

Account maintenance fees. These are fees for maintaining your account.
Account Transfer Fees. These are charges for moving assets either into our out of an existing account.
Agency bonds. Bonds issued by government agencies which were authorized by Congress including the Federal National Mortgage Association (FNMA), Federal Home Loan Banks (FHLB), and Government National Mortgage Association (GNMA).
Asset backed bonds. Bonds backed by specific holdings of the issuing company, such as equipment or real estate.
Baby bonds. A bond with a par value of less than $1,000.
Bearer bonds. Bonds with coupons attach that pay interest only to the bearer upon surrender of the coupons.
Bond rating companies. A private sector company that evaluates the financial condition of the bond issuing company, its revenues, profits, debt, and other critical areas, and gives the company a rating which indicates the relative safety of the bond. They only rate corporate and municipal bonds. They include: Standard & Poor's, Moody's, and Fitch's.
Bond ratings. Bond ratings are measures of the riskiness of a company. Ratings run from "AAA" (Standard & Poor's) or "aaa" (Moody's) for the safest to "D" for the extremely risky. Ratings categorize bonds by default risk, the risk of the company being unable to repay the bond
Book-entry bonds. Bonds which are registered and stored electronically, similar to stock purchases.

Business risk. Risk that the bond's value will decline due to problems with the company's business.
Call provision. A provision that allows the issuer to repurchase the bonds before the maturity date. Deferred calls provide more protection.
Callable bonds. Bonds which can be called, i.e. redeemed, before maturity at the option of the issuer.
Capital Gains. This is the difference between what you paid for the bond and what you sold it for, or the par value if you held the bond to maturity.
Collateralized mortgage obligations (CMOS). More complex and specialized versions of mortgage backed bonds.
Commission costs. These are the cost associated with trading of bonds. While all bond trades incur commission costs, some newly issued bonds are sold without commission cost as the issuer absorbs the costs. Most trades however, incur commission costs, which are paid to the broker who arranged the trade.
Convertible bond. Bond which gives the holder the right to convert the bond to company stock instead of getting the cash repayment.
Corporate Bonds. Bonds secured corporate debts by collateral or real property liens.
Coupon interest rate (or interest rate). The percentage of the par or face value that will be paid annually to the holder in the form of interest.
Current Yield. It is the ratio of annual interest payments to the bond's market price.
Custody (or annual) fees. These are fees the brokerage house charges to hold the bonds in your account. May be a minimum amount for small accounts ($15 per year), a specific charge per holding (8 basis points per security), or a percentage of assets for large accounts (25 basis points on assets under management)
Debenture. A long-term unsecured bond. It can have a hierarchy of payment, with unsubordinated and subordinated debentures. These are bonds backed by the credit of the issuing company.
Discount bonds. A bond that is sold at a discount to its par value. Generally, upon maturity the accrued interest and original investment add to the bond's par value.
Downgrade. A situation where a bond rating company reduces the bond rating of a bond generally due to a deterioration in the company's financial condition.
Equivalent taxable yield (ETY). This is the yield that must be offered on a taxable bond to give the same after-tax yield on a tax-exempt bond.
Euro Bonds. Bonds issued by U.S. companies and sold outside of the U.S. in U.S. dollars.
Exchange rate risk. Risk that changes in exchange rates will impact profitability for firms working internationally.
Financial risk. How the firm raises money could affect the financial performance of the firm and the value of the bonds.
Floating rate bond. Bond whose interest payments fluctuate according to a specific benchmark interest rate.
General Obligation bonds. Bonds backed by the taxing power of the issuer.
Inactivity/Minimum balance fees. These are fees imposed because you did not trade or have account activity during the period or because you failed to keep a minimum balance in your account.
Indenture. A document that outlines the terms of the loan agreement.
Inflation risk. Risk that a rise (decline) in inflation will result in a decrease (increase) in the bond's value.

Interest rate risk. Risk that a rise (fall) in interest rates will result in a decline (rise) in the bond's value.
Interest. Interest is the coupon payment received each period. These are taxed at your marginal tax (MTR).
Intermediate-term bonds. Bonds with a maturity of 2 to 10 years.
International Bonds. Bonds issued by international companies and sold internationally in various currencies.
Issuer. The corporation or government agency that issues the bond.
Junk Bonds. Bonds with very low bond ratings, a higher interest rate and default rate, and are almost always callable.
Liquidity risk. Risk that investors will be unable to find a buyer or seller for a bond when they need to sell or buy.
Long-term bonds. Bonds with a maturity of greater than 10 years.
Long-term Capital Gains. These are gains made in selling bonds held for more than 1 year. These are taxed at 0-20% depending on how long you have held the assets and your taxable and adjusted gross income.
Markup. This is the difference between the buying price and the calculated selling price.
Maturity date. The date when the bond expires and the loan must be paid back.
Mortgage-backed bonds. Bonds backed up by a pool of mortgages.
Par value. The face value or amount returned to the holder of the bond at maturity.
Political or regulatory risk. Unanticipated changes in the tax or legal environment will have an impact on a company's bonds.
Price. The price that the bond sells for.
Redemption. The process of redeeming a callable bond before its maturity date.
Revenue bonds. Bonds backed by the revenues of a specific project.
Risk of Downgrading. Should a bond's rating be downgraded, the seller would need to reduce the price of the bond (resulting in a lower yield to the seller and a higher yield to the buyer) to make up for the increased risk.
Short-term bonds. Bonds with maturity usually a year or less.
Short-term capital gains. These are gains made in selling bonds owned less than 1 year. They are taxed at your MTR.
Sinking fund. Money set aside annually to pay off the bonds at maturity.
Subordinated bond. Bond that will be paid after the other loan obligations of the issuer are paid.
Taxes. Taxes must be taken into account to get the true return of your portfolio but which are not noted on your monthly reports.
Term or Bond Maturity. The maturity of the bond.
Treasury Bills. A short-term debt obligation issued at a discount and redeemed at face value upon maturity in 3, 6, or 12 months.
Treasury Bonds. A long-term debt obligation issued at or near par and interest is paid semiannually.
Treasury Notes. An intermediate-term debt obligation issued at or near par and interest paid semiannually.
Unsecured corporate debts. Bonds not secured by collateral, and pay a higher return.
Upgrade. A situation where a bond rating company improves the bond rating of a bond due generally to an improving financial condition.
US Savings EE Bonds. Savings bonds issued by the US government that pay a fixed rate of interest with is reset every 6 months.

US Savings I bonds. Bonds issued by the U.S. government, and tax deferred until maturity. They are not marketable, but can be redeemed from local banks. bonds sold at face value, with interest paid at maturity, with the interest rate set to inflation with a fixed component.
Yankee Bonds. Bonds issued by international companies and sold in the U.S. in U.S. dollars.
Yield to Maturity. This is the true yield received if the bond is held to maturity, which assumes that all interest payments can be reinvested at the same rate as the bond itself.
Yield. The annual interest on a bond divided by its price.
Zero-coupon bonds. A discount bond which pays no interest until maturity.

Review Questions

1. How do bonds reduce the overall risk of a portfolio?
2. What seven risks are bonds susceptible to?
3. What is a bond rating? What does a high rating mean? What is Standard & Poor's highest bond rating? Lowest bond rating?
4. What are the six major categories of bonds?
5. How are bond values determined? What three things affect bond prices?

Case Studies

Case Study 1

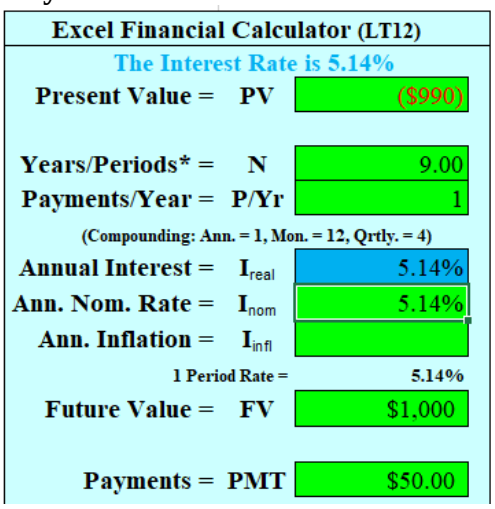
Data

Bill is considering purchasing a bond with a 5 percent coupon interest rate, a par value of $1,000, and a market price of $990. The bond will mature in nine years.

Calculations

A. What is the bond's current yield?
B. Calculate the bond's yield to maturity using your financial calculator.

Case Study 1 Answer



A. The bond's current yield is the annual interest payments divided by the market price. The annual interest payments are the coupon interest multiplied by the par value—0.05 * 1,000, or $50. The price of the bond is $990, so the yield is $50 / $990, or 5.05%.
B. To calculate the yield to maturity, first clear the memories of the calculator and set it to annual payments. Set your present value as negative, what you would pay for the bond (PV = –990), your interest payments as your payment (PMT = 50), your future value as your par value (FV = 1,000), and your number of years as nine (N = 9). Then solve for your interest rate (I = 5.14%).

Note: Since Bill paid less for the bond than par, and his coupon interest rate was 5 percent, this would increase his YTM above your coupon interest rate.

Case Study 2

Data

Three friends—Kimberly, Natalie, and Clinton—are from Nevada, where there is no state income tax. They have asked you to determine the equivalent taxable yield on a municipal bond. This municipal bond is from the same state as your friends and is exempt from state and local taxes for interest. The bond's coupon yield is 3.75 percent with five years left until maturity, and it is selling at par. Kim is in the 15 percent tax bracket, Natalie is in the 28 percent tax bracket, and Clinton is in the 35 percent tax bracket. Calculate the equivalent taxable yield for your three friends.

Calculations

Assuming a similar AAA corporate bond yields 5.0 percent, which of your friends should purchase the municipal bond?

Case Study 2 Answers

Kimberly is in the 15% federal marginal tax bracket, so the equivalent taxable yield is 4.41%, or 3.75% / (1 – .15).

Natalie is in the 28% federal marginal tax bracket, so the equivalent taxable yield is 5.21%, or 3.75% / (1 – .28).

Clinton is in the 35% federal marginal tax bracket, so the equivalent taxable yield is 5.77%, or 3.75% / (1 – .35).

Assuming a corporate bond yields 5.0%, only Kimberly should purchase the corporate bond.

Case Study 3

Data

You paid $1,000 for a Boston Scientific bond at the end of the previous year. At the end of last year, the bond was worth $1,050. You are in the 25 percent federal marginal tax rate, and you live in a state that has no state income tax. Over the course of last year, you received $40 in coupon interest payments.

Calculations

A. What was your before-tax return for the bond?

B. What is your after-tax return, assuming you did not sell the bond?

Case Study 3 Answers

Calculations

A. You only pay taxes on realized income, not unrealized income. Your before-tax return is:

($1,050 – 1,000 + 40) / 1,000, or 9.0%

B. Your after-tax return would include the unrealized capital gains and the interest after you paid taxes. Since this is interest income, it is taxed at your marginal tax rate of 25%

(there is no state tax). The after-tax return is:
(1,050 – 1,000 + [40 * (1 - .25)]) / 1,000 = 8.0%.
Of the $40 coupon, you pay $10 in taxes and keep the remaining amount.

22. Investing 5: Understanding Stocks

Introduction

Of all the major asset classes, stocks (or equities) have consistently delivered the highest return over the longest period of time. It is critical for you to understand basic information about stocks if you want to achieve better returns than those yielded by long-term bonds and cash. This chapter will give you a basic understanding of how and why stocks perform the way they do. This chapter will also help you understand why you should consider stocks or stock mutual funds when building your portfolio.

Before I begin the discussion of stocks, I would like to reiterate three important principles of successful investing discussed earlier.

First, stay diversified. Diversification is your best defense against risk. When investing in stocks, do not invest in individual stocks but in portfolios of stocks. Investing is risky and uncertain; minimize risk by diversifying your stock holdings immediately by investing in index funds, ETFs, or diversified mutual funds.

Second, use caution if you are investing in individual stocks. The fastest way to get rich or poor (depending on your luck) is investing in individual stocks. If you must invest in individual assets, know what you are investing in. Do your homework. Spend time learning about the company, its financial statements, its management, its short- and long-term strategy, its domestic and global industry, and its competition. Note that I emphasize that this chapter on stock basics is not sufficient background information to enable you to invest wisely in individual equity assets. I strongly recommend that you invest in low-cost, low-turnover and tax efficient index or mutual funds that hold hundreds of individual assets instead of investing in individual stocks.

Finally, do not waste too much time and energy trying to beat the market. It is very difficult, expensive, and time-consuming to beat the market (to gain returns in excess of the returns on the major asset classes). While it may be possible to beat the market on a short-term basis, it is very difficult to consistently beat the market on a long-term basis.

Objectives

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

A. Review risk and return for stocks and common stock terminology
B. Understand how stocks are valued and why stocks fluctuate in value
C. Know stock-investing strategies and the costs of investing in stocks
D. Understand plans and strategies for stocks.

Review Risk and Return for Stocks and Stock Terminology

Stocks, or equities, are an important part of most investors' portfolios. As an asset class (not as individual stocks), common stocks have a history of delivering strong, long-term capital gains, making stocks the best and most tax-efficient type of investment return. In addition, dividends on stocks are currently taxed at a much lower rate than interest on bonds, so earnings from stocks are a viable alternative to earnings from bonds.

Investing in individual stocks can be risky. Stocks are susceptible to changes in the domestic and world economy as well as changes in the company and political environment. The growth of a stock or equity investment is susceptible to a number of risks; therefore, a stock's growth is not solely determined by interest rates alone. Investing in a diversified portfolio can reduce the overall risk of your portfolio.

Stocks and Risk: All Risk Is Not Equal

Stocks are susceptible to a number of risks, including the following:

Interest-rate risk. Interest rates may rise or fall at any time, resulting in a decline or increase in a stock's value. Rising interest rates lower the present value of a stock.

Inflation risk. A rise or decline in inflation may result in an increase or decrease in the value of a stock. For most stocks, a higher rate of inflation results in a lower value of a stock. The inverse of this situation is also true.

Company risk. The share price may rise or decline because of problems with the company. The better the future prospects for a company, the higher the present value of the stock. The inverse of this situation is also true.

Financial risk. Whether or not a company is viewed as a financial risk has the potential to affect the performance of the company's stock. Companies that are less risky or have better prospects can usually borrow money at lower rates of interest; hence, these companies have lower expenses and higher earnings, which will cause an increase in their stock price. The inverse of this situation is also true.

Liquidity risk. Investors take the risk that they may be unable to find a buyer or seller for a stock when they need one. Often, liquidity is more closely related to market conditions than company conditions.

Political or regulatory risk. Unanticipated changes in the tax or legal environment may have an impact on a company. Since taxes and the legal environment affect the outlook of a company, any regulatory changes that improve a company's long-term prospects will generally result in a higher price for that company's stock. The inverse situation is also true.

Exchange-rate risk. Changes in exchange rates may affect profitability for international companies. As exchange rates strengthen, the cost of domestically produced goods increases when these goods are sold overseas, which causes an increase in the stock price. The inverse situation is also true.

Market risk. Overall market movement may affect the price of a company's stock. Investors often monitor the way a stock responds to movement in the market. A measure of how sensitive a stock is to movements in the market is called "beta" (β). A stock with a beta of one moves very closely with the market. A stock with a beta that is greater than one will be more volatile than the market. A stock with a beta of less than one will be less volatile than the market. Betas can help investors determine a stock's market risk.

As you are building and monitoring your portfolio, you should track the beta of your portfolio, or the weighted beta of each of the individual stocks or mutual funds in your portfolio. This will tell you how risky your overall portfolio is in comparison to the market.

A diversified portfolio moves with the market: one company's successes or failures cannot affect it as much. Remember the fourth principle of good investing: stay diversified. Do not invest solely in individual stocks—invest in a broad range of financial assets. Do not invest solely in large-cap stocks either; broaden and deepen your portfolio to include international, small-cap, and other asset classes.

Beware of using leverage. Using leverage is the process of increasing your purchasing power by borrowing money to invest in financial assets. Leverage increases risk: it magnifies capital gains and losses because the rate of return on the loan is fixed, while the rate of return on the investment is not. Do not use leverage to invest.

Understand Stock Terminology

There are a number of important terms you should understand before you begin working with stocks:

Common stock is an ownership share of a company. The company initially sells common stock through an initial public offering, or IPO. The stock is then traded among investors in secondary markets. Owners of common stock take more risk than owners of other types of stock, but they also receive a greater reward if the company performs well.

Preferred stock is also an ownership share of a company. However, this type of stock differs from common stock in that the dividend is paid before dividends on common stock are paid to shareholders. However, if the company's profits increase, the dividend is not increased accordingly, so return is limited.

Classes of stock: Some companies have multiple classes of stock, usually called Class A,

B, etc. These multiple classes of stock usually give certain advantages to the Class A shares, such as increased voting power. Companies may also have different dividend policies for different classes of stock.

Shareholders (stockholders) are investors who own shares, or equity, in a company. When you purchase shares of stock from a company, either individually or through a mutual fund, you become a partial owner in that company.

Voting rights: Shareholders have the right to vote on major policy issues. Usually, a shareholder is given one vote for each share of common stock he or she owns. However, some companies issue different classes of shares, and some classes have extra voting rights. Generally, shareholders vote by proxy, a practice similar to voting with an absentee ballot.

Book value per share is the value of each share of the company's stock after the company's liabilities have been subtracted from the company's assets. To find the book value per share, subtract the company's liabilities from the company's assets to find the company owner's equity (as seen on a balance sheet); then divide this amount by the weighted average number of shares that are outstanding. The book value per share is based on the value of the company's assets at their purchase cost, minus depreciation, or the amount the asset has decreased in value since it was purchased. This value is based on the tax code and not on the actual loss in value of the assets. In other words, it is the value of the company's assets at cost minus their depreciated amount.

Earnings per share refers to the level of earnings of each share of stock—not necessarily the amount that will be paid out as dividends. Earnings per share equals the net income minus preferred stock dividends divided by the weighted average number of common shares outstanding.

Dividend yield refers to the annual yield of dividends per share divided by the current market price. The dividend yield indicates the amount of return on the current share price. Dividend yield is only one way investors receive a return on their investment.

Stock splits are when the firm issues new shares of stock, which in turn, lowers the current market price. For example, assume you have 10 shares of stock priced at $100 per share ($1,000 total). If the stock splits two-for-one, you would then have 20 shares. The price of the stock would most likely decline from $100 per share to $50 per share ($100 divided by 2). You would still have the same total value of $1,000, but the price for each share would now be $50 per share instead of $100 per share, and you would now have 20 shares instead of 10 shares. While a stock split has no impact on a company's value, it may be a positive indicator of the company's prospects.

Reverse splits reduce the number of shares outstanding and raise the stock's price. A reverse split is the opposite of a stock split.

Stock repurchases are when companies buy back their own shares. This is generally positive for the investor because each time a company repurchases stock, the investor owns a larger proportion of the company. In addition, a stock repurchase signals to the market that the company considers their shares undervalued.

Classification of Common Stocks

There are a number of different classifications for stocks. You should recognize that these classifications are temporary and may differ from investor to investor and from one time period to another.

Blue-chip stocks are the stocks of the largest and best-managed companies. There is not a specific list of blue-chip stocks, and the stocks that are considered "blue chips" change from year to year. The phrase "blue chip" relates to poker, where the blue chips are the highest value of chip.

Growth stocks are the stocks of companies that are growing faster than average; these companies generally reinvest dividends. These companies also generally have higher price-earnings ratios and higher price-to-book ratios than the market as a whole.

Value stocks are less expensive, compared to the overall market. The companies that are value stocks generally have lower price-earnings ratios and lower price-to-book ratios than the market as a whole.

Income stocks are the stocks of companies that pay dividends on a regular basis.

Cyclical stocks are the stocks of companies whose share prices move up and down parallel to the state of the economy.

Defensive stocks are the stocks of companies whose share prices move opposite to the state of the economy.

Making Money in Stocks

Investors make money on stocks in two ways: dividends and capital gains.

Dividends are payments companies make to shareholders with part of the companies' profits. Different types of companies have different dividend policies, and these policies can change from year to year.

Capital gains are an increase in share value. Investors purchase shares in companies with the expectation that the price of the shares will increase. Because of lower tax rates for long-term capital gains, capital gains are the preferred type of earnings for companies and individuals. The following are descriptions of the different types of capital gains:

Realized capital gains are gains that are realized when shares of an asset are sold.

Unrealized capital gains are known as "paper gains" because the asset has yet to be sold, and the gains have not yet been realized.

Short-term capital gains are gains that apply when stock is owned less than one year. These gains are taxed as ordinary income.

Long-term capital gains are gains where the investor has held the financial asset longer than 366 days. Making the distinction between short-term and long-term capital gains is important because gains made on shares owned longer than one year and sold are taxed at a preferential (lower) federal tax rate than gains made on shares owned less than one year and sold.

Understand How Stocks Are Valued and Why Prices Fluctuate

The goal of stock valuation is to determine the intrinsic value of a company (in other words, the company's fundamental economic value). If the market price of the company's stock is greater than the company's intrinsic value, the investor should sell the stock. If the market price of the company's stock is less than the company's intrinsic value, the investor should buy the stock. Determining a company's intrinsic value is one of the most challenging responsibilities an investor has. Determining this value is accomplished using various tools, including dividend discount models, fundamental analysis, cash-flow analysis, and technical analysis. Proper stock valuation is a difficult, time-consuming, and challenging activity—it is not something that can be done in a few minutes or that can be calculated using a program that can be purchased on the Internet. The purpose of this chapter is to familiarize you with some terminology that will help you understand stock valuation—not to give you the tools to value stocks. Teaching proper valuation of stocks is beyond the scope of this course.

Dividend discount models regard the value of a stock as the present value of all future dividends that will be earned while holding that stock; these dividends are discounted at the company's required rate of return, or discount rate. The value of a company's common stock is found by dividing the dividend you expect to have in the future by the current required rate of return you require for holding this stock, or discount rate (*k)*, minus the stock's long-term growth rate (*g*).

$$\text{Value of common stock} = D_1 / (k - g)$$

The letter *g* represents how fast you expect dividends to grow over the next 50 years—the long-term growth rate. It is very difficult to determine the exact value of a company's stock using this method because it is impossible to accurately project either the dollar amount of future dividends or the growth rate. However, this model may still be helpful in your stock analysis.

Fundamental analysis assumes that the value of the stock can be determined by the future

earnings of the company. Analysts spend a great deal of time investigating the company, the industry, the global industry, and the global economy to determine the intrinsic value of the company and gather the necessary information for fundamental analysis. Fundamental analysis has been found to be a valuable tool for stock valuation, particularly when analysts are able to forecast earnings that are significantly different than the market consensus.

Cash-flow analysis assumes that the value of the company is measured by the discounted value of the free cash flows to all shareholders, including equity shareholders. Free cash flows are defined as cash flows in excess of cash flows required for operations and investment. To value a stock based on cash-flow analysis, investors build cash-flow models that forecast expected cash flows to all shareholders and to the company as a whole. While cash-flow analysis is helpful in determining intrinsic value, the value of the company often lies in areas that are difficult to quantify in terms of assets, such as video libraries for entertainment companies or patents for medical companies.

Technical analysis assumes that supply and demand are the key factors necessary to understand stock prices and markets. Technical analysis focuses on the psychological factors that determine a company's value, such as greed and fear, as well as the economic factors that determine a company's value. Major research studies have found that this type of analysis is not as reliable in predicting stock prices.

In addition to the methods discussed above, a few key ratios are often used to value stocks:

Price-earnings ratio (PE) is the market price of the stock divided by the earnings per share, or the amount you are paying for one dollar of earnings. The PE ratio is one of the most widely used ratios and compares the financial performance of different companies, industries, and markets. It is most useful when comparing a company's current PE ratio to a company's historical PE ratio (i.e., today's PE ratio compared to the PE ratio for each of the past 10 years), the industry PE ratio (i.e., a weighted average of all the PE ratios of companies within an industry), or the market PE ratio (i.e., a weighted average of all the PE ratios of companies within an market). The company's forecasted PE ratio, or the PE ratio for the upcoming year, is generally considered to be more important than the company's historical, or accounting, PE ratio.

Price-to-book ratio (PB) is the price of the company's stock divided by the company's book value per share, or the amount you are paying for one dollar's worth of assets, as shown on the balance sheet. The PB ratio does not consider the actual value of the assets, only the non-depreciated portion of the assets; there can often be a major discrepancy between the actual value of the assets and the book value of the assets.

Return on equity (ROE) is the company's earnings per share divided by the company's book values per share, or a measure of how well the company is utilizing its assets to make money. Generally, the higher this ratio, the better the company is utilizing its resources. Understanding the trend of ROE is important because it indicates whether or not the company is improving its financial position.

Dividend payout ratio shows the dividends paid by the company divided by the earnings of the company. The dividend payout ratio can also be calculated as dividends per share divided by earnings per share. A high dividend payout ratio indicates that the company is returning a large percentage of company profits back to the shareholders. A low dividend payout ratio indicates that the company is retaining most of its profits for internal growth. The dividend payout ratio will be different for different types of companies.

Know Why Stocks Fluctuate in Value

There are many different reasons why stocks fluctuate in value. The most common reasons for fluctuations include changes in interest rates; the perceived risk of the company; company earnings, dividends, and cash flow; supply and demand; and investor sentiment in the market.

Interest rates effect the expected return, or discount rate, investors require to invest in stocks. This discount rate is greatly influenced by the interest rate. As interest rates decrease, shareholders' discount rates also decrease; future earnings are therefore discounted at a lower rate, which results in a higher value of the company. As interest rates increase, shareholders require a higher discount rate to invest; all future earnings are therefore discounted at this higher rate, which reduces the value of the company.

Perceived risk of the company impacts company value. There is an inverse relationship between perceived risk of the company and its stock price. This is because as the perceived riskiness of the company decreases, investors are willing to pay more for the company stock; this results in an increase in stock price. The inverse of this situation is also true.

Earnings, dividends, and cash flow have an impact. As earnings, dividends, and cash flow per share increase beyond investor expectations, investors are willing to pay more for the stock, and the stock price generally increases. The inverse is also true.

Supply and demand effect stock prices. Prices may rise and fall based solely on supply and demand for the shares. For example, an investor with a large number of shares may need to sell shares of a stock to meet his or her cash needs. When the shareholder sells these shares, the supply of shares that are for sale increases, and the price of the shares is likely to fall. Likewise, if an investor gets new money into his or her accounts and decides to substantially increase his or her holdings in a stock, the price for that stock will likely rise as demand increases.

Investor sentiment in the market has an impact on stock prices. They may rise or fall based on the general sentiment investors have about the market and about how well the overall market is performing. If investor sentiment is positive and the market is performing well, investors will likely bid up the price of all stocks. If investor sentiment is negative and the market is performing poorly, investors will typically be less willing to purchase stock, resulting in lower stock prices.

Know Stock-Investing Strategies and the Costs of Investing in Stocks

There are several different strategies for investing in stocks. The most common are the buy-and-hold strategy, the dollar-cost averaging strategy, and the dividend-reinvestment strategy.

Buy-and-Hold Strategy

The buy-and-hold strategy refers to buying a stock and holding it for an extended period of time. This is a very cost-effective, long-term strategy. This strategy helps investors minimize brokerage fees and avoid market timing, where investors try to forecast whether the market will go up or down and invest accordingly. It also minimizes taxes because realized gains are taxed as long-term instead of short-term capital gains. Since you keep the stock for an extended period of time, you are not taxed on unrealized capital gains until these gains are realized when you sell the stock. Moreover, while you may still receive dividends each year, these dividends are taxed at lower rates than interest rates on bonds or savings accounts.

Dollar-Cost Averaging

Dollar-cost averaging refers to purchasing a fixed dollar amount of a security at regular intervals, for example, every month. This investing strategy is based on the general trend of the market and averages out fluctuations in the market; it takes luck and market timing out of the equation, and it adds discipline to your investing. This is a good investment strategy, particularly if you are planning to fund your investments by paying yourself (taking 10 to 20 percent or more out of your paycheck each month).

Dividend-Reinvestment Plans (DRIPs)

A dividend-reinvestment plan refers to a strategy in which additional shares of stock are purchased with a stock's dividend payments. This strategy simplifies the investment process by allowing you to avoid brokerage fees in purchasing additional shares of stock. While you still pay taxes each year on the dividends received, the avoidance of brokerage costs results in a higher overall return.

Costs of Investing in Stocks

The costs of investing in stocks can be divided into three categories: explicit costs, implicit costs, and hidden costs.

Explicit Costs

Explicit costs are reported to you each month; these costs include brokerage commissions and custody fees.

Brokerage commissions are service charges assessed by a broker in return for arranging purchases or sales of financial assets. Commissions vary widely from broker to broker. The

commission may be a set amount, such as $15 for a sale or trade, or a percentage of the purchase or sale price, such as 75 basis points (0.75 percent). Commissions apply to both buying and selling. You should agree on these costs with your broker prior to trading.

Custody fees, or annual fees are the fees a brokerage house charges for holding stocks, bonds, or mutual funds in your account. These charges may be a minimum amount for stock accounts (for example, $15 per year) or a specific charge per holding (for example, 18 basis points per security). These fees may also be assessed as a percentage of assets under management (for example, 25 basis points).

Implicit Costs

Implicit costs are those you may not see until months after you sell a security. The most common implicit cost is taxes. It is critical that you account for taxes when you are valuing the total return of your portfolio. Implicit costs such as taxes are not noted on your monthly report, and most investors do not think about them until they have to pay them. Understand taxes before you begin paying them.

Taxes on capital gains are taxed paid on capital gains earned by selling stocks or securities. Short-term capital gains are earned when you sell assets you owned for less than a year: they are taxed at your marginal tax rate, which includes both your federal and state marginal tax rates. Long-term capital gains are earned when you sell assets you held for more than one year: they are taxed at 0 to 23.8 percent, depending on your income level and how long you held the assets. Generally, the longer you hold an asset, the longer you can defer paying taxes on capital gains.

Taxes on stock dividends are taxes paid on dividends, which are the returns you get from a company. See Figure 1 below for further understanding of taxes on long term capital gains and stock dividends.

Hidden Costs

In addition to understanding explicit and implicit costs, you should be aware of these hidden costs involved in investing in stocks:

Account transfer fees are costs for moving assets in or out of an existing account. Understand the costs before you begin trading.

Account maintenance fees are fees for maintaining your account.

Inactivity fees are fees for not having any account activity over a certain period of time.

> **Minimum balance fees** are charged when you fail to maintain the required minimum balance in your account. Make sure you know what the minimum balance on your account is.

Interest on margin loans is interest charged on money you borrow to buy securities.

Understand Plans and Strategies for Stocks

Following are a few ideas for your plans and strategies for stocks. The numbers refer to specific parts of your Investment Plan (LT05A).

Plans and Strategies

Overall Investment Plan

- Stocks are good at doing what they do well, gaining returns in excess of inflation at a higher level of risk.
- We will invest in stocks/stock mutual/index funds which are great at gaining returns in excess of inflation.
- We will compare our stock/funds to the S&P500 for Large Cap, Russell 2000 for small cap, EAFE for International, S&P REIT for REITs, and MSCI EM Free for emerging markets so we can know how we are doing.

General Investing

- Due to the many different types of stocks and stock asset classes, investors can invest at differing risk levels within this asset class.
- While risk of individual stocks can be high, buying multiple stocks or stock mutual funds can reduce that risk considerably (no-load and low cost stock mutual/index funds are recommended).
- Some stocks are likely necessary to give you the returns needed to grow your portfolio above inflation as part of your diversified portfolio.
- As you age and get closer to retirement, stocks, because of their risk, are a generally recommended to become a smaller percentage of your overall portfolio due to their higher volatility.
- As you review stock and stock mutual funds for your portfolio, make sure you follow the principles of successful investing.

Summary

Of all the major asset classes, stocks have consistently delivered the highest return over the longest period of time. It is therefore critical for you to understand basic information about stocks if you want to achieve better returns than those yielded by long-term bonds.

Stocks, or equities, are an important part of most investors' portfolios. As an asset class (and not as individual stocks), common stocks have a history of delivering strong, long-term capital gains; stocks are the best and most tax-efficient type of investment return. Having individual stocks in a diversified portfolio can reduce the overall risk of the portfolio. Stocks are susceptible to a number of risks, including interest-rate, inflation, company, financial, liquidity, political or regulatory, exchange-rate, and market risks.

Understanding stocks requires you to understand a new set of terminology. There are a number of different classifications for stocks. You should realize that these classifications are temporary: they may differ from investor to investor and from one time period to another. Investors make money on stocks in two ways: dividends and capital gains.

The goal of stock valuation is to determine the intrinsic value of a company, or the company's fundamental economic value. If the market price of the company's stock is greater than the company's intrinsic value, the investor should sell the stock. If the market price of the company's stock is less than the company's intrinsic value, the investor should buy the stock. Determining a company's intrinsic value is one of the most challenging responsibilities an investor has. Determining this value is accomplished using various tools, including dividend discount models, fundamental analysis, cash-flow analysis, and technical analysis. Proper stock valuation is a difficult, time-consuming, and challenging activity.

Assignments

Financial Plan Assignments

Continue to work on your Investment Plan. As you do, it your assignment is to review the history of stocks over the past 5, 10, 25, 50, and 75 years. How have stocks performed overall? What do stocks add to a portfolio? What disadvantages do stocks have? How can you minimize the disadvantages of stocks, while at the same time enjoying the advantages stocks offer? While stocks may be risky in the short term, they deliver higher risk-adjusted returns in the long term. Consider the following concepts:

Benchmarks: What are the major benchmarks or indexes that correspond with stocks? (See Possible Benchmarks for Investment Plans (LT15)). It is likely you will include stocks in your diversified portfolio, so it is important that you select the major benchmarks you will follow to help you understand how stocks perform.

Generally, investors consider stocks more risky than bonds. What do they mean by that? To see graphically the volatility of stocks versus other asset classes, open Historical Return Simulation for Asset Classes (LT23). Go to the *Asset Class Data* tab and use the light-blue drop-down boxes to select your asset classes (or you can just use the asset classes listed). Use the dark-blue drop-down boxes to select your time period. Then go to the *Charts* tab. Push the *F9* button to see the impact of standard deviation.

This worksheet builds random portfolios with the expected return and standard deviation of the period and asset class chosen. It then assumes that each asset class builds 10 different portfolios, and those portfolios are run for 20 years. The differences between the 10 different portfolios are shown in the same colored lines. The more the colored lines move together, i.e., the more each of the random portfolios move together, the less risky or less volatile the asset class. The more the same colored lines diverge, the more risky or more volatile the asset class. Now compare the portfolios for large-capitalization stocks, small-capitalization stocks, and international stocks.

You may get a sense for the volatility in this asset class.

While stocks are generally more volatile (or risky) than bonds, their returns are higher to compensate for this additional risk. To see what the returns have been for various types of stocks, go to Expected Return Simulation and Benchmarks (LT27). Go to the tab labeled *Returns and Risk*. Look for the 1-, 5-, 10-, 25-, 50-, 75- and 85-year returns for large-capitalization, small-capitalization, international, and emerging-market stocks. How have these assets performed compared with bonds or inflation? You might also look at the return and risk history of Real Estate Investment Trusts, or REITs, which have characteristics of both equities and bonds.

Now that you have reviewed the historical asset class performance, estimate your expected return for your Plan for Stage 1 and Stage 2. This process involves three steps:

1. Determine your asset-allocation targets.
2. Using those targets, use historical estimates over specific time periods to get a recommendation for your expected return.
3. Adjust the historical data to take into account current market conditions and expectations.

First, to get your asset-allocation targets, start with your stocks, bonds, and other asset class allocations determined earlier in Section III.C.1 and III.C.2. For most individuals, your initial emergency fund allocation will be to Treasury Bonds, completing your bond allocation. The more difficult allocation is to divide up your equity or stock allocations. It is important to recognize risk in building your portfolio. Your bond allocations are generally the least risky. Within stocks, the large-cap stocks add the next level of risk and are generally the least risky of all equities. Next in order of risk come small-cap stocks, international stocks, and emerging-market stocks, all of which have much more risk than large-cap stocks. I generally recommend that investors have over half or more of their stock allocations in large-cap stocks because they are the least risky of all stocks or equities. Conservative and very conservative investors may have two-thirds to three-quarters of their equity allocation in these large-cap stocks. Realize that your allocation will differ in comparison to other investors depending on your age, risk tolerance, and investment experiences.

Finally, there are asset classes that are neither bonds nor equities but have some characteristics of both. Real Estate Investment Trusts (REITs) fall under this category and may be useful to include in your allocation. I include these as “Other Asset Classes.”

I strongly recommend you have a minimum of four asset classes, consistent with building your investment portfolio. I generally recommend investors include more asset classes than four, with the riskier asset classes (i.e., small-cap and emerging-market stocks) limited in their allocations to between 5 percent and 15 percent. Determine your asset allocation targets for Stage 1 (now) and Stage 2 (retirement) and include these targets in Section III.B.1 and III.B.2.

Second, you need to get an idea of how that allocation would have done using historical data and

your proposed asset allocation. To determine this historical return, use Expected Return Simulation and Benchmarks (LT27) and include this as Exhibit 1. Using the light-blue drop-down boxes, include the asset classes you are interested in. Using the dark-blue drop-down boxes, include the time periods over which you are interested. Finally, using the green boxes, type in your allocation targets for each asset class, making sure the totals add up to 100 percent. For example, a period of 80 means you are using the last 80 years of data ending in 2007 and calculating the geometric return for that asset class. Note that your choice of time periods will have a significant effect on the historical data. I generally recommend that investors use the longest time period available.

After you have entered your allocations and time periods, **LT27** will give you a weighted return using historical data. I encourage you to change the time periods (look at 1, 5, 10, 50, and 80 years to see what impact that has on your weighted returns). Determine your weighted return for Stages 1 and 2, your periods before and during retirement.

Finally, adjust the expected returns from **LT27** to account for current market conditions. I strongly recommend that if your weighted return is greater than 7.5 percent from the historical returns, use an expected return of less than 7.5 percent (6.5-7.5 percent). I also recommend that your expected return for Stage 2, or retirement, be less than your expected return on Stage 1. Determine your expected return and enter these into your Plan in Sections I.A.1 and I.A.2. Print off Exhibit 1 from **LT27.**

To calculate risk, instead of using standard deviation, beta, or other measure of risk, we have simplified the plan to state that we accept the risk of our weighted benchmarks. Copy your allocations from Section III.B.1 and II.B.2 to the sections on risk in Section I.B.1 and I.B.2.

Learning Tools

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

Possible Benchmarks for Investment Plans (LT15)
This document shows possible benchmarks for most of the major asset classes.

Historical Return Simulation for Asset Classes (LT23)
This spreadsheet shows the impact of various investment strategies and the volatility for different asset classes. This spreadsheet will also show you the historical impact of different asset allocation decisions for several asset classes.

After-Tax, ETY, and Other After-Inflation Returns (LT26)
This spreadsheet calculates the after-tax return, equivalent taxable yield, and after-inflation return on various assets.

Expected Return Simulation and Benchmarks (LT27)
This spreadsheet shows a historical perspective on returns and standard deviation

(risk) for the major asset classes over the last 1, 5, 10, 25, 50, 75, and 85 years. The spreadsheet also includes recommended benchmarks for some of the major asset classes.

Review Materials

Terminology Review

Assets under management. This is another way an investment advisor is paid. It is calculated as a percentage of your assets under management, i.e., if you have $500,000 with an advisor and their fee is 1.0% per year, you will pay them $5,000 per year.

Captive brokers. These are brokers whose company is part of a group which owns a mutual fund company. These brokers may be encouraged to sell company mutual funds which may not be the best fit for the investor but are in the interest of the company.

Cash accounts. This is money with the broker which you use to pay for purchases or receive any cash. There is a specific time between notification of purchases and when the purchases must be paid.

Commissions. Commissions are the way a broker or investment advisor is paid. It is either a percentage of every buy or sell order (e.g., 20 bps per trade), or a specific charge for a trade (e.g., $9.99).

Day orders. These are orders to buy and sell securities which are good only until the end of the trading day.

Deep-discount and on-line brokers. These are brokers who are even cheaper than discount brokers. They do only trading, but at a 90% discount to full-service brokers. On-line can even be cheaper with other services.

Discount-service brokers. These are brokers who only perform trading, but usually at a 50% to 70% discount to full-service costs.

Discretionary accounts. These are accounts where you authorize a broker or investment advisor to make trades for you and your account. Exercise caution with this as the broker can buy and sell securities at will and you are responsible for all taxes and commission costs.

Full-service brokers. These are brokers who will give you all the tools, research and other advice to help you trade and invest.

Independent brokers. These are brokers whose company is not part of a major chain or who own a captive mutual fund company. They may be inclined to give unbiased advice as they do not sell specific mutual funds.

Initial public offerings (IPOs). These are the very first shares ever issued by a company. Investment bankers serve as underwriters or intermediaries for these IPOs

Investment advisor. A person or an organization that helps makes the day-to-day decisions regarding a portfolio's investments for investors.

Limit orders. These are orders to sell or buy a specific number of shares at a specific price or better. This is generally the best method in working with brokers.

Maintenance margin. This is money you put up to buy on margin. If your maintenance margin falls below a specific level, you will be required to put up more money. If not,

your position will be closed out.
Margin accounts. These are accounts where you borrow from the brokerage firm to purchase financial assets. This is debt, and can amplify both gains and losses.
Margin call. This is a call by the broker to put up more money when your margin declines below a certain level. I recommend you do not buy on margin. It is using debt to invest and you can lose more than your original investment doing this.
Market orders. These are orders to sell or buy a specific number of shares at the currently available or market price. Be careful as the market can move quickly and dramatically between when you place the order and order execution time.
Open orders (GTC: good till canceled, GTD: good till date specified). These are orders which are good until filled or canceled. Be very careful with open or GTC /GTD orders. If you fail to cancel specific orders, you might have orders filled that you forgot to close out.
Primary and Secondary markets. Primary markets are markets for trading newly issued securities. Secondary markets are for trading already issued shares of stocks, bonds, and other securities. Secondary markets consist of organized exchanges and over-the-counter or electronic markets where existing shares are traded.
Securities markets or organized exchanges. These are areas used to facilitate trading of financial instruments.
Over-the-Counter (OTC) Market. This is an electronic network of dealers used to execute trades without specialists or middle-men.
Seasoned new issues. These are new shares being issued by a company that is already publicly traded.
Stockbroker. A stockbroker is a person who is employed by and solicits business for a commission house or merchant.
Stop (or stop-loss) orders. These are orders to sell a specific number of shares if the stock price falls below a certain price or buy a specific number of shares if the stock price rises above a certain price. These are used to set prices to safeguard against major fluctuations.

Review Questions

1. What are eight risks that stocks are susceptible to?
2. What is leverage? How does leverage affect risk?
3. What is common stock? Preferred stock?
4. What are the two ways an investor can make money in stocks?
5. What is the goal of stock valuation? Why is it important for an investor to know a company's intrinsic value? Based on a company's intrinsic value, when should an investor buy or sell a stock?

Case Studies

Case Study 1

Data

Peter and Jessica, acting on the advice of their next-door neighbor, recently purchased their first stock, 500 shares of a small-capitalization Internet company trading at $80 per share. The neighbor told them that the stock was a "real money maker" because it recently had a two-for-one stock split and would probably split again soon. Even better, according to the neighbor, the company was expected to earn $1 per share and pay a $0.25 dividend next year. Peter and Jessica have so far been unimpressed with the stock's performance—the stock had underperformed the S&P 500 index this year.

Application

Peter and Jessica have come to you for advice. What is your recommendation?

Case Study 1 Answer

Peter and Jessica lack an important part of investing process—knowledge of what they are invested in. Apparently their next-door neighbor lacks that same understanding. Buying stock is the process of understanding and owning a piece of a company. It is not enough to just know the numbers; they must know what the numbers mean, especially with individual stocks. Peter and Jessica do not know what the numbers mean.

Before they invest in individual stocks, they should learn more about the investment process. When buying individual stocks, it is critical to understand what is going on in the world, region, country, economy, industry, and company. They need to understand Investing Principles 6 and 8: If you must invest in individual assets, know what you invest in and who you invest with, and don't waste too much time, money, and energy trying to beat the market.

For people who have never invested before, I believe buying index mutual funds (which are portfolios of stocks or bonds) is a much better first step in the investment-education process. Buying individual stocks is the last and top step on the bottom of the investment hourglass, not the first step.

Case Study 2

Data

Anne own 200 shares of ABC stock, selling at $410 per share. In order to make the stock more affordable for the average investor, ABC's management has decided to split the stock.

Calculations

A. How much was Anne's investment before the split?
B. Assuming ABC's management decides to split the stock three-for-one, how many shares would Anne own after the split?
C. What is the new price per share after the split?
D. How much would Anne's investment be worth after the three-for-one split?

Case Study 2 Answers

Calculations

A. Before the split, Anne's investment was worth $82,000, or 200 shares multiplied by $410 per share.

B. Afterward, Anne would have 600 shares, or 200 shares multiplied by 3.

C. Afterward, the price of the share should decline to $136.67, or $410 divided by 3.

D. After the split, the value of Anne's investment should remain at $82,000, or $136.67 multiplied by 600 shares.

Case Study 3

Data

MAM Corporation recently announced that its year-end earnings per share (EPS) for this last year was $4.50, and they estimate next year's EPS will be $5 per share. MAM stock is currently selling at $85 per share.

Calculations

A. What is the historical (last year's) PE ratio for MAM?

B. What is the estimated (or forward) PE ratio for MAM?

C. Assume the earnings prospects for MAM deteriorate and the company now estimates next year's earnings to be $4 per share. What would be MAM's new forward PE ratio?

Case Study 3 Answers

Divide the price per share by the earnings per share to calculate the respective PE ratios. PE ratios are normally computed with an *x* after them to denote "times."

A. The historical PE is $85 / $4.5, or 18.9x.

B. The forecast or forward PE ratio is $85 / $5, or 17.0x.

C. Assuming prospects decline for next year, the forecast or forward PE ratio would be $85 / $4, or 21.3x.

Case Study 4

Data

Clinton owns 1,000 shares of Boston Scientific Stock, selling at $50 per share at the beginning of the year. He is in the 25 percent federal marginal tax rate, and he live in a state that has no state income tax. At the end of the year, the stock rose to $55 and he received $1.50 in dividends.

Calculations

A. What was Clinton's before-tax return?

B. What is Clinton's after-tax return, assuming he held the stock?

Case Study 4 Answers

Calculations

A. Clinton only pays taxes on realized income, not unrealized income. Clinton's before-tax return is:

(55 – 50 + 1.5) / 50, or 13.0%.
B. Clinton's after-tax return would include the unrealized capital gains and the dividend after he paid taxes. Since this is a stock dividend, it is taxed at the preferential rate of 15%. The after-tax return is:
(55 – 50 + [1.50 * (1 – .15)]) / 50 = 12.55%.
Of the $1.50 dividends, Clinton pays 22.5 cents in taxes and keeps the remaining amount.

23. Investing 6: Understanding Mutual Funds

Introduction

Mutual funds are collections of stocks, bonds, and other financial assets that are owned by a group of investors and managed by a professional investment management company. As an investor in a mutual fund, you own a share of the fund that is equal to the amount of your investment divided by the total value of the fund.

Mutual funds provide many important benefits to investors; these benefits particularly apply to investors who are just beginning to invest. Since a mutual fund can include hundreds of different securities, the performance of the fund is not dependent on any single security: the risk is spread among the various securities. In most cases, a portfolio manager is assigned to monitor the performance of securities in the fund. Well-chosen mutual funds can help you achieve your financial goals.

Objectives

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

A. Explain the advantages, disadvantages, types and classes of mutual fund shares.
B. Understand how to calculate mutual fund returns.
C. Understand the costs of investing in mutual funds and how to purchase a mutual fund.
D. Understand plans and strategies for mutual funds.

Explain the Advantages, Disadvantages, Types and Classes of Mutual Fund Shares

There are both advantages and disadvantages to investing in mutual funds. The following is a discussion of some of these advantages and disadvantages.

Advantages of Mutual Funds

One of the main reasons for the creation of mutual funds was to give investors who wanted to make smaller investments access to professional management. However, mutual funds offer many advantages to investors of all types, such as:

Diversification: Investing in a single stock or bond is very risky, but owning a mutual fund that holds numerous securities reduces risk significantly. Mutual funds provide diversification, which is crucial to a well-balanced portfolio. Diversification is particularly crucial in small accounts.

Professional management: It is difficult and time consuming to pick the best stocks and bonds

for your portfolio and to try to beat the benchmarks on these stocks and bonds. Allowing a professional mutual fund manager to make decisions about stocks and bonds for you can save you time and frustration.

Minimal transaction costs: Buying individual stocks and bonds is expensive in terms of transaction costs. Mutual funds offer the advantage of economies of scale in purchases because mutual fund transactions are typically large. Economies of scale refers to the fact that mutual fund costs may decrease as the mutual fund's asset size increases, since brokers may charge lower fees to try to get more of the mutual fund's business.

Liquidity: Money invested in mutual funds is generally liquid. You can sell your shares and collect money from open-ended funds (funds that can create and redeem shares on demand), usually within two business days. If the open-end funds are no-load funds, investors are not required to pay transaction costs when they buy or redeem shares.

Flexibility: Owning individual stocks and bonds does not allow for much flexibility in terms of liquidity, or the ability to access your money. You cannot write checks on the value of individual stocks and bonds. However, many mutual funds allow for more flexibility by allowing you to write checks on your account.

Low up-front costs: Certain types of mutual funds have financial benefits that make them less expensive than individual stocks and bonds. For example, no-load mutual funds can be sold and redeemed without incurring any sales charges, and open-ended mutual funds can be purchased at the fund's net asset value (NAV). A fund's NAV is calculated daily by subtracting the fund's liabilities from its assets and dividing the resulting amount by the number of outstanding shares. The benefit of open-ended funds is that you do not need to pay a premium or a sales charge to purchase or sell the shares.

Service: Mutual fund companies generally have good customer service representatives who can answer your questions and help you open accounts, purchase funds, and transfer funds. Mutual fund companies may also offer other services, including automatic investment and withdrawal plans; automatic reinvestment of interest, dividends, and capital gains; wiring funds to and from your accounts; account access via phone; optional retirement plans; check-writing privileges; bookkeeping services; and help with taxes.

Disadvantages of Mutual Funds

Although there are many advantages to investing in mutual funds, there are also some disadvantages.

Below market performance: Generally, most 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.

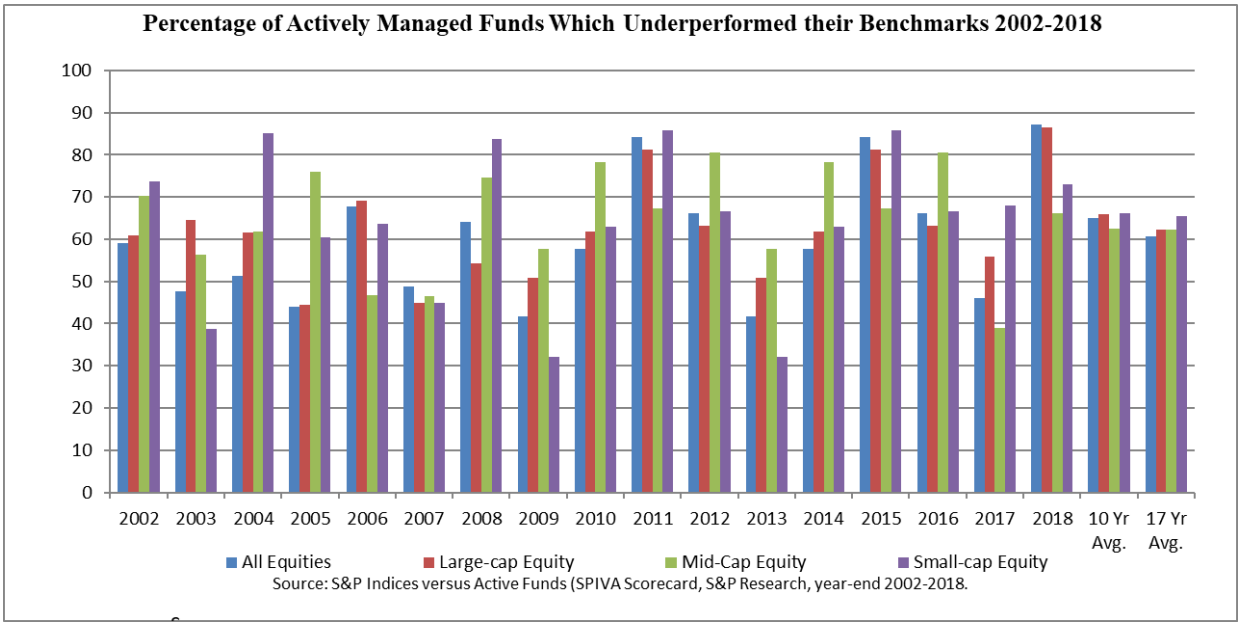
For the period from 1962 to 1997, the average actively managed fund, or a fund whose purpose is to outperform a specific index by the active buying and selling of securities, failed to outperform their benchmarks. In 22 of 35 years, less than half of all actively managed funds beat their benchmarks.[1]

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.[2]

Recent experience is not much different. In the last 10 years, 60–65 percent of actively managed funds failed to beat their benchmarks, depending on asset class (see Chart 1).

Chart 1. Percentage of Actively Managed Funds That Failed to Beat Their Benchmarks[3]



High costs: Unless you analyze funds carefully before you buy them, you may inadvertently choose a mutual fund that charges significant management, custodial, and transfer fees. Each of these fees reduces your total amount of return. Moreover, many mutual funds charge loads (sales charges) and 12b-1 fees, which is are paid by shareholders to cover the cost of marketing the fund to other investors. These charges and fees also reduce your total amount of return.[4]

Risks: Mutual funds are subject to both market-related risks and asset-related risks, particularly in very concentrated portfolios, which are not as well diversified.

Inability to plan for taxes: Mutual funds are considered pass through vehicles for tax purposes and are required to distribute 95 percent of all capital gains and dividends to shareholders at the end of each year. Even if shareholders do not sell their mutual fund shares, if they are in taxable vehicles they may be required to pay a significant tax bill each year, particularly if the fund trades often and has a lot of short-term interest, dividends, or capital gains. It is difficult to plan for taxes because the decisions that affect the amount of taxes you will pay are made by the portfolio manager, not you.

Premiums or discounts: Closed-end mutual funds may be traded at a premium or discount to the fund's underlying net asset value. These premiums and discounts are based on investor demand more than they are based on actual share value; therefore, premiums and discounts are not constant over time.

New investor bias: Shares purchased by new investors dilute the value of the shares owned by current investors. When new money enters the mutual fund at net asset value, the money must be invested, which costs roughly 0.5 percent in an average U.S. stock fund. Thus, the funds of current investors are used to subsidize the purchase of the new investors' shares.

Describe the Different Types of Mutual Funds

There are three major types of mutual funds that parallel the major asset classes: money market, stock, and bond mutual funds.

Major Types of Mutual Funds

Money market mutual funds invest primarily in short-term, liquid financial assets, such as commercial paper and U.S. Treasury bills. The goal of these funds is to obtain a higher return than traditional savings or checking accounts.

Stock mutual funds invest primarily in common stocks listed on the major securities exchanges discussed in the previous section. Each type of stock mutual fund has a particular emphasis or objective, such as large-cap stocks, small-cap stocks, value stocks, growth stocks, and so on.

Bond mutual funds invest primarily in the bonds offered by companies or institutions. Each of these bond mutual funds has a particular emphasis or objective, such as corporate, government, municipal, and agency bonds. Most of these funds have specific maturity objectives, which relate to the average maturity of the bonds in the fund's portfolio. Bond mutual funds can either be taxable or tax-free, depending on the types of bonds the fund owns.

Specialty Mutual Funds

Index funds are mutual funds that are designed to match the returns of a specific benchmark.

Since these funds buy and sell securities infrequently (i.e., they have a low turnover), they are very tax-efficient investment vehicles. Index funds have the option of following many different benchmarks, including the S&P 500 (large-cap stocks), Russell 5000 (small-cap stocks), MSCI EAFE (international stocks), Barclays Aggregate (corporate bonds), and DJ REIT (real estate investment trusts). As of March 9, 2017, there were 1,185 different index funds listed in the Morningstar database (Morningstar is one of the largest and best private data providers of mutual fund information).

Exchange-traded funds (ETFs) are similar to mutual funds in that they comprise groups of stocks; however, ETFs are different because they are traded in an organized exchange. Because ETFs are purchased on an exchange, they incur all the transaction fees and custody costs that stocks do. They are also similar to stocks in that they are priced throughout the day rather than at the end of the day like mutual funds. ETFs can be both shorted and purchased on margin. ETFs can be structured as either unit investment trusts (UITs), whose money is invested in a portfolio where the composition is fixed for the life of the fund, or open-end mutual funds, where money is invested in a portfolio that can change over time. The UIT structure does not allow for immediate reinvestment of dividends. As of March 9, 2017, there were 1,750 different ETFs listed in the Morningstar database.

Balanced funds are mutual funds that purchase both stocks and bonds, usually in a set ratio (e.g., 60 percent stocks and 40 percent bonds). The benefit of these funds is that the fund manager makes both the asset-allocation decisions and the stock-selection decisions for the investor.

Asset-allocation funds are mutual funds that rotate investments among stocks, bonds, and cash, with the goal of beating the return of a specific benchmark after all expenses have been accounted for. These funds invest in the asset classes that the portfolio managers expect to perform the best during the coming quarter.

Life-cycle mutual funds change their allocations of stocks and bonds depending on the age of the investor. As an investor ages, life-cycle funds reduce their allocations in stocks and increase their allocations in bonds, which typically makes the fund more consistent with the goals of an older investor. These funds make asset-allocation decisions for the investor and aim to reduce transaction costs.

Hedge funds are mutual funds that assume much more risk than normal mutual funds in the expectation of higher returns. Sometimes the managers of these funds take long positions, in which they buy and hold assets; sometimes the fund managers take short positions, in which they borrow assets and sell them. The managers of hedge funds hope they will later be able to buy back the assets at a lower price before they must return them to the lender.

Describe the Different Classes of Mutual Fund Shares

Mutual funds may be divided into classes depending on the loads, or sales charges. There are two

types of loads, front-end and back-end. Front-end loads are commissions charged at purchase of the fund; they directly reduce the amount of money invested by the amount of the load. Back end loads are sales charges to compensate the sales force for selling the fund.

While there are differences of opinion as to the choice of load versus no-load funds, research has found that the performance of load funds and no-load funds is generally identical over the periods analyzed. However, when the sales charges are included in the calculation of returns, no-load funds significantly outperform load funds.[5]

While there are differences in classes of shares among investment management companies which charge loads, they generally include the following.

Class A shares commonly have a front-end or back-end load to compensate for the sales person's commissions. Because of the high loads, they usually have lower management fees.

Class B shares commonly have a back-end load that is paid when the shares are sold. The amount of this back-end load traditionally declines over time. Class B shares generally have higher expense ratios when compared to Class A shares.

Class C shares generally have lower front- and back-end load fees but higher management fees.

Class R shares are generally for retirement purposes. Check the loads and management fees, which may be substantial.

No-load shares are sold without a commission or sales charge. Generally, this type of mutual fund share is distributed directly by the investment management company instead of through a sales channel. These shares may have higher management fees to compensate for the lack of a front- or back-end load.

Class Y shares have very high minimum investments (i.e., $500,000) but have lower management fees and waived or limited load charges. These are generally for institutional investors.

Class Z shares are only available for employees of the fund management company.

Understand How to Calculate Mutual Fund Returns

There are two ways to make money on mutual fund holdings: capital appreciation and distributions.

Capital Gains

One way to earn money on mutual fund shares is to purchase shares and hold them for an extended period of time. Then, when the market value of the shares increases, you can sell the shares and collect capital gains. Capital gains are generally the preferred type of earnings

because they are not taxed until you sell your mutual fund shares and you get to decide when to sell those shares. In addition, capital gains are taxed at a preferential rate by the federal government whereas ordinary income may be taxed at a rate of up to 38.6 percent.

Distributions

Distributions are the second way you can make money on mutual funds. They are a less attractive type of earnings than capital gains because you do not have control over the taxes associated with distributions. Even if you do not sell any mutual fund shares, you must still pay taxes on your mutual fund's annual distributions. There are five main types of distributions: short-term capital gains, long-term capital gains, qualified stock dividends, ordinary (non-qualified) dividends, and bond interest and bond fund distributions.

Short-term capital gains: Short-term capital gains are earnings on assets you owned for less than 366 days. Short-term capital gains are taxed at your marginal tax rate, which can be up to 39.6 percent for federal taxes and 10 percent for state taxes.

Long-term capital gains: Long-term capital gains are earnings on assets the fund has owned for 366 days or more. In 2018, long-term capital gains are taxed at a federal rate depending on your taxable income and AGI. There is also an added Medicare tax on long term capital gains of 3.8 percent if your adjusted gross income (AGI) is $250,000 or higher (Married Filing Jointly).

Qualified stock dividends: A qualified dividend is a dividend paid by a U.S. corporation whose stock you held for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (see Taxes on Securities Earnings Including Qualified Dividends (LT32)). In 2018, qualified stock dividends are taxed at the same rate as capital gains.

Ordinary (or non-qualified) stock dividends: Ordinary stock dividends are cash earnings paid to investors that have not held the stocks for the necessary amount of time. These dividends are taxed as ordinary income at both the federal and state levels.

Bond dividends and interest: Bond dividends and interest are distributions from bonds and bond mutual funds. These earnings are taxed at your marginal tax rate, which may be as high as 39.6 percent for federal taxes and 10 percent for state taxes.

The key to making money on mutual fund holdings is to invest in funds with high after-tax returns. The higher the after-tax returns on a fund, the more quickly you will be able to achieve your personal and financial goals.

Calculating Mutual Fund Returns

Calculating mutual fund returns is not as easy as it sounds. Too often investors only account for the explicit costs of trading and they forget about the implicit tax costs. These costs can significantly reduce the amount of a fund's return. Remember to invest wisely and to account for

after-tax returns.

Calculating total returns: Mutual fund returns include dividends and distributions as well as any net asset value (NAV) appreciation. The basic equation for total return is as follows:

([ending NAV – beginning NAV] + distributions) / beginning NAV

Before using this equation, be sure to adjust your beginning and ending net asset values to account for the costs of both front-end and back-end loads. These costs will significantly decrease your return.

Calculating before-tax returns: Before-tax returns are the same as total returns if all distributions are reinvested. The before-taxes total return includes the increase in the net asset value and the increase in the number of shares. The total return before taxes is calculated as follows:

([#ES * EP] – [#BS * BP] + distributions) / (#BS * BP)

In the before-tax returns equation, the variables are defined as follows:

#BS = number of beginning shares owned
BP = beginning price of the shares
#ES = number of ending shares owned
EP = ending price of the shares

Calculating after-tax returns is more difficult because you must know your marginal tax rate at the federal, state, and local levels and the tax rate for the different types of distributions. If all distributions are reinvested, the after-tax total return includes the increase in the net asset value, the increase in the number of shares, and the after-tax impact of distributions. The after-tax (AT) total return is calculated as follows:

([#ES * EP] – [#BS * BP] + ATSD + ATLCG + ATSCG + ATBDI) / (#BS * BP)

In this equation, the variables are defined as follows:

#BS = number of beginning shares owned
BP = beginning price of the shares
#ES = number of ending shares owned
EP = ending price of the shares
ATSD = after tax stock distributions, or stock dividend distributions * (1 – the tax rate on stock dividends)
ATLCG = after tax long-term capital gains distributions, or long-term capital gains distributions * (1 – tax rate on long-term capital gains)
ATSCG = after tax short-term capital gains distributions, or short-term capital gains distributions * (1 – tax rate on short-term capital gains)

ATBDI = after tax bond dividends and interest distributions, or bond dividends and interest distributions * (1 – the tax rate on bond dividends and interest)

Remember that the tax rate on short-term capital gains, bond dividends, and bond interest is your marginal tax rate, which includes your federal, state (if applicable), and local (if applicable) tax rates.

Understand How to Purchase a Mutual Fund and the Costs of Investing in Mutual Funds

There are five steps to buying a mutual fund:

1. Determine your investment objectives, goals and key principles.
2. Select your risk level, asset classes, asset allocation and your investment benchmarks
3. Identify funds that meet your objectives subject to your investment principles.
4. Evaluate the funds and choose wisely
5. Make the purchase and monitor performance versus benchmarks.

Step 1: Determine Your Investment Objectives, Goals and Principles of Successful Investing

The first step is to determine your investment objectives and goals. What is the ultimate purpose of the funds you will be investing? Before you can decide on the funds you will invest in, you must know your budget and your financial goals. Understand where you are currently in your investment program and determine which key principles of investing will help you reach your financial goals.

Step 2: Select your Risk Level, Asset Classes, Asset Allocation and your Investment Benchmarks

The second step is to determine your risk level. How much risk are you willing to take? Your risk is determined by your asset allocation, your percentage of investments in each asset class. Find your risk tolerance by taking a risk tolerance test (see A Risk Tolerance Test (LT16) as an example). From that, determine your asset classes you will invest in and set your asset allocation, your percentage of your portfolio in each asset class.

Next, choose an appropriate investment benchmark. The benchmark you choose is very important because it will help you determine how well your mutual fund is performing over time. Before choosing a benchmark, you must decide which asset class you want to invest in and the way you want your fund to perform. Choose the benchmark that most closely matches the performance you are seeking. Do you want your benchmark to be broadly based (i.e., have more constituents) or narrowly based (i.e., have fewer constituents)? Generally, a more broadly based benchmark is better because it is more diversified, and the returns will be less influenced by the poor performance of a single security. I recommend choosing a benchmark with as many constituents as possible.

Step 3: Identify Funds That Meet Your Objectives

The third step is to identify funds that meet your objectives. One of the easiest ways to identify mutual funds that will meet your needs is to use resources such as financial publications or financial services. Another resource you can use to identify mutual funds that meet your needs is online databases. After you have input your objectives, a database will generate a list of funds that fit your criteria. Examples of these databases include Morningstar Mutual Funds (see Using Morningstar to Select Funds (LT07)) and Schwab One Source. These databases can help you learn about a mutual fund's performance, size, fees, investment style, and objectives.

Step 4: Evaluate the Funds

The fourth step is to evaluate the funds. To effectively evaluate a mutual fund, you must understand a number of characteristics that differ among funds. The following tips will help you evaluate mutual funds:

Compare funds with the same objectives. It makes no sense to compare funds with different objectives. Funds that are trying to accomplish different goals will have different return and risk characteristics. Make sure you are comparing funds with similar objectives.

Evaluate the fund's long-term performance versus the long-term performance of its corresponding benchmark. The difference between the fund's return and the benchmark's return is known as the fund's tracking error. Research the reasons a particular fund has done well. If the fund has performed well because it has made good security selections, this is a good sign; however, make sure the fund has not inflated its returns by buying outside of its asset class, such as a large-cap U.S. mutual fund buying securities from Mexico or Brazil. Try to determine whether the fund has a record of good performance over many years or if the fund has only performed well during a single year. Examine the history of returns during both up markets and down markets. If the fund has historically underperformed as compared with its benchmark and similar funds, avoid the fund. It is easier to spot funds that are performing badly than funds that are performing well.

Look at portfolio managers. How long has the manager been managing the fund? Was he or she managing the fund during periods of good performance? After a fund has performed well, good managers will sometimes leave a company to start their own mutual fund company, and new managers will be assigned to manage the fund. Look at how long the managers have been managing the fund. If they have not been managing the fund for very long, you may want to consider other funds.

Examine the size of the fund. How much has the fund grown or shrunk in the last month, quarter, or year? If a fund is shrinking, it generally sells its liquid assets first. After this liquidation, investors who still have investments in the fund are stuck with illiquid stocks, which cannot be sold or must be sold at a substantial discount.

Research the fund's history. How long has the fund existed? Has it changed its style? How did it perform under previous names and managers? Mutual fund companies sometimes rename a poorly performing fund and change the fund's investment objectives to mask poor performance. Be on the lookout for these changes.

Identify the fund's fee structure. Sometimes funds will add additional fees or impose back-end loads on investors to reduce the mutual fund company's costs. One example of an additional fee is the 12-b1 fee, which is a marketing fee paid by shareholders to cover the cost of marketing the fund to other investors. Avoid funds that charge 12b-1 fees. Generally, I recommend purchasing only no-load mutual funds. Although you cannot control returns, you can control costs.

Once you have selected a few funds you are interested in, read each fund's prospectus carefully. The prospectus should explain the fund's goals, the fund's investment strategy, any investment limitations the fund has (asset class constraints), any tax considerations that will be of importance to investors, the minimum account size, the investment and redemption process for buying and selling shares in the fund, fees the investor is responsible for paying, and the fund's annual turnover ratio. Turnover is particularly important, as it is an indication of how tax-efficient the mutual fund is. Funds with high turnover ratios generally cause investors to pay more taxes than funds with low turnover ratios, as each sell generates a taxable event.

Consult other sources of information. There are many different sources of financial information that can help you choose a good mutual fund. Printed sources (many of which have online sources as well) include *The Wall Street Journal*, *Morningstar Mutual Funds* (see Using Morningstar to Select Funds (LT07)), *Forbes*, *Business Week*, *Kiplinger's Personal Finance*, *Smart Money*, and *Consumer Reports.* A good electronic source is the Motley Fool website at www.fool.com.

Step 5: Make the Purchase and Monitor Performance

Once you have selected the fund that is right for you, you are ready to make the purchase. There are three ways to purchase a mutual fund: (1) you can make the purchase directly through the mutual fund company, (2) you can work through a financial professional, or (3) you can use a mutual fund supermarket.

Buying through the mutual fund company: If you do this, the mutual fund will likely be a no-load fund without annual custody fees. You will have access to many or all of the mutual fund company's services, including a toll-free number and Internet account access. Some mutual fund companies' systems are also compatible with major money-management software, such as Intuit Quicken or Microsoft Money.

Buying through a financial professional: If do this, you will likely be charged a load on the sale (a load is similar to a sales commission). The financial professional will likely sell you a class of shares (called R shares), which will rebate the financial professional a commission, or the financial professional will charge you an annual custody fee. Many mutual funds have

multiple classes of shares, each with different loads and management fees. Research has shown that, on average, individuals who invest in load funds do not gain higher returns than individuals who invest in no-load funds.

If you decide to purchase your mutual fund through a financial professional, you will still have access to all the services offered by the mutual fund company. Whether you buy directly from the mutual fund company or through a financial professional, you should check to make sure you will be able to access your account through Intuit Quicken, Microsoft Money, or other software programs. Keep in mind that not all mutual funds can be accessed through software programs. Also, be sure that the amount you are willing to invest is larger than the minimum account size.

Buying through a mutual fund supermarket: If you do this, you will still receive all the benefits offered by the mutual fund company. If you work with one of these companies, you will have access to a wide range of mutual fund companies. Mutual fund companies "give back" a portion of their management fees to the mutual fund supermarkets, such as Fidelity Funds Network or Charles Schwab, each month to compensate the supermarkets for bringing in new customers; therefore, mutual fund supermarkets usually charge you less for their services. Minimum account balances and management fees vary from fund to fund, but a custody fee is not generally charged on funds purchased through a mutual fund supermarket.

Explain the Costs of Investing in Mutual Funds

There are a number of explicit, implicit, and hidden costs associated with investing in mutual funds:

Explicit Costs

Loads are a sales charge an investor must pay to purchase certain types of mutual fund shares. Front-end loads are charged when a fund is purchased and are essentially sales charges to pay the broker for selling the fund. Back-end loads are charged when an investor sells certain types of shares. Some funds use back-end loads to discourage investors from switching funds too often. Back-end loads are often given a sliding scale, which means that the longer you hold the shares, the smaller the back-end load. No-load funds do not charge a commission when funds are purchased or sold.

Management fees are assessed to compensate the portfolio manager; these fees are generally based on a percentage of annual average assets (e.g., 75 basis points, or 0.75 percent per year of assets under management). These fees are assessed annually but are taken out of the net asset value on a daily basis (i.e., the fund managers are paid daily).

Annual custody fees are charged to hold mutual funds or ETFs in your account. The custody fee may be a fixed amount for small accounts. For large accounts, the custody fee may be either a specific charge per holding or a percentage of assets held.

Other fees: There are a number of other fees that may be assessed to your mutual fund, including 12b-1 fees, distribution fees, and transfer agent fees. A mutual fund charges investors 12b-1 fees to cover some of the costs of advertising and marketing the fund to new investors. The fund also charges distribution fees to cover the costs of selling the fund. The transfer agent fee is charged to compensate the transfer agent, or the company or institution responsible for ensuring shares are transferred correctly, for maintaining the investor's records.

Overall expense ratio is the overall cost of all management fees, custodial fees, trustee fees, and other fees. It represents the most important explicit cost you should consider when evaluating mutual funds. An overall expense ratio of 2.25 percent means the mutual fund must earn 2.25 percent before you will break even on your investment.

Implicit Costs

Implicit costs are expenses that must be accounted for to calculate the true return of your portfolio; these costs do not appear on your monthly mutual fund report. The implicit cost of investing in a mutual fund is taxes. You must pay taxes on the four main types of distributions: bond dividends and interest, stock dividends, short-term capital gains, and long-term capital gains.

Hidden Costs

Transaction costs cover the expenses of buying and selling securities and the expenses that are not covered by any other fees. These expenses include commission costs, bid-ask spreads, and soft-dollar arrangements. Mutual funds that have high turnover—funds that buy and sell a lot of securities—will have much higher transaction costs than mutual funds that use a buy-and-hold investment strategy. Recent research has shown that in some high-turnover funds, the hidden costs of trading are more than double the explicit overall expense ratio. Such costs significantly reduce the amount of return on the fund.

Commission costs are the costs incurred by the mutual fund buying and selling the securities in the fund. Mutual fund companies are not required by law to disclose the amount of commission costs in the prospectus, although this information should be included in the firm's statement of additional information. A good way to evaluate commission costs is to look at the mutual fund's turnover ratio. The turnover ratio is a measure of trading activity during the current period. The turnover ratio is calculated by dividing the average number of net assets in the fund by the amount of securities that have been bought and sold. A turnover ratio of 50 percent means that half of the value of the mutual fund has been bought or sold during the period. Not only does turnover raise commission costs but it also results in short-term capital gains, which are taxed at a higher percentage rate than long-term capital gains.

Bid-ask spread: Contrary to popular belief, investors may be charged different prices for buying a security and for selling a security. The difference between these two prices is the bid-ask spread. This spread can vary depending on the liquidity of the security and the supply and

demand for the security.

Soft-dollar arrangements: Many mutual funds have soft-dollar arrangements with brokerage houses whereby the brokerage house charges commissions for services in addition to charges for order execution. These commissions may be charged for research, access to information sources, computer equipment, and even personal services.

Other hidden costs: In addition to transaction costs, mutual funds may charge several other hidden costs, such as account transfer fees, account maintenance fees, inactivity fees, and minimum balance fees.

Understand Plans and Strategies for Mutual Funds

Following are a few ideas for your plans and strategies for mutual funds. The numbers refer to specific parts of your Investment Plan (LT05A).

Plans and Strategies
General Investing

- Due to the many different types of stocks and bond mutual funds, investors can invest at differing risk levels with mutual funds
- Index funds and Exchange Traded Funds (ETFs) are great alternatives to actively managed mutual funds, and offer cost, tax, and other advantages
- While risk of individual stocks and bonds can be high, buying mutual/index funds can reduce that risk considerably, and is recommended
- If you are choosing to put in a small amount of savings each week or month, choose no-load mutual/index funds due to no transaction fee.
- If you are making one large purchase and holding it long-term, choose the ETF due to its slightly lower annual costs.
- Remember that most actively managed funds fail to beat their benchmarks after all costs and fees, and most index funds return close to their benchmarks.
- Moreover, the costs of investing in individual stocks and bonds can be high, and low-cost, no-load and tax-efficient index funds are generally very cheap.

Summary

Mutual funds are collections of stocks, bonds, and other financial assets that are owned by a group of investors and managed by a professional investment company. As an investor in a mutual fund, you own a share of the fund that is equal to the amount of your investment divided by the total value of the fund.

One of the main reasons for the creation of mutual funds was to give investors who wanted to make smaller investments access to professional management. However, mutual funds offer many advantages to investors of all types. These advantages include diversification, professional management, low transaction costs, liquidity, flexibility, low up-front costs, and services. The

disadvantages of mutual funds include the risks of below market performance, inability to plan for taxes, and new investor bias.

There are three major types of mutual funds that parallel the major asset classes: money market mutual funds, stock mutual funds, and bond mutual funds. Within the main asset class that each of the mutual funds comprises, there are many smaller asset classes that investors should consider when selecting a mutual fund. There are also several specialty mutual funds you should know about: index funds, exchange traded funds (ETFs), balanced funds, asset-allocation funds, life-cycle mutual funds, and hedge funds.

Calculating mutual fund returns is not as easy as it sounds. Too often, investors account for only the explicit costs of trading and forget about the implicit tax costs; these costs can significantly reduce the amount of a fund's return.

There are five steps to buying a mutual fund: (1) determine your investment objectives, (2) choose an appropriate investment benchmark, (3) identify funds that meet your objectives, (4) evaluate the funds, and (5) make the purchase.

Assignments

Financial Plan Assignment

Continue to work on your Investment Plan. As you do, it your assignment is to gain an understanding of how mutual funds can give you exposure to the major asset classes. How have mutual funds performed versus the individual securities that mutual funds comprise? What do mutual funds add to a portfolio? What disadvantages do mutual funds have? How can you minimize the disadvantages of mutual funds while at the same time maximizing their advantages?

Mutual funds have their own separate benchmarks, which are noted in the *Wall Street Journal* each week and each month.

Learning Tools

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

Possible Benchmarks for Investment Plans (LT15)
This document shows possible benchmarks for most of the major asset classes.

After-Tax, ETY, and Other After-Inflation Returns (LT26)
This spreadsheet calculates the after-tax return, equivalent taxable yield, and after-inflation return on various assets.

Using Morningstar to Select Funds (LT07)

This tool gives instructions on how to use Morningstar, a company that tracks mutual fund and financial asset performance. Using this tool and your criteria that you determined as to what makes a good fund, you can find mutual funds that match your criteria.

Mutual Fund Selection Worksheet (LT7B)

This worksheet lists the criteria for what makes a good mutual fund so you can compare various mutual fund within specific asset classes. If filled out correctly, it is a good tool to determine which mutual better meets your criteria and needs.

Review Materials

Terminology Review

12-b1 fees. These are fees paid by the shareholders to market the fund to other possible shareholders. These are just marketing fees. Avoid them.

Account Transfer Fees. These are charges for moving assets either into our out of an account.

Asset allocation funds. These are mutual funds which rotate asset classes among stocks, bonds, and cash for the best return. Asset allocation funds invest the fund's assets in the asset classes expected to perform the best over the coming period of time.

Balanced funds. These are mutual funds which purchases both stocks and bonds generally in a specific percentage or relationship, i.e. 60% stocks and 40% bonds. Their benefit is that they perform the asset allocation, stock selection, and rebalancing decision for the investor.

Bond mutual funds. Bond mutual funds are funds which invest a majority of their assets in bonds of specific types of companies or institutions. These funds generally have a specific objective, i.e. "corporate," "government", "municipals," "growth,", etc. which relates to the types of bonds the mutual fund invests in. In addition, most have a specific maturity objective as well, which relates to the average maturity of the bonds in the mutual fund's portfolio.

Capital gains. Capital gains are the best type of earnings as capital gains at the share level are not taxed until you sell your mutual fund shares. You decide when to taxed.

Closed-end mutual funds. These are mutual funds with a specific number of shares outstanding. Individuals must purchase shares from existing shareholders, and shares may trade at a premium to (more than) or discount (less than) the underlying Net Asset Value (NAV). These premiums or discounts may be based more on investor demand than the underlying share value.

Custody (or annual) fees. These are fees the brokerage house charges to hold the mutual funds or ETFs in your account. May be a minimum amount for small accounts ($15 per year), a specific charge per holding (8 basis points per security), or a percentage of assets for large accounts (25 basis points on assets under management).

Distributions (i.e., interest, dividends, realized capital gains, etc.). Distributions is a less attractive type of earnings. Even though you do not sell any mutual fund shares and most investors reinvest earnings, you are still liable to pay taxes on all distributions that your mutual fund makes during the year. Distributions are divided into 5 main types:

- **Short-term capital gains**. These are capital gains where the Fund has owned the assets for less than 366 days. These are taxed at your Federal and state "ordinary" or "Marginal Tax Rate (MTR)"
- **Long-term capital gains**. These are capital gains where the Fund has owned the assets for more than a year (366 days). These are taxed at rate dependent on your taxable

income.

- **Qualified stock dividends**. These are payment of cash to the Fund by the companies owned where the company owned the shares for a specific length of time. These are taxed at a preferential rate depending on your taxable income.
- **Ordinary (not-qualified) stock dividends**. These are payment of cash to the Fund by the companies who did not hold the stock for the required length of time. Taxes on ordinary or non-qualified stock dividends are at your Federal and state Marginal Tax Rate.
- **Bond interest and bond fund distributions**. These are taxed at your Federal and state Marginal Tax Rate.

Diversification. The process of risk reduction due to holding numerous securities that are diversified across sectors, asset classes and market capitalization.

Exchange traded funds (ETFs). These are portfolios of stocks similar to mutual funds which trade on organized exchanges. ETF's trade like stocks, are purchased with all the transaction/custody costs, are priced throughout the day (rather than at day's end like mutual funds), and can be sold short and purchased on margin. ETFs can be either in a unit investment trust (UIT) format or an open-end mutual fund structure. The UIT structure does not allow for reinvestment of dividends.

Hedge funds. Hedge funds are less-regulated mutual funds which take much more risk than normal with the expectation of much higher returns. Generally they can take both long positions (where they buy assets) and short positions (where they short-sell assets, i.e., borrow assets and sell them). They hope to later buy back the assets at a lower price before they must return them to the borrower.

Inactivity/Minimum balance fees. These are fees because you did not have account activity during the period or because you failed to keep a minimum balance in your account.

Index funds. Index funds are mutual funds designed to match the returns of a specific index or benchmark. Different Index funds may track many different benchmarks, including the S&P500 (Large-cap stocks), Russell 5000 (small-cap stocks), MSCI EAFE (international stocks), Barclay Aggregate (corporate bonds), DJ REIT (Real estate investment trusts), etc. Index funds are tax efficient since they do little in buying and selling of securities, and their goal is to match the return of their relative benchmarks.

Life-cycle funds. These are funds which change their allocation between stocks and bonds depending on investor age. As an investor ages, life cycle funds reduce their allocation to stocks and increase their allocation to bonds, more consistent with the goals and objectives of an older investor.

Loads. Loads are sales charges to compensate the sales force for selling the fund. Loads directly reduce the amount of money invested by the amount of the load. Loads can either be front-end or back-end, depending on when the mutual fund company takes out the load or sales charge. Generally, research has found that the performance of load funds and no-load funds is identical. When the sales charges are included, no-load funds significantly outperform load funds. (Matthew R. Morley, "Should You Carry a Load? A Comprehensive Analysis of Load and No-Load Mutual Fund Out-of-Sample Performance," Journal of Banking and Finance, vol. 27, nu. 7 (2003), pp. 1245-71.)

Management fees. These are fee charged by the advisor to a fund generally on the basis of a percentage of average assets under management, i.e. 75 basis points or .75% a year.

Minimum purchase amount. This is the minimum amount the mutual fund company will allow you to purchase in their funds to begin investing.

Money market mutual funds. Money market mutual funds are funds which invest the majority

of their assets in short-term liquid financial instruments such as commercial paper and government treasury bills. Their goal is to obtain a higher return, after fees and expenses, than traditional bank savings or checking accounts.

Mutual fund returns. Mutual fund returns include distributions of dividends, capital gains, and interest, and any NAV appreciation. Your total return: (ending NAV–beginning NAV)+ distributions / beginning NAV. Mutual Fund after-tax returns is your return after all taxes are taken out. Mutual fund before-tax returns is your return before taxes.

Mutual fund supermarkets. Mutual fund supermarkets i.e., Fidelity Funds Network, Charles Schwab, or Jack White, allows you the benefits of the mutual fund company while you get access to a whole range of mutual fund companies (but not all of them). Mutual fund companies rebate part of their management fees back each month to the "mutual fund supermarkets" to have them included in their list of funds.

Mutual fund. It is a way of holding financial and real investments. It is an Investment company that pools money from investors to buy stocks, bonds, and other financial investments. Investors own a share of the fund proportionate to the amount of their investment divided by the total value of the fund.

Mutual fund share classes. These classes of shares vary depending on the loads and management fees paid. While there are differences in classes of shares among investment management companies which charge loads, they generally are:

- **Class A Shares**: These shares commonly have a front-end or back-end load to compensate for the sales person's commissions. Because of the front-end loads, they usually have lower management fees.
- **Class B Shares**: These shares commonly only have a back-end load that is paid only when the shares are sold. This load traditionally declines over time. Class B shares generally have higher expense ratios when compared to Class A shares.
- **Class C Shares**: These shares generally have a lower front- and back-end load fees, but higher management fees.
- **Class R Shares**: These shares are generally for retirement purposes. Check the loads and management fees which may be substantial.
- **No-Load Shares**: These are shares sold without a commission or sales charge. Generally, these shares are distributed directly by the investment management company, instead of going through a sales channel. They may have higher management fees to compensate for the lack of a front- or back-end load.
- **Class Y Shares**: These are shares with very high minimum investments, i.e., $500,000, but which have lower management fees and waived or limited load charges. These are generally for institutional investors.
- **Class Z Shares**: These are shares only available for employees of the fund management company.

New investor bias. New investors dilute the value of existing investor's shares. Since new money comes into the fund at Net Asset Value, and since this money must be invested (at roughly 0.5% on average in the U.S.), existing investors are subsidizing new investors coming into the fund

No-load mutual funds. Mutual funds that are sold without a sales charge and are redeemed without a charge as well.

Open-end mutual funds. These are mutual funds that can be purchased and sold each day at the fund's Net Asset Value, which is the fund's assets less liabilities, divided by the number of shares outstanding.

Stock mutual funds. These are stock mutual funds are funds which invest a majority of their

assets in common stocks of listed companies. These funds generally have a specific objective, i.e. "large-cap," "small-cap", "value," "growth,", etc. which relates to the types of stocks the mutual fund invests in.

Taxes on Distributions. These are taxes on your distributions which must be taken into account to get the true return of your portfolio but which are not noted on your monthly reports.

Total expense ratio. This is the total percentage of assets that are spent each year to manage the fund including management fee, overhead costs, and 12b-1 fees.

Transaction costs. These are costs of the fund buying and selling securities, which are not included in other costs. Mutual funds which turn over the portfolio often, i.e. buy and sell a lot, will have higher transactions costs. A good proxy for this is the turnover ratio.

Turnover ratio. This is a measure of trading activity during the period divided by the fund's average net assets. A turnover ratio of 50% means half the fund was bought and sold during the period. Turnover costs money and incurs taxes.

Types of Mutual funds. The types of mutual funds generally follow the major asset classes, i.e., money market, stock, and bond mutual funds.

Review Questions

1. What are mutual funds? Why are they suitable for the novice investor?
2. What are seven advantages of investing in mutual funds?
3. What are six disadvantages to investing in mutual funds?
4. What are the three major types of mutual funds?
5. What are the three different ways in which you can purchase a mutual fund?

Case Studies

Case Study 1

Data

Bill and Sally invested in five mutual funds. They are in the 25-percent federal and 7-percent state marginal tax brackets, and made $40,000 in taxable income. Based on taxable income, 2019 qualified stock dividends and long-term capital gains are taxed federally at 15 percent if your marginal tax rate is 25 percent). They are concerned to calculate their returns.

Calculations

A. Calculate the before-tax and after-tax returns on each of the funds in their portfolio for 2016 (from 12/31/15 – 12/31/16.

B. Calculate their overall portfolio before-tax and after-tax returns. Note that the first three funds are all taxable, the municipal bond fund is federal tax-free for interest only, and the Treasury bond fund is state tax-free for interest only.

Fund Name	Ending NAV	Beginning NAV	Short-term Distributions	LT CGain & Qual. Div.	Short-term Cap. Gain	Weight in Portfolio
FIDELITY MAGELLAN FUND (FMAGX)	91.36	89.43	0.546	2.119	-	50%
SCHWAB SMALL-CAP INDEX-SEL (SWSS	28.1	24.1	0.391	0.762	-	10%
VANGUARD S/T BND INDX-INV (VBISX	10.43	10.43	0.146	0.001	0.001	20%
WFA MUNICIPAL BOND FUND-INV (SX	10.34	10.45	-	-	-	10%
VANGUARD SHRT TRM TREAS-INV (VFI	10.64	10.65	0.094	0.002	0.030	10%

For the period beginning 20151231 and ending 20161231

Notes: ST = short-term distributions. For bond funds, these are interest and short-term capital gains; for stock funds, they are non-qualified dividends, interest, and short-term capital gains. LTCG Distr. = Long-term capital gains distributions. Qual. Stock Distr. = qualified stock dividend distributions. % Portfolio is the beginning weight of the assets in your portfolio. Remember, your overall portfolio return is your return of each asset multiplied by your beginning period weight. Bloomberg put LTCG and Qualified Dividends together.

To calculate the after-tax return from each asset, determine the amount of taxes you will pay on each type of earning. Since you have not sold the assets, the only taxes you will pay will be on the distributions you have received. Subtract out the taxes on distributions to give you the distributions you get to keep, and calculate your return.

$(NAV_{Ending} - NAV_{Beginning} + (\text{Distributions} * 1\text{- tax rate})) / NAV_{Beginning}$

Remember that the tax benefits on municipal and Treasury bonds are only on the interest distributions. You still must pay all taxes on the capital gains distributions.

Federal Marginal Tax Rate	25.0%	Federal Tax on Qualified Dividends	15.0%
State marginal Tax Rate	7.0%	Federal LT Capital Gains Rate:	15.0%

LT33

	Ending Net Asset Value (NAV)	Beginning Net Asset Value	Short-term Distr. (1)	Long-term Capital Gains Distr.(2)	Qualified Stock Distr. (3)	Short-term Capital Gains Distr. (4)	Percent of Portfolio (5)	Fund Return
Stock Funds (all taxable):								
Fidelity 500 Index	91.36	89.43	0.546	2.119			50%	5.14%
Tax Rate (all taxable)			0.320	0.220	0.220	0.320		
AT Return		1.93	0.371	1.653	-	-		4.42%
Schwab Small Cap	28.10	24.10	0.391	0.762			10%	21.38%
Tax Rate (all taxable)			0.320	0.220	0.220	0.320		
AT Return		4.00	0.266	0.594	-	-		20.17%
Bond Funds:								
Corporate Bond Funds (all taxable):								
Vanguard ST Bond	10.43	10.43	0.146	0.001	-	0.001	20%	1.42%
Tax Rate (all taxable)			0.320	0.220		0.320		
AT Return		-	0.099	0.001	-	0.001		0.97%
Muni Bond Funds (Federal Tax Free for Interest only (5)):								
WFA Muni Bond	10.34	10.45			-		10%	-1.05%
Tax Rate (Fed tax free)			0.070	0.220		0.070		
AT Return		(0.11)	-	-	-	-		-1.05%
Treasury Bond Funds (State Tax Free for Interest Only(5)):								
Vanguard ST T- Bond	10.64	10.65	0.094	0.002	-	0.030	10%	1.09%
Tax Rate (state tax free)			0.250	0.220		0.250		
AT Return		(0.01)	0.071	0.002	-	0.023		0.79%

Overall Portfolio Weight:	100.00%
Overall Portfolio Before Tax:	4.99%
Overall Portfolio After Tax:	4.39%

Notes:

Case Study 1 Answers

To calculate the after-tax return on each asset, determine the amount of taxes you will pay on each type of earning. Since you have not sold the assets, the only taxes you will pay will be taxes on distributions you have received. Subtract the amount of distribution taxes you must pay to find the amount of distributions you will get to keep, and calculate the amount of return you will get to keep after taxes.

<u>Case Study 2</u>

Data

Bill is concerned about turnover. He knows that the turnover rate for

financial assets is a measure of the amount of trading activity completed during a year; the turnover rate is expressed as a percentage of the average amount of total assets in the fund. A turnover rate of 10 percent means that 10 percent of the average amount of total assets in the fund were bought and sold during the year. He also knows that a mutual fund investor must pay taxes on any distributions received during the year, including distributions the investor reinvests in additional shares. While high turnover may lead to higher returns, high turnover always leads to higher transaction costs as well as increased taxes if assets are held in taxable accounts. Bill's marginal tax rate is 35 percent, and he lives in a state that does not have a state income tax, so his short-term distributions will be taxed at 35 percent.

- The following information is for two of Bill's bond mutual funds:

Mutual Funds	Fund A	Fund B
Beginning NAV	$100.00	$10.00
Short-Term Distributions	$1.00	$0.90
Ending NAV	$109.00	$10.10

Calculations

- Calculate Bill's before-tax and after-tax returns on Fund A and Fund B.
- What would have changed had the mutual funds been stock mutual funds and the distributions been qualified stock dividend distributions instead of bond distributions?

Case Study 2 Answer

A. Bill's before tax and after-tax returns are:

	Fund A	Fund B
YTD Nominal Returns	10% (note 1)	10%
Estimated Turnover	10%	90%
Taxes on Short-Term Distributions	35%	35%
Taxes Paid (on Short-Term Distributions)	$.035	$0.315
After-Tax Return	9.65%	6.85%
Loss from Nominal Return Due to Taxes	0.35%	3.15%

To calculate Bill's before-tax return, the formula is (ending NAV + distributions – beginning NAV) / beginning NAV.

- Fund A: (109.00 + 1.00 – 100.00) / 100.00 = 10 percent
- Fund B: (10.10 + 0.90 – 10.00) / 10.00 = 10 percent

The formula for finding the after-tax return is:

(ending NAV + [(distributions – taxes paid) – beginning NAV]) / beginning NAV, or:

- Fund A: (109 + [(10 – 3.50) – 100]) / 100 = 9.65%
  - Bill pays $0.10 * .35 in taxes and keeps $0.10 * (1-.35).
- Fund B: (10.10 + [(0.90 – 0.315) – 10.00]) / 10.00 = 6.85%
  - Bill pays .90 * .35 in taxes and keeps .90 * (1-.35).

Regarding Fund A, Bill must pay 35 percent,, or $3.50, in taxes on a $10 distribution. Thus, his nominal return is 10 percent, his after-tax return is 9.65 percent, and he loses 0.35 percent to taxes.

Regarding Fund B, Bill must pay 35 percent, or 31.5 cents in taxes on a 90-cent distribution. Thus, his nominal return is 10 percent, but his after-tax return is 6.85 percent, and he loses 3.15 percent to taxes.

Although both funds have the same nominal return and the same tax rate, Fund B's return is 29-percent lower because of taxes related to higher turnover. Clearly, understanding taxes is very important. Know your tax-rate on each type of earnings.

B. If the distributions would have been qualified stock dividend distributions instead of short-term distributions, instead of paying taxes at 35 percent, which is Bill's ordinary income rate, he would pay a preferential tax rate of only 15 percent for both Fund A and Fund B.

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[1] John Bogle, *Common Sense on Mutual Funds: New Imperative for the Intelligent Investor*, John Wiley & Sons, USA, 1999, p. 119.
[2] Rich Fortin and Stuart Michelson, "Indexing Versus Active Mutual Fund Management," *Journal of Financial Planning*, vol. 15, no. 9, 2002, 82.
[3] S&P SPIVA Scorecard Year-end 2018, *S&P Research*, 2019.
[4] Matthew R. Morey, "Should You Carry the Load? A Comprehensive Analysis of Load and No-Load Mutual Fund Out-of-Sample Performance," *Journal of Banking & Finance*, vol. 27, no. 7, 2003, 1245–7.
[5] Matthew R. Morley, "Should You Carry the Load? A Comprehensive Analysis of Load and No-Load Mutual Fund Out-of-Sample Performance," *Journal of Banking and Finance*, vol. 27, no. 7 2003, 1245–71.

24. Investing 7: Understanding How to Build Your Investment Portfolio

Introduction

In this chapter, you will use what you have learned about goal setting, asset classes, and investing to begin building a successful investment portfolio. Before you can build a successful portfolio, you must first understand how to select investment vehicles, learn the phases of successful investing, and know how to use the investment process to build your portfolio.

Objectives

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

A. Understand which factors control investment returns and how to select investment vehicles
B. Understand the elements of a successful investment portfolio
C. Explain the investment process and how to build a successful portfolio
D. Understand plans and strategies for building your portfolio.

Understand Which Factors Control Investment Returns and How to Select Investment Vehicles

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."[1] There are six factors that control investment returns.[2] Five of those factors are within your personal control, while only one is outside 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.

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;
- Keeping your risk consistent with your risk tolerance through a correct asset allocation mix;
- Maintaining adequate diversification at your level of risk;
- Reducing fees, expenses, transactions costs, and taxes; and
- Doing the math that controls returns.

Most novice investors spend their time on areas they cannot control, i.e., investment returns, and fail to be concerned over areas they can control, i.e., savings, asset allocation, time, and expenses.

How to Select Investment Vehicles

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 with a tax-advantaged framework that allows you to invest in various financial assets. Tax advantages include the deferral of current taxes (as for a traditional IRA or 401(k)) or the elimination of future taxes on earnings (as for a Roth or Education IRA). 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 a grocery store.

Investment 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 toward helping you build a retirement account. 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 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 2018.

Understanding how to select investment vehicles can help you identify the tax benefits and other benefits of different investment vehicles. Understanding these priorities can help you determine which investment vehicles will help you achieve your financial goals the quickest. The process of selecting investment vehicles is divided into three sections: free money; tax-advantaged money; and tax-efficient, wise investments. Understanding these priorities 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, in the form of money provided by your company when you participate in a company-sponsored retirement plan. 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 401(k), Keogh (or small business retirement plan for sole proprietorships), or other retirement plan. A matching plan is used as an incentive for employees to remain with the company and invest in a retirement plan. Some states also allow a tax deduction for your contribution to that state's 529 plans for education, which is, in essence, free money as well.

Table 1.
Select Investment Vehicles for 2018 (Before Catch-Up)

Plan	***Tax-Deferred***	***Tax-Eliminated***	***Maximum Amount***	***For Employees of:***
401(k)	Yes		$19,000	Businesses w/ Plans
Roth 401(k)		Yes	$19,000	Businesses w/ Plans
403(b)	Yes		$19,000	Non-profit, tax-exempt
Roth 403(b)		Yes	$19,000	Non-profit, tax-exempt
457	Yes		$19,000	State/Municipalities
SEP IRA	Yes		$56,000	Small Businesses
SIMPLE IRA	Yes		$13,000	Small Businesses
IRA	Yes		$6,000	Individuals
Roth IRA		Yes	$6,000	Individuals
Education IRA		Yes	$2,000	Individual Education
529 Plans		Yes	$485,000 per child	Individual Education

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, to take full ownership of the free money. If you leave for any reason prior to the required time, you forfeit the match, but your contributions are fully vested, and you can take them with you to your next place of employment.

Examples of free money include company matching in a 401(k) or 403(b) plan, or even in a Roth 401(k) or Roth 403(b) plan.

Priority 2: Tax-Advantaged Money

There are two different types of tax-advantaged vehicles: tax-eliminated and tax-deferred. 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 by eliminating future taxes by choosing a Roth IRA or Roth 401(k) rather than one of the traditional retirement accounts. 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 defer taxes by choosing a traditional IRA or 401(k). To help you decide which type of IRA is better for you, see Roth versus Traditional: Which Is Better for You (LT28) in the Learning Tools directory of the website. This tool allows you to set an annual contribution, an estimated rate of return on earnings, and your current and (estimated) future tax rates. By changing your future tax rates, you can determine whether your balance in the future would be higher or lower, all other areas being held constant. It also has the 8 questions you should ask to help you determine which to choose.

Tax-eliminated accounts require you to pay taxes on the principal before investing; however, you do not have to any pay any taxes on the capital gains or earnings in the future. There are several different tax-eliminated investment vehicles that can help you save for retirement (i.e., Roth IRAs and 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 depositing the money into your retirement account. In other words, you are contributing after tax dollars to your account. Once you reach age 59.5, you can take both the principal and interest out of this retirement account without paying taxes on the money. Paying taxes beforehand eliminates taxes on all capital gains and earnings in this account. Roth IRAs have an additional advantage: if you need 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 59.5 years old.

With many 529 funds and Series EE and I bonds, you are also 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 withdrawn as it is considered ordinary income for tax purposes.

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) and 403(b) 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 (AGI—the income on which you pay taxes) would be $42,000. 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 59.5 and take this money out of your retirement accounts, you are not only required to pay taxes on your $3,000 investment but you must also pay taxes on any earnings the IRA investment has produced. The initial investment and any earnings are taxed at your ordinary income-tax rate, which can be as high as 39.6 percent.

The risk of using tax-deferred investment vehicles is that you must be at least age 59.5 to make withdrawals. If you withdraw funds before reaching 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 45 percent of your investment in taxes and penalties (a 10 percent penalty charge plus 35 percent in taxes if you have the highest marginal tax rate possible). Even tax-deferred earnings that have remained in your retirement account for more than 12 months are taxed as ordinary income rather than the preferential long-term capital gains rate.

Priority 3: Tax-Efficient, 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' performance by comparing their returns after taxes and transaction fees to the appropriate benchmarks. 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:

$$\text{Return}_{\text{after tax}} = \text{Return}_{\text{before-tax}} * (1 - \text{marginal tax rate})$$

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 and 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 ordinary marginal tax rate, stock dividends are taxed at a preferential rate, and unrealized capital gains are not taxed 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. Long term capital gains are taxed at a much lower rate than ordinary income. Remember there is a 3.8 percent additional Medicare

tax on long term capital gains if your Adjusted Gross Income (AGI) is more than $250,000 (MFJ)) compared to ordinary rates). Earn as much of your income as possible in the form of long-term capital gains.

You can replace ordinary income with long term 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 create a taxable event.

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, which can be as high as 35 percent. 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 education expenses.

Selecting Investment Vehicles

Some investment vehicles are preferred over others because they provide tax and other advantages. Unfortunately, some of the investment vehicles with tax advantages also have lower maximum contribution limits. For example, in 2019 the maximum amount you could contribute to a Roth IRA was $6,000, while there was no limit on how much you could invest in individual financial assets without the tax benefits.

Although some investment vehicles have limitations, it is still a good idea to adhere to the process. You should first invest money in vehicles that are the highest priority. 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. If you own financial assets that are actively traded or generate a lot of income, these assets should be held in your retirement accounts so you will not have to pay taxes on them until you take them out at retirement. 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 manage 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 you must pay on these funds will add little to your yearly tax bill.

Describe the Elements of a Successful 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 and on his or her goals, budget, and experience in investing. It is impossible to discuss the strategies 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 (see Chart 1). In an earlier chapter, you saw the top of the investment hourglass, which details 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. This chapter includes the bottom of the investment hourglass, which describes a pattern of successful portfolios.

The bottom of the investment hourglass is divided into four levels, representing the phases of investment. The first level of the hourglass represents the phase in which you develop your emergency fund and food storage. The second level represents the phase in which you develop your portfolio's core, which includes broad market index funds or core mutual funds. The third level represents the phase in which you diversify your portfolio by broadening and deepening your asset classes. Finally, the fourth level represents the phase in which you develop your opportunistic assets, such as individual stocks and sector funds.

Levels two, three, and four are also divided in terms of taxable assets and retirement assets. Taxable assets are assets whose earnings you will need to pay taxes on each year. Retirement assets are assets you will not need until after you retire and on which you do not pay taxes until you take the money out at retirement. The breakdown of your assets between your taxable and

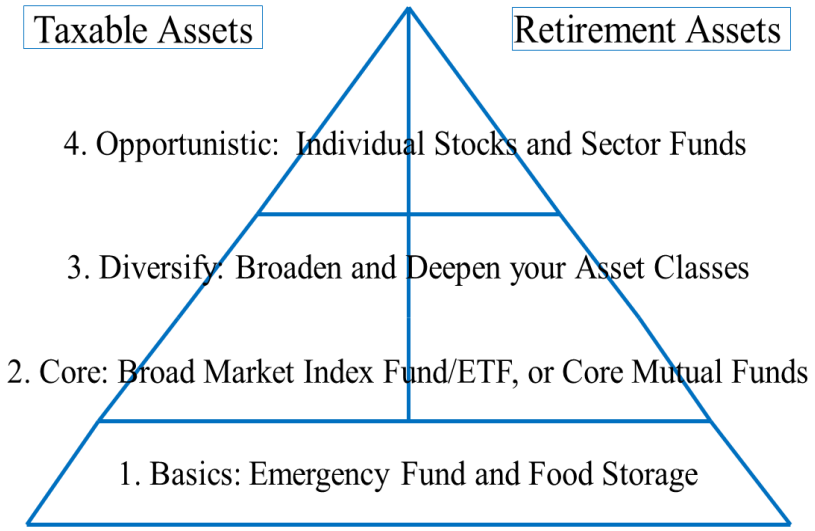
retirement accounts will depend on your personal goals and your available retirement vehicles.

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 taxes have on these two types of accounts is not the same, so retirement and taxable assets should be managed differently.

Phase 1: Building an Emergency Fund and Food Storage

While this course will not cover the process of building your food storage, please be aware of its importance. If you lose your source of income, food storage can help reduce the amount of cash needed to survive.

Chart 1: The Investment Hourglass Bottom



The main objectives of your emergency fund should be liquidity, safety, and the preservation of principal. The first assets you add to your portfolio should be low-cost, high-liquidity money-market mutual funds or other savings vehicles, such as savings accounts, money-market deposit accounts, short-term Treasury bills, or CDs (see the chapter on **Cash Management** on the website for ideas of other assets that could be included in your emergency fund). Ideal assets for your emergency fund will allow for adequate liquidity in case of an emergency while still giving you a positive return (or as close to a positive return as possible) after inflation and taxes. The goal for this phase is to accumulate three to six months of income in your emergency fund before you begin investing in any other phase. If you are worried about your job security or if you have a volatile income stream, you may want to maintain a higher percentage of your income in this

fund.

Phase 2: Building a Core

The main objective of this phase is to give your portfolio broad exposure to the equity market. The assets in the equity market have consistently yielded the highest return of any of the major asset classes after taxes and inflation.

I recommend investing in a large-capitalization stock mutual fund or index fund because large-cap stocks are the least risky of all equity asset classes and because mutual funds are diversified and low cost. S&P 500 index funds will have roughly 500 stocks in their portfolios.

For this phase, you will want to purchase a low-cost, broad market index fund or a core low-cost, low-turnover mutual fund. Using the principles discussed in Investing 1: Before You Invest**,** invest in the main equity markets. These markets will give you a higher risk-adjusted return. I recommend purchasing a low-cost, no-load index fund that follows large-cap stocks. These funds generally have a low minimum purchase amount (sometimes less than $100) and cost about 0.30 percent (or 30 basis points: a basis point equals 1/100 of a percent) per year or less. These funds have low turnover, are very tax-efficient, and generally match the performance of the benchmark.

During this phase, you should also add a broad market index fund or core mutual fund to your retirement vehicles (your 401(k) plan and/or your IRA). The amount you invest in your retirement account versus the amount you invest in your taxable account depends on your personal goals and budget and the availability of retirement vehicles.

Phase 3: Diversifying Your Portfolio

In this phase, your main objective is to increase your portfolio's diversity beyond your core market exposure.

To deepen your exposure to the market, you will need to add equity assets other than your core or large-cap stocks to your portfolio. Ideas for diversifying your portfolio include adding smaller assets from the equity asset class, such as a small-cap stock fund or a mid-cap stock fund.

To broaden your exposure to the market, you will need to purchase asset classes in addition to U.S. large-cap stock funds. For example, you can broaden your asset classes by purchasing international stock or bond funds, a real estate investment trust, or emerging markets stock or bond funds. During this phase, you should also add these diverse assets to your retirement account to deepen and broaden your exposure.

Phase 4: Developing Your Opportunistic Assets

This phase is optional; it involves purchasing individual stocks or sector funds that usually have a higher risk. Many investors eliminate this phase completely with little impact to their

portfolios.)

If you decide to move into the opportunistic phase, the assets you should purchase include individual stocks and sector funds. Sector funds are mutual funds that follow a specific industrial sector, such as technology or financials. You would invest in stocks and sectors that you think are likely to outperform your other benchmarks. Remember that high-turnover funds should be included in your retirement account so you can defer taxes.

Once you have incorporated the principles in the bottom of the investment hourglass into your portfolio, you can continue to diversify your portfolio by adding additional assets and asset classes that are consistent with the principles and priorities discussed in this chapter (see Investment Process Worksheet (LT13) which can help you with this process.

Explain the Investment Process and Know How to Build Your Portfolio

Once you understand the principles of investing and have developed your Investment Plan, you must learn the process of investing. The process of investing is a disciplined approach to building an investment portfolio. There are many ways to approach building your investment portfolio; the process of investing outlined in this chapter is a consistent, logical, and principle-supported approach that can help you minimize transaction costs and taxes. This approach to building an investment portfolio will also teach you a logical order for purchasing securities and will help you set financial goals as you build your portfolio.

There is a five-step investment process that will help you build your portfolio once you have established your Investment Plan.

1. Determine Your Initial Target Portfolio Monetary Goal

The first step is to determine an initial size for your portfolio, or a target monetary goal. You must decide how much money you want to invest in your portfolio. An easy way of determining your target portfolio size is to divide the dollar amount of your emergency fund by the percentage of funds you want to invest in cash and bonds. Cash and bonds are usually the assets included in your emergency fund. Let us assume you make $60,000 per year, your goal for an emergency fund is four months of income ($60,000 / 12 * 4, or $20,000), and your target allocation for bonds and cash is 20 percent. With this information you can calculate your target portfolio size by dividing the dollar amount of your emergency fund ($20,000) by the percentage of funds in bonds and cash (20 percent) to give you your initial target portfolio ($100,000). This goal is the first of many target portfolio goals you will set.

2. Determine Target Percentages for Each Asset Class

Once you know the target size of your portfolio, you can use the target allocation percentages listed in your Investment Plan to determine how much you will invest in each remaining phase.

Assume that in your Investment Plan, you listed a target allocation of 60 percent in core

exposures, 10 percent in international investments, 10 percent in small-cap investments, and 20 percent in bonds and cash. To calculate the target amount for your core investments, multiply 60 percent by your target portfolio size of $100,000; you should invest $60,000 in the core asset class. The remaining asset class allocations are calculated in a similar manner: 10 percent multiplied by $100,000 equals a $10,000 allocation for international and real estate investments, respectively, and 20 percent multiplied by $100,000 equals a $20,000 allocation for bonds and cash, which make up your emergency fund.

3. Calculate the Target Amount for Each Asset Class in Both Taxable Accounts and Retirement Accounts

Next, separate the allocations into the categories of taxable accounts and retirement accounts. Continuing with the previous example, let us assume that, regarding your core allocations, 35 percent is allocated to taxable accounts (e.g., funds for a down payment on a home and education) and 25 percent is allocated to your retirement account. Let us also assume that half of international and small-cap investments are allocated to retirement accounts and half are allocated to taxable accounts. How do you determine the amount of these allocations?

The target amount of each asset you should allocate to your taxable accounts and retirement accounts is the percentage of each asset multiplied by the target portfolio amount. To find the amount of core assets you should allocate to your taxable accounts, multiply 35 percent by $100,000, which results in $35,000 for your core taxable account. To find the amount of core assets you should allocate to your retirement account, multiply 25 percent by $100,000, which results in $25,000 for your core retirement account. You can calculate the allocation amounts of the remaining asset classes in a similar manner.

No percentage of your emergency fund is allocated to a retirement account. Since this account is for emergencies, the funds must be readily available; hence, you should not put these funds in a retirement account.

4. Research Potential Candidates for Financial Assets and Select the Assets Most Likely to Help You Achieve Your Goals

In this step, you determine which assets are likely to deliver the return you need to achieve your goals. The next chapter on Choosing Financial Assets discusses the process of choosing financial assets.

5. Purchase the Assets and Compare the Actual Portfolio with the Target Portfolio

Once you have determined which assets you would like to include in your portfolio, the final step is to purchase these assets. Purchase your emergency fund first, then your core assets, and then the assets you are including to diversify your portfolio. The order of purchasing assets that this chapter outlines is important; however, once you have purchased your emergency fund, you can purchase all the remaining assets simultaneously if desired.

Once you reach your target portfolio size and your individual asset allocation targets for phases one through four, create a new target portfolio size by adding a specific amount to your original target portfolio size (e.g., $100,000). Your new target portfolio goal would be $200,000. You can then incorporate all new investments in your portfolio according to the new target allocations in your Investment Plan. Keep your investments consistent with your goals, your budget, the investing principles outlined in this course, and your Investment Plan.

Examining a Sample Portfolio

Following is an example to help you understand the process of investing: Jim is 25 years old; he is married and is the father of one child. He earns $50,000 a year, pays 10% to his church for tithing, and has adequate health and life insurance. Jim has no credit card or consumer debt and has written a detailed Investment Plan. Jim is an aggressive investor, and he wants to maintain six months of income in his emergency fund. The following data come from Jim's Investment Plan. Using the investment process discussed in this chapter, we will follow Jim and his wife through the five steps of the investment process.

Phase	Asset Class	Financial Asset	Benchmark	Total	Taxable	Retirement
Emergency	Cash/Bonds	Fidelity Bond	Barclays Ag.	25%	25%	0%
Core	Large Cap	Vanguard 500	S&P 500	55%	35%	20%
Diversity	International	Oakmont Int'l	MSCI EAFE	10%	6%	4%
Diversity	Small Cap	Wells Fargo	Russell 5000	10%	6%	4%

First, Jim must determine the target size of his portfolio. Jim's goal for his emergency fund is six months of income ($25,000), and his target allocation for cash and bonds is 25 percent. To calculate the target size of Jim's portfolio, divide $25,000 by 25 percent, which equals $100,000, his initial target monetary goal.

Second, Jim must determine how much he should invest in each asset class. Jim's target portfolio size is $100,000: he wants to invest 25 percent ($25,000) in his emergency fund, 55 percent ($55,000) in his core, and 10 percent ($10,000) in international and small-capitalization funds, respectively.

Third, Jim must calculate the amount of each asset he should allocate to taxable accounts and retirement accounts during each phase of investing. Multiply the target allocation of each asset by the target portfolio size. In this case, Jim's allocations would be as follows:

Phase	Financial Asset	Taxable	Retirement	Total
Emergency	Fidelity Bond Fund	$25,000	$0	$25,000
Core	Vanguard 500 Fund	$35,000	$20,000	$55,000
Diversity (Broaden)	Oakmont Int'l Fund	$6,000	$4,000	$10,000
Diversity (Deepen)	Wells Fargo Small Cap.	$6,000	$4,000	$10,000
Total Target Size		$72,000	$28,000	$100,000

Fourth, Jim should research potential candidates for financial assets and select the assets most likely to help them achieve their goals.

Fifth, Jim and his wife must purchase the funds they selected.

This investment process is a disciplined, systematic approach to constructing an investment portfolio. It is only one of many ways of building a portfolio. Some final cautions about building a portfolio are important:

Remember to invest in your emergency fund first. You might consider making no-load, open-end mutual funds an important part of your emergency fund because of the liquidity of no-load funds.

When you receive your paycheck, remember to pay the Lord first (tithing and other charitable contributions) and yourself second (a minimum of 10 to 20 percent). Put the money you have used to pay yourself directly into your emergency fund until you have saved at least three to six months of income. While you are in the process of building your emergency fund, the only other investment you should consider is a retirement account that provides free money through a matching plan (see the discussion on the selecting investment vehicles). If this type of retirement account is available to you, invest the minimum amount necessary to receive your free money, and then use the rest of your savings to fill your emergency fund.

Finally, do not begin prepaying your mortgage, i.e., making additional mortgage payments, until you have saved at least three to six months of income in your emergency fund. If problems arise that limit your income, a large emergency fund is often the key to surviving and keeping your home.

Understand Plans and Strategies for Building Your Portfolio

Following are a few ideas for your plans and strategies for building your portfolio. The headings and numbers refer to specific parts of your Investment Plan (LT05A) which is a good template for your Investment Plan.

I. Introduction and Purpose

- Who is this plan for? (I.A.)
- What is the purpose of this plan? (I.B.)
- What are the investment principles you will use to develop your investment plan? (I.C.)

II. Risk and Return Objectives

- What are you investment objectives?
- What are your objectives? (II.A.)
- Which investment vehicles will you use? (II.B.)
- What are your time frames for these investments? (II.C.)
- What is your expected return for your portfolio for each time frame? (II.D.)

- What risk-type of investor are you? What is your expected risk for your portfolio for each time frame? (II.E).)

III. Investment Guidelines and Constraints

- What are your investment guidelines before retirement and after retirement? (III.A.)
- What are your investment constraints (liquidity, time horizon, taxes and unique needs)? (III.B.)

IV. Investment Policy

- What are your acceptable and unacceptable asset classes? Will you use debt to invest (buy on margin or sell short – I recommend no)? (IV.A.)
- What are your investment benchmarks (IV.B.)
- What is your target asset allocation both before and during retirement? (IV.C.)
- Will you invest active, passive or both? (IV.D.)
- What is the maximum you will invest in any individual asset, i.e., company stock, in any single investment, or in any single sector?
- What is the maximum you will invest in any new investment (except broad mutual funds)?
- How much will you invest in your company stock?
- Will you invest in any unlisted security (I recommend no)?
- What is your current investment strategy?
- What is your tax strategy and what different types of investment vehicles will you use?
- How will you fund your investments?

V. Investment Monitoring and Evaluation

- How will you monitor your portfolio? (V.A.)
- How and how often will you rebalance your portfolio and what rebalancing method will you use? (V.B.)
- How often will you communicate results to your spouse? (V.C.)
- How and how often will you revise your Investment Plan? (V.D.)
- Who will be following and following up on this Plan? (V.E.)

Summary

There is a difference between financial assets (investment assets) and investment vehicles. Financial assets are specific classes of securities that you can invest in, including stocks, bonds, mutual funds, real estate, money-market mutual funds, CDs, and so on. Investment vehicles are special types of investment accounts that provide special tax advantages and allow you to invest in various financial assets. These accounts are useful because they provide specific tax advantages that are not available if financial assets are purchased individually.

Understanding how to select investment vehicles can help you identify the tax benefits and other

benefits different investment vehicles offer. Understanding these priorities can help you determine which investment vehicles will help you achieve your financial goals the quickest. The process is divided into three sections: free money; tax-advantaged money; and tax-efficient, wise investments. Understanding the process can help you determine which investment vehicles you should use first in working toward your financial goals.

Some investment vehicles are preferred over others because they provide tax advantages and other advantages. Unfortunately, some of the investment vehicles that are higher on the priority list also have lower maximum-contribution limits. Although some investment vehicles have limitations, it is still a good idea to adhere to the process. You should first invest money in vehicles that are the highest priority. 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.

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 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 bottom half of the investment hourglass describes a pattern of successful portfolios I have seen in my experience.

The bottom of the investment hourglass is divided into four phases. The first level of the hourglass represents the phase in which you develop your emergency fund and food storage. The second level represents the phase in which you develop your portfolio's core, which should include broad market index funds or core mutual funds. The third level represents the phase in which you diversify your portfolio by broadening and deepening your asset classes. Finally, the fourth level represents the phase in which you develop your opportunistic assets, such as individual stocks and sector funds. This final step is optional.

To build a successful portfolio, you must first learn about the process of investing. The process of investing is a disciplined approach to building an investment portfolio. This approach teaches a logical order for buying securities and helps you minimize transaction fees and taxes. There are many ways to approach building your investment portfolio; the process of investing outlined in this chapter is a consistent, logical, and principle-supported approach that can help you minimize transaction costs and taxes. This approach also teaches a logical order for purchasing securities and helps you set financial goals to help you as you build your portfolio.

Once you have established your Investment Plan and understand how to build your portfolio, there is a five-step investment process that will help you build your portfolio:

1. Determine a target monetary size goal for your portfolio.
2. Determine target percentages for each asset class.

3. Calculate the target amount for each asset class in both your taxable accounts and retirement accounts.
4. Research potential candidates for financial assets and select the assets most likely to help you achieve your goals.
5. Purchase the assets and compare the actual portfolio with the target portfolio.

The investment process presented in this chapter is just one method of building a portfolio. As you build your portfolio, follow your Investment Plan carefully. This plan will help you make choices that are consistent with your personal goals, your risk-tolerance level, and your budget. Write a well thought-out Investment Plan, follow the principles you have learned in this course, and invest according to your plan. Remember to follow the principles of wise investing and the priorities and processes of investing; be aware of the effects of taxes, turnover, and costs; keep allocations within your target ranges; limit turnover as much as possible; use dividends, or interest, to buy new financial assets or make changes to your existing assets; sell wisely and infrequently; if you are able, sell appreciated assets in the form of donations; and remember the investment hourglass!

Assignments

Financial Plan Assignments

Continue to work on your Investment Plan. For this chapter, you must first determine the size of your emergency fund. This fund should contain three to six months' worth of income. This is the first asset you will invest in, before mutual funds of stocks, bonds, and other asset classes.

Second, determine what percentage of your portfolios you can allocate between taxable and retirement accounts. The amount you can put in retirement accounts is limited each year by the IRS. Make an estimate for planning purposes. If you have no better idea, split the allocation initially to half in retirement and half in taxable accounts. Remember that you will have no allocation to retirement for your emergency fund because you need access to those funds in an emergency, and you do not want to pay a penalty to the IRS.

Third, once you know your emergency fund, divide that by your allocation to bonds and cash (your percentage allocation) to get your initial target portfolio size goal. You can then multiply each of your asset allocation targets by their respective percentages to come up with the amounts you need in each asset class and in each of the retirement and taxable accounts.

Finally, transfer this data to Investment Process Spreadsheet (LT13). You can put in your data for your emergency fund and your asset allocation percentages, and it will calculate your initial target portfolio size for you and your allocations to the various asset classes.

Learning Tools

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

Investment Process Spreadsheet (LT13)

This Excel spreadsheet helps you determine how much you should invest in different assets based on the asset-allocation targets in your Investment Plan. It can also help you as you work toward reaching your investment targets by showing you the target amount for each asset, the amount you have invested thus far, and the amount that remains for you to reach your target.

Roth versus Traditional: Which Is Better for You (LT28)

This Excel spreadsheet helps you determine which retirement account would be most beneficial to you: the Roth IRA or the traditional 401(k) or 402(b) IRA. It has the 8 questions to ask to help you determine which to choose.

Review Materials

Terminology Review

After-tax return. This is your return after you pay taxes. It is calculated as: after-tax return = before-tax * (1 – marginal tax rate) and your marginal rate includes both your federal, state and local (if any) taxes.

Distributions. These are distributions of interest, capital gains, and dividends by a mutual or index fund while you own the underlying shares. Even though you have not sold the shares, you are responsible to pay taxes on this distributions because the mutual fund is a pass-through vehicle and the taxes on these distributions are paid at the shareholder level.

Education investment vehicles. These are investment vehicles with the purpose to help you save for your children's education, i.e., Education IRA, 529 plans.

Free money. This is money that is made available by a company, generally on a matching basis, to encourage greater participation in company sponsored retirement plans, i.e., 401k, Roth 403b, Keogh, etc. It is also money made available through education tax benefits, i.e. 529 plan contributions deductible from state taxes.

Initial target portfolio. This your first goal for a target dollar amount as you begin building your portfolio. It is calculated by taking your emergency fund goal and dividing it by your percentage in bonds and cash.

Investment vehicles. The investment vehicle is the tax-law defined framework that has specific tax advantages, i.e., 401k, 403b, Individual Retirement Account (IRA), SEP IRA, Roth IRA, Roth 401k, etc. Investment vehicles have different benefits, i.e., due to matching (free money), tax elimination, tax deferral, or just tax-efficient and wise investing. Investment vehicles are like shopping carts in the grocery store, they are the things you put your groceries, or financial assets, into.

Investment/financial assets. Investment or financial assets are the securities that are invested in by the investment vehicles, i.e., stocks, bonds, mutual funds, REITs, MMMFs, CDs, etc. They are like the groceries you put in your shopping cart, which is your investment vehicle.

Long-term capital gains. These are federal taxes on gains held more than 366 days. It may be taxed at a preferential rate depending on your marginal tax rate.

Marginal tax rate. This is your taxes on each additional dollar of earnings. If you made $1 more this year, at what rate would it be taxed.

Ordinary dividends. These are stock dividends earned from holding a stock an insufficient number of days within a specific period to be reported as qualified dividends. Ordinary dividends

are taxed at a federal marginal or ordinary tax rate.
Priority of money. This is an educational tool to help individuals determine the order of which they should utilize investment vehicles to achieve their personal and family goals.
Qualified dividends. These are stock dividends earned from holding a stock a minimum number of days within a specific period. Qualified dividends are taxed at a federal preferential tax rate depending on your marginal tax rate.
Retirement vehicles. These are investment vehicles to help you save for retirement. These include for private businesses: 401-k, Roth 401-k plans; non-profit tax-exempt businesses: 403-b/Roth 403-b plans; State and municipalities: 457 plans; Individual retirement accounts: IRA/Roth IRA; and small business plans: SEP IRA, SIMPLE IRA;
Short-term capital gains. These are federal taxes on gains held less than 366 days. It are taxes at your ordinary or marginal tax rates.
Tax-advantaged money. This is the process of using investment vehicles that have specific advantages. There are two types: Tax deferred and tax-eliminated vehicles.
Tax-deferred money. This money has the ability to be invested before-tax, with principle and earnings taxed only at retirement (IRA, SEP IRA, etc.). This money converts long-term capital gains into short-term income for tax purposes.
Tax-efficient and wise investments. This is money that is invested tax-efficiently and wisely, consistent with the principles of successful investing discussed earlier.
Tax-eliminated money. This money can be used at retirement (or for education) without penalty and without taxes, i.e., a Roth IRA/410k/403b for retirement, and 529 Funds and Education IRA for education. You pay the taxes upfront, and then pay no taxes on earnings or capital gains when you take it out at retirement.

Review Questions

1. What is the difference between financial assets and investment vehicles?
2. Name at least three investment vehicles (see Table 1).
3. What are the three priorities of money in regard to investment vehicles?
4. What is Phase I of successful investing? What type of financial assets should this phase include?
5. What is the first step in the investment process?

Case Studies

Case Study 1

Data

Suzie is 25 years old, single, and makes $50,000 per year in 2019. Assume she is in the 12 percent marginal federal tax bracket and the 5 percent marginal state tax bracket. Her company has a 401(k) plan (but not a Roth) that matches 50 percent of contributions up to 3 percent of her annual salary. Suzie determines that she can save 20 percent of her salary every year, and she will set the entire 20 percent ($10,000) aside for retirement each year. She thinks her taxes will be higher when she retires.

Application

A. According to the process of selecting investment vehicles discussed, which investment

vehicles should she use and why?
B. How much did she save considering her savings, company match, and tax saving?

Case Study 1 Answers

Suzie should use the process of selecting investment vehicles to solve this problem.

First, she should take advantage of free money.

Suzie has the option of saving up to 3 percent of her salary, or $1,500 per year, that her company will match with 50 percent of that amount, or $750.

Note that this money is tax-deferred, or money that has not been taxed yet. The maximum contribution for 2019 in a 401(k) account is $19,000. Since Suzie's first priority is free money, she should first invest $1,500 in her 401(k) plan. Note that Suzie also saves on taxes when she invests in her 401(k) plan because investments in her 401(k) reduce her adjusted gross income because these investments are tax-deferred.

Second, Suzie should capitalize on tax-eliminated money.

Investments in a Roth IRA or a traditional IRA or more investments in her 401(k) are all good options, but because she believes her taxes will be higher in the future, she should choose the Roth IRA. A Roth IRA not only offers total elimination of future taxes, it also has the additional benefit of allowing her to withdraw the principal without incurring a penalty or taxes because the money has already been taxed. Suzie can invest up to $6,000 per person in a Roth IRA or traditional IRA in 2019. If Suzie invests $1,500 in her 401(k) plan and $6,00 for herself in a Roth IRA, she still has $2,500 remaining.

Third, Suzie should take advantage of tax-deferred money.

Suzie could invest the remaining $2,500 in her 401(k), even though there is no additional match. Remember, her goal was to invest $10,000 for retirement.

Based on the priorities discussed, Suzy should invest the following in each vehicle:

Free Money	$1,500	401(k)	for the Company Match
Tax-Advantaged	$6,000	Roth IRA	for the Elimination of Future Taxes
Tax-Advantaged	$2,500	401(k)	for Tax Deferral
Total	$10,000	Total Amount Suzie Saved	

B. In addition, Suzie received the following:

1. Invested $10,000 of her own money
2. Got a free $750 match from her company
3. Saved $680 on next year's taxes. (This is her 12 percent federal marginal tax rate and her 5 percent state tax rate) multiplied by the $4,000 she invested in her 401(k) plan. The total amount Suzie saved, including the match and tax savings, is $11,430.

<u>Case Study 2</u>

Data

Suzie recently married, and her husband, Bill, just graduated with a master's degree. Suzie and Bill are square with the Lord, have adequate insurance, and are out of credit

card debt (although they still have 3.25 percent student loans outstanding), and they know their goals but have not yet written their Investment Plan. They have agreed to save 20 percent of everything they will be earning to pay themselves. Bill starts his first job next week and will be making $50,000 per year, and Suzie is making $50,000 per year as well. They will be investing 20 percent, or $20,000, each year.

Application

How should they invest that money? What should they invest in first? Second? Third? How much should they invest? How should they invest?

Case Study 2 Answers

Bill and Suzie should follow the principles of the bottom of the investment hourglass. While we do not have enough information to give allocations and amounts, we can give general guidelines:

First, Bill and Suzie should invest in their emergency fund and food storage. Once this is filled, they should go on to core assets. Once core assets have been filled, Bill and Suzie should go on to diversify their assets.

<u>Case Study 3</u>

Data

Bill and Suzie are now both 30,and have one child. Suzie stays home with the baby. They are earning $60,000 per year, are full tithe payers, have adequate health and life insurance, are out of credit card and consumer debt, and have an Investment Plan. They are aggressive investors, want three months of income as an emergency fund, and have determined their asset classes and investment benchmarks as 75 percent equities and 25 percent bonds and cash with targets:

25% Bonds/Cash (Barclays Aggregate)	25% T,	0% R
55% U.S. (S&P 500 Index)	35% T,	20% R
10% Small Cap (Russell 5000 Index)	4% T,	6% R
10% International (MSCI EAFE Index)	4% T,	6% R

How should Bill and Suzie build their portfolio?

Case Study 3 Answers

1. Determine the initial target portfolio monetary goal.

   An easy method is to take their emergency fund goal and divide it by the percentage of assets in cash and bonds (which are generally used for your emergency fund).

   If their goal is three months of income ($15,000) and their target allocation for cash and bonds is 25 percent, their target fund size would be $15,000 times 25 percent, or $60,000.

2. Determine asset classes and target percentages.

   Multiply their asset class percentages by their initial target portfolio size to get their asset-allocation targets.

   Emergency Fund (25% * $60,000) $15,000

Note that your first allocation will always produce your target emergency fund amount.

U.S. (55% * $60,000)	$33,000
International (10% * $60,000)	$6,000
Small Cap (10% * $60,000)	$6,000
Total Portfolio Target	$60,000

3. Calculate the target amount for each asset class in both the taxable and retirement accounts.

Take the target weight of each asset on both the taxable and the retirement side multiplied by the target portfolio size to get the target asset size.

For example, Bill and Suzie decided that 4 percent of their small cap allocation of 10 percent is in the taxable accounts, with the remaining 6 percent in their retirement accounts. Their dollar allocations would be

Taxable: 4% * $60,000 = $2,400
Retirement: 6% * $60,000 = $3,600

4. Research potential candidates for financial assets and select the assets most likely to deliver the return you need.

Using the principles discussed earlier, Bill and Suzie would select the assets they would purchase to gain exposure to their chosen asset classes.

For example, if Suzie and Bill decided that their core U.S. allocation was to be the Vanguard S&P 500 Index fund, their dollar allocations to Vanguard would be

Taxable: 35% * $60,000 = $21,000
Retirement: 20% * $60,000 = $12,000

5. Purchase the assets and compare the actual portfolio against the target portfolio.

<u>Case Study 4</u>

Data

Bill and Suzie are now 40 years old and have four children. They are earning $80,000 per year and have achieved their initial target portfolio size goal. Their financial house is in order; they have three months of income in their emergency fund and have determined the same asset classes and investment benchmarks as they did before. Their holdings and allocations are

ING Direct Internet Savings Account	$20,000	25%
Vanguard S&P 500 Index Fund	$35,000	55%
Fidelity Small Cap Fund	$10,000	10%
Oakmark International Fund	$10,000	10%

How should Bill and Suzie build their next portfolio (assume their next portfolio size goal is $200,000)?

Case Study 4 Answers

1. Determine their next target portfolio size goal.

Bill and Suzy added $140,000 to their initial portfolio size goal of $60,000. Now their goal is $200,000. They will need to readjust their target allocations

consistently with this goal.

With their current salary of $80,000, their three-month emergency fund value would be $20,000, which they already have.

Their allocation to bonds and cash, however, is now 25% * $200,000, or $50,000. Since their emergency fund is filled, they now can purchase additional fixed income securities to fill this gap.

2. Determine asset classes and target percentages.

Multiply their asset class percentages by their next target portfolio size to get their asset allocation targets.

Emergency Fund (25% * $200,000)	$50,000
U.S. (55% * $200,000)	$110,000
International (10% * $200,000)	$20,000
Small Cap (10% * $200,000)	$20,000
Total Portfolio Target	$200,000

3. Calculate the target amount for each asset class in both the taxable and retirement accounts.

Take the target weight of each asset in both the taxable and retirement side multiplied by the target portfolio size to get the target asset size. For example, Bill and Suzie decided that 4 percent of their small cap allocation of 10 percent is in the taxable accounts, with the remaining 6 percent in their retirement accounts. Their dollar allocations would be

Taxable:	4% * $200,000 = $8,000
Retirement:	6% * $200,000 = $12,000

4. Research additional candidates.

Bill and Suzie's emergency fund is completed. But they still have allocation in the bonds/cash asset class of $30,000. Using the principles discussed earlier, Bill and Suzie could then select another asset to gain exposure to their chosen asset classes.

Suppose they decided to add the Charles Schwab Intermediate Term Bond Fund to their portfolio. Their bonds/cash allocation would be

Bonds/Cash Allocation 25% * $200,000 =	$50,000
Emergency Fund = (20 / 200) = 10% or	20,000
Remainder of 15%, or	$30,000

5. Purchase the new assets and compare the actual portfolio against the target portfolio.

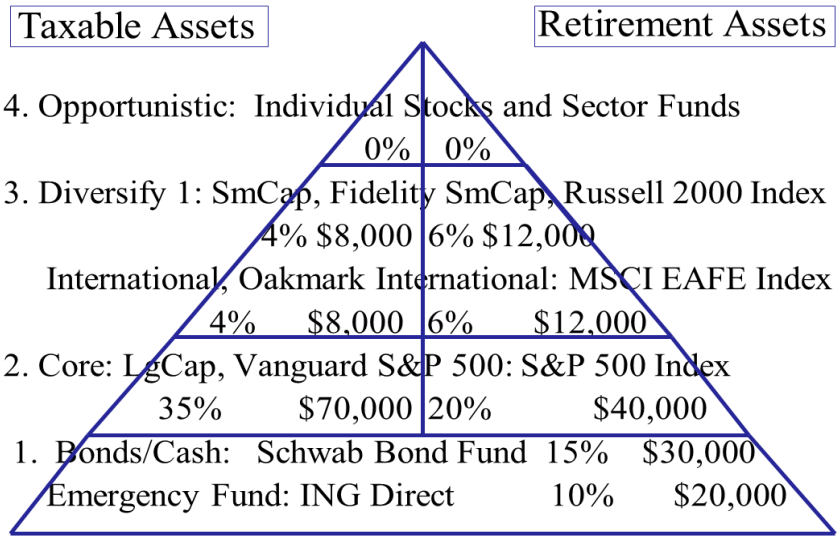
A. Since their emergency fund is full, they could begin purchasing the Schwab Intermediate Bond Fund.

B. Purchase core assets.

C. Purchase diversification assets.

D. Purchase opportunistic assets (optional).

Bill and Suzie's target portfolio would be:



[1] Fred R. Shapiro, "Who Wrote the Serenity Prayer," *Yale Alumni Magazine*, Jul./Aug. 2008
[2] Jim Seaberg, unpublished document, 2014.

25. Investing 8: Understand Selecting Financial Assets

Introduction

You are now ready to begin selecting specific assets for your portfolio. Before you get started, you should recognize that this step cannot be completed in one day. In fact, it is likely that your portfolio will be most successful if you build it a little at a time by adding small amounts of money to your investments each month. In explaining how investing can help us become self-reliant, L. Tom Perry said:

> Be prudent, wise, and conservative in your investment programs. It is by consistently and regularly adding to your investments that you will build your emergency and retirement savings. This will add to your progress in becoming self-reliant.[1]

As Perry states, you should strive to be prudent, wise, and conservative in your investing. The information provided in this chapter will help you to follow his counsel as you select securities for your investment portfolio.

Objectives

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

A. Understand why you should wait to purchase individual stocks until your assets have grown
B. Know how to find information on financial assets and taxes
C. Understand what makes a good mutual fund and the big deal about index funds
D. Understand how to pick the mutual/index/exchange traded funds
E. Understand plans and strategies for picking financial assets.

Understand Why You Should Wait to Purchase Individual Stocks

This chapter provides a detailed framework for selecting mutual funds but only briefly discusses a framework for selecting stocks. If you add individual stocks to your portfolio before it has become large enough to handle them, you are violating four of the principles of successful investing: stay diversified; invest low-cost; know what you are investing in; and don't spend too much time, energy, and money trying to beat the market. Purchasing individual stocks is not a necessary part of a successful portfolio. The following paragraphs explain these principles:

1. Stay Diversified (Principle 3)

Buying individual stocks early in your investing career violates the principle of diversification. It

is difficult to achieve an acceptable level of diversification in a small portfolio with a limited number of stocks. Investing in individual stocks is both the fastest way to become rich and the fastest way to become poor. Drawn by the potential for high returns, some investors treat the stock market like a lottery and invest a large percentage of their portfolio in a single investment. Such investors ignore the principle of diversification and significantly increase their risk.

The best way to build your portfolio is by wisely investing money in a variety of assets and asset classes (e.g., a diversified mutual fund) each month—not by aggressively "betting" on a single stock.

2. Invest Low-Cost and Tax-Efficiently (Principle 4)

When you have a small portfolio, investing in individual stocks is very expensive. Transaction costs for purchasing stocks are the highest of any major asset class. Also, many of the costs of individual stocks are charged according to the number of transactions and not based on the amount purchased or sold. Costs for smaller purchases or sales are therefore much higher as a percentage of the assets purchased or sold than are costs for larger purchases or sales.

3. Know What You Are Investing In (Principle 6)

Although several chapters in this course discuss investing in stocks and specify the qualities of a good stock, you have not learned all you need to know to successfully evaluate stocks for your portfolio. While buying individual stocks can be fun and exciting, it can also be a form of gambling if you do not have the necessary knowledge base. Your knowledge of stocks will grow with experience; the information on the website will not give you all of the tools necessary to make good stock-selection decisions, but it will give you a good foundation.

4. Don't Spend Too Much Time, Energy, and Money Trying to Beat the Market (Principle 8)

Trying to beat the market through purchasing individual stocks is a time-consuming and challenging activity. Expending great amounts of time and energy selecting individual stocks violates the principle that you should not spend too much time trying to beat the market. Most of you will be able to gain more substantial returns through wise investing and proper asset allocation.

5. Stock Selection Is Not Required for a Successful Portfolio

It can be fun and intellectually challenging to select individual stocks; however, your return will usually be greater and your risk will be reduced if you wisely select your asset allocation targets and use an index or other low-cost mutual fund to purchase a diversified portfolio of stocks. You can have a successful portfolio without ever buying an individual stock or sector fund.

Since many of you will not become experts at analyzing companies, it will be in your best interests to focus on developing a "Sleep-Well Portfolio." This is done by writing and carefully

following your Investment Plan, maintaining a generally passive strategy (indexing is a viable long-term strategy for most investors), enjoying your family and friends (make memories, not investment reports), and doing well in your day jobs (make a difference where you work).

Know How to Find Information on Financial Assets and Taxes

The Internet has facilitated a virtual explosion of information related to financial assets and investing. Many companies provide investing information on the Internet in hopes that investors who use the information will buy their products or use their services. Unfortunately, much of this information is biased, flawed, or even incorrect. So where can you find reliable mutual fund and stock information? There are a number of helpful resources you can and should use before selecting your financial assets.

Good Sources of Information

Mutual fund monitoring companies: These companies usually provide information to subscribers for an annual fee. Mutual fund monitoring companies include Morningstar Mutual Funds and Lipper Analytics.

Stockbrokerage firms: The different types of stockbrokerage firms range from full-service brokerages to discount and online brokerage houses. Full-service brokerage firms usually supply investment data to their clients free of charge, while discount firms usually charge a fee. Stockbrokerage firms include companies such as Merrill Lynch, TD Ameritrade, Morgan Stanley, and Charles Schwab.

Fund supermarkets: Mutual fund supermarkets are brokerage houses that offer mutual funds from many different fund families. To compensate these mutual fund supermarkets for bringing in new customers, mutual fund companies rebate part of their management fees to them. Mutual fund supermarkets have large databases composed of the mutual funds they offer, and they make these databases available to clients. Mutual fund supermarkets include companies such as Schwab, Fidelity, and TD Ameritrade.

Financial websites: There are a number of reliable financial websites you can access without paying a fee, including www.indexfunds.com, www.money.cnn.com, http://finance.yahoo.com, www.fool.com, www.money.msn.com, and www.dailyfinance.com.

Financial publications: There is a great deal of information available in financial publications such as *The Wall Street Journal*, *Financial Times*, *Kiplinger's*, and *Smart Money*.

Libraries: Libraries also house a lot of helpful information. The Harold B. Lee Library at Brigham Young University has a wealth of information—much of it online—that can help students analyze the various financial assets they are thinking of including in their portfolios.

Finding the Best Format for Information

Investors need to have access to accurate and current information. Although there are many good sources that offer financial information, the best sources are databases that are regularly updated and easy to search via the Internet.

One example of such a database is Morningstar.com. Morningstar provides both free information and subscription information to investors; it is just one of many available databases. Please note that I am merely using this database as an example; I am neither endorsing Morningstar nor implying it is the best database. However, I do think the information provided by Morningstar is generally good. Graphs for this chapter are from Morningstar, Library Edition and are examples of the types of information that are available on mutual funds as of August 8, 2014. This product is also available as a free resource for students enrolled in many colleges. For help in using Morningstar on the Internet or from your local college, see Using Morningstar to Select Funds (LT07).

Taxes on Financial Assets

All investment earnings are not created equal. There are different taxes and tax rates on different types of financial assets. Some have preferential federal, and others preferential state tax rates. Taxes on financial assets fall under three main headings: (1) stocks, (2) bonds and savings vehicles, and (3) mutual funds (which include index funds and exchange traded funds). Note that each of these assets is taxed at the federal level and may be taxed at the state and local level as well, depending on your state of residence (see Table 8).

Taxes on Stocks (or Equities)

There are two main types of federal taxes on stocks: capital gains taxes and taxes on dividends. Capital gains are realized earnings from selling a stock. They are divided into short-term and long-term realized capital gains.

Stock dividends are of two types, qualified and ordinary (or not qualified). A qualified dividend is a dividend paid by a U.S. corporation where the investor held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (see Taxes on Security Earnings Including Qualified Dividends (LT32)). Qualified dividends are taxed at a preferential federal tax rate. An ordinary dividend is a dividend that is not qualified, i.e., you have not held the stock for a long enough time period to qualify for the preferential tax treatment.

Taxes on Bonds and Savings Vehicles

There are two main types of bond taxes: capital gains taxes and taxes on interest, or coupon, payments:

Capital gains are taxed similarly to stocks.

Interest, or coupon payments, is payments received as part of the contractual agreement to

receive interest payments. They are taxed at your ordinary, or marginal, tax rate.

Bonds that receive preferential tax treatment for interest (municipal bonds and Treasuries) have a preferential tax rate of 0 percent on their respective taxes, i.e., 0 percent federal tax for municipal bonds and 0 percent state tax for Treasuries. You must still pay capital gains taxes on any capital gains earned by both types of bonds.

Taxes on Mutual Funds

Mutual funds are pass-through vehicles, which means that taxes are not paid at the fund level but are instead passed through to the individual shareholders who must then pay the taxes. Mutual fund taxes are mainly on capital gains, stock dividends, and interest, or coupon, payments. They are handled the exact same way as the taxes for stocks and bonds discussed earlier.

Describe the Process of How to Pick a Good Mutual/Index Fund

Before you can choose which funds you will invest in, you must understand the process of choosing good mutual funds:

1. Determine the asset classes that are appropriate for your Investment Plan and choose the appropriate benchmarks.
2. Determine key criteria for each asset class (e.g., costs, fees, diversification, etc.) to identify the best potential funds based on your principles of successful investing.
3. Use a database program to set your chosen parameters and evaluate each potential candidate.
4. Evaluate each candidate based on your criteria and select the best funds.
5. Purchase the funds and monitor performance carefully.

Be careful not to purchase funds before distributions are made. Distributions result in taxes and are generally made in December. Try to purchase your mutual funds after their distributions are made.

You already determined the asset classes your portfolio should contain and the appropriate benchmarks for these asset classes in previous chapters**.** Therefore, you have already completed steps one and two. This chapter will discuss steps three and four; you will learn how to determine key parameters for evaluating mutual funds of specific asset classes, and you will learn how to use a database program to set those parameters and evaluate potential candidates.

There are a number of important criteria you should consider when selecting mutual funds. Seven of the key criteria include diversification, low cost, tax-efficiency, low turnover, low levels of un-invested cash, no manager style drift, and small (or positive) tracking error.

1. Wide Diversification

Diversification is your most important defense against market risk. Select mutual funds that include many different companies in each portfolio category. Avoid investing in sector funds or

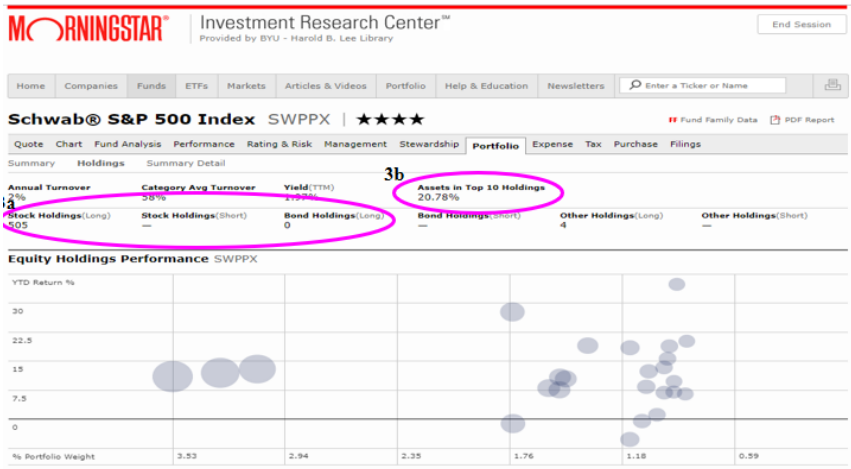
industry funds, individual stocks, or concentrated portfolios of any kind until you have sufficient education, experience, and assets. Even then, keep the percentage of these assets low in relation to the amount of your overall assets.

There are four main factors that determine whether a mutual fund is sufficiently diversified: numbers, concentration, types of assets, and location.

Numbers: What is the total amount of holdings, or securities, in the fund? You want to select a fund that holds many securities and industries. Check the number of holdings in the fund (see Table 1). If the fund has only 15 holdings, it is not very diversified and you should carefully understand each of those 15 companies. If the fund has 504 holdings (as does the Vanguard 500 index fund), it is much more diversified. Since there are over 500 companies in the portfolio, and since no company is a significant portion of the portfolio, it is not as critical that you carefully understand each of the companies in the portfolio.

Concentration: What percentage of the fund is allocated to the top 10 holdings? If 50 percent or more of the fund is invested in the top 10 holdings, then the fund has a high concentration in these holdings. If only 17 percent of the fund is invested in the top 10 holdings, then the fund has a lower concentration in these holdings and your risk is most likely spread out over many companies.

Table 1. Morningstar Website: Diversification



Source: All Morningstar charts are from Morningstar Library Edition, 2019-03-05

In addition, by looking at the top 10 holdings of a mutual fund, you can see the percentage of net assets or of the value of the portfolio that the top 10 stock comprises. Generally, the lower the concentration in the top 10 holdings, the lower the risk of a problem with a single company, and the better for most investors.

Type of assets: What types of assets are in the fund? If the mutual fund is an equity fund or a

bond fund, then all assets should be of the same asset class. However, if the fund is a balanced fund, an asset-allocation fund, or life-cycle fund, you should examine the percentage of the fund that is allocated to stocks, bonds, and cash. Again, the more diversified the fund is in terms of its holdings of different types of financial assets, the less volatile the fund will be.

Location: What is the location of the companies that are included in the mutual fund? The more diversified the locations, the less risk to the fund. Companies from different geographical areas are subject to different business cycles; hence, these companies should experience highs and lows at different times in the investment cycle.

2. Low Cost

Investment returns are limited, and investment costs of all kinds reduce your returns. If you have two funds with the same return, the fund with the lower expense ratio will give you the higher actual return. Keep costs low!

I recommend you invest in low-cost, no-load (i.e., without a sales charge) mutual funds. You should rarely (if ever) pay sales charges of any kind. Because you are a long-term investor, it may be acceptable to invest in funds with back-end loads or funds with a sales charge for selling within a specific period of time, as long as that period of time is under 180 days. You should also minimize management fees as much as possible. Remember, a dollar saved is a dollar you can invest to earn more money.

Costs are explained in the mutual fund's prospectus (a document that describes all aspects of the mutual fund) in the section entitled "Fees, Management Fees, and Expenses" (see Table 2). This section details all administrative costs, management fees, 12b-1 fees, and other charges. The most important ratio listed in this section is the total expense ratio. This is the overall cost of the listed fees. Remember that the fund manager will reduce your investment by this amount every year. The lower this ratio, the more you will be able to earn for your personal goals. Note that the Vanguard Fund charges 0.16 percent a year for total expenses. Compare this to the average total expense of large-cap stocks, which is .92 percent. While you cannot change the management fee once you have invested in a fund, you can and should understand the management fee before you invest in any fund.

If you are investing in a non-retirement investment vehicle, taxes are another important expense you should analyze. Look at the tax cost ratio in the section entitled "Returns: Tax Analysis." Too many investors fail to account for the impact taxes will have on their returns: taxes typically reduce returns by about 25 percent each year.

Table 2. Morningstar Website: Costs

3. Tax Efficiency

If you are investing in a non-retirement investment vehicle, taxes are another important expense you should analyze. Look at the tax cost ratio in the section entitled "Returns: Tax Analysis." Too many investors fail to account for the impact taxes will have on their returns: taxes typically reduce returns by about 25 percent each year.

When investing in taxable funds, choose funds with an eye to obtaining high returns while keeping taxes low. Taxes reduce the amount of money you can use for personal and family goals. Watch the historical impact of taxes for the fund because it is likely to be similar in the future. Remember, it is not what you earn, but what you keep after taxes that makes you wealthy.

Your tax-adjusted return is the estimated return after the impact of taxes. There are two ratios to watch: the tax cost ratio and the potential capital gains exposure (see Table 3).

The tax cost ratio is the percent of nominal fund returns that is taxable, assuming the fund is taxed at the highest rate, and is calculated as (1 + return) * (1 – tax cost ratio) – 1. If a fund had an 8 percent return and the tax cost ratio was 2 percent, investors in the fund took home 6.00 percent, or (1.08 * .98) – 1. The potential capital gains exposure is an estimate of the percent of the fund's assets that represent capital gains. If this number is high, there is a high probability that investors may receive gains as capital gains rather than as ordinary income.

Table 3. Morningstar Website: Tax Efficiency

Schwab® S&P 500 Index SWPPX | ★★★★

Quote Chart Fund Analysis Performance Rating & Risk Management Stewardship Portfolio

Compare

Tax Analysis

	1-Mo	3-Mo	6-Mo	YTD	1-Yr	3-Yr	5-Yr	10-Yr	15-Yr	Since Inception
Pretax Return										
SWPPX	3.21	1.39	-3.07	11.46	4.63	15.20	10.58	16.57	8.26	7.61
Tax-adjusted Return *										
SWPPX	3.21	0.35	-4.06	11.46	3.56	14.41	9.86	16.00	7.71	7.07
% Rank in Category	48	44	38	48	27	15	8	11	13	—
Tax Cost Ratio										
SWPPX	—	—	—	—	1.02	0.68	0.65	0.48	0.51	—
Potential Cap Gains Exposure										
SWPPX	45.40									

(02/28/2019)

Currency is displayed in USD.
* Post tax returns are load adjusted.

4. Low Turnover

Look for funds with low turnover. Turnover is a measure of the amount of trading activity that takes place during a given period of time; turnover is shown as a percentage of the average amount of total assets in the fund. Calculate turnover by adding the fund's sales and purchases and dividing by two. High turnover, or excessive trading, increases the amount of taxes and transaction costs you will have to pay. Many costs associated with turnover are hard to quantify and are therefore not disclosed in the prospectus. Other costs that stem from high turnover include commissions, bid-ask spreads (the difference between what buyers are willing to pay and what sellers are asking for in terms of price), and market impact costs (a jump in price that occurs when a manager tries to buy a large block of shares). Remember that each transaction generates a taxable event, and the cumulative taxes can be very expensive.

A mutual fund's turnover is described under the prospectus heading "Annual Turnover" (see Table 5). You want a mutual fund that invests long-term, consistent with the principles of good investing. The more turnover a fund has, the more the investor will spend on transaction costs and taxes (which are not included in the total expense ratio). The more costs the fund generates, the higher the fund's returns must be to offset these expenses.

You should also look at the section entitled "Potential Capital Gains Exposure in the Returns: Tax Analysis." You should avoid mutual funds that have a high potential for earning short-term capital gains because they are taxed at the highest marginal tax rate.

5. Low Un-Invested Cash Low

Un-invested cash is cash the mutual fund has not yet invested in securities. High levels of un-invested cash are drags on a mutual fund's performance. For example, if the fund's portfolio has a small percentage of large-cap stocks and a large percentage of cash, the low rate of return on the cash will dilute the higher rate of return on the large-cap stocks. Look for funds that keep the percentage of cash in their portfolios low. Some mutual funds hold large amounts of cash to fund potential redemptions or to comply with their investment policy. Choose funds that are fully invested (95 to 99 percent, depending on the asset class and fund size) in the market segment you are targeting. Do not pay the mutual fund to manage cash. While it is acceptable for open-end mutual funds to have some frictional cash, this cash should comprise less than 5 percent of the fund.

The percentage of un-invested cash in a fund is listed in the "Asset Allocation" section of the prospectus (see Table 5). Remember that the amount of un-invested cash in a fund may change over time, so monitor this amount. The Vanguard fund has 0.4 percent un-invested cash.

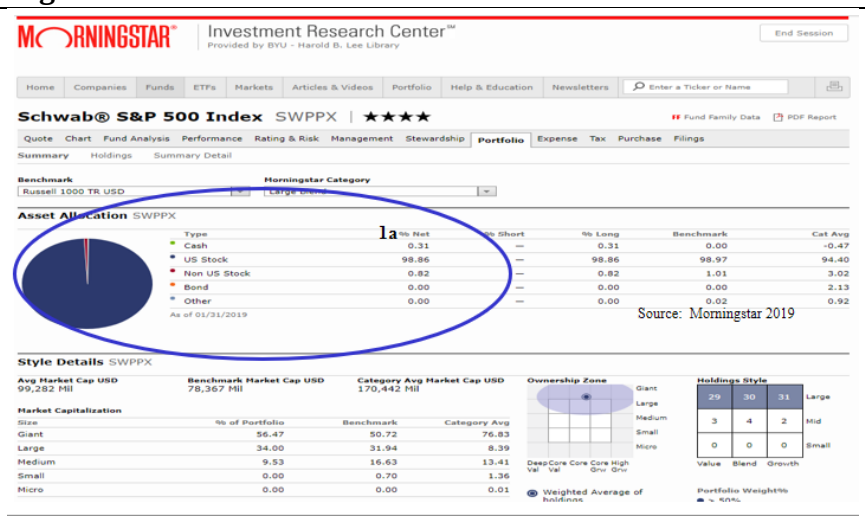
6. No Manager Style Drift

The law requires that mutual funds have a prospectus available for individual clients to review. This prospectus states the investment objective of the fund (whether the fund will invest in large-capitalization stocks, international bonds, real estate, etc.). Manager style drift relates to the fund manager's style and the types of companies the fund will buy or sell. Over time, portfolio managers may change the types of companies they choose to invest in; this change is called manager style drift. Changes in the size, geographical location, or relative valuation of the companies included in the fund can alter a manager's investment style. Since this investment style affects the performance of the fund, a portfolio manager should generally remain consistent in the types of companies he or she selects for the fund.

The fund's prospectus should clearly define the asset classes that will be included in the portfolio, the size of the target companies, and whether the portfolio has a growth or value tilt. A growth tilt means that the portfolio manager invests in stocks that have higher price-earnings and price-book ratios than the market and are likely to grow faster than the market. A value tilt means that the portfolio manager invests in stocks that are cheaper than the market and have lower price-earnings and price-book ratios than the market. A portfolio manager should not change the type of asset classes included in the fund. You are paying the manager to invest in the asset classes that are detailed in the prospectus, and this is what he or she should do. If you purchase a small company mutual fund, the fund manager should not purchase international or emerging market shares because these investments are not part of the fund's target asset classes. If you want exposure to these asset classes, you should invest in a mutual fund that specializes in international and emerging market shares.

Table 4. Morningstar Website: Turnover

Table 5. Morningstar Website: Un-Invested Cash



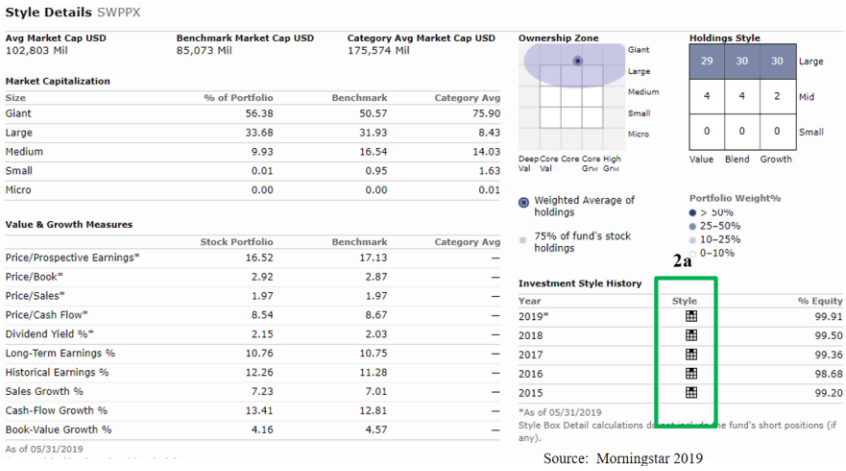
The portfolio manager's investment style is described in the "Manager's Style" box in the section called "Portfolio: Style Box Details" (see Table 6). The diagram in the "Manager's Style" box lists the company valuation across the top and the company size on the side. The manager's style should not have changed over time. If you see that it has changed, find another fund where the style has remained consistent.

7. Small (or Positive) Tracking Error

Tracking error (or trailing return, as defined by Morningstar) is the difference between the return on the fund and the return on the fund's benchmark.[2] Tracking error should be small, meaning that the fund return should be very close to the benchmark return. Generally, the smaller the tracking error, the more consistent the performance of the fund is compared to its benchmark. If the tracking error is negative, the fund has yielded lower returns than the benchmark. Most

people do not complain too much if the tracking error is positive, or in other words, if the fund has yielded higher returns than the benchmark.

Table 6. Morningstar Website: Manager Style Drift



Style Details SWPPX

Avg Market Cap USD	Benchmark Market Cap USD	Category Avg Market Cap USD
102,803 Mil	85,073 Mil	175,574 Mil

Market Capitalization

Size	% of Portfolio	Benchmark	Category Avg
Giant	56.38	50.57	75.90
Large	33.68	31.93	8.43
Medium	9.93	16.54	14.03
Small	0.01	0.95	1.63
Micro	0.00	0.00	0.01

Value & Growth Measures

	Stock Portfolio	Benchmark	Category Avg
Price/Prospective Earnings*	16.52	17.13	–
Price/Book*	2.92	2.87	–
Price/Sales*	1.97	1.97	–
Price/Cash Flow*	8.54	8.67	–
Dividend Yield %*	2.15	2.03	–
Long-Term Earnings %	10.76	10.75	–
Historical Earnings %	12.26	11.28	–
Sales Growth %	7.23	7.01	–
Cash-Flow Growth %	13.41	12.81	–
Book-Value Growth %	4.16	4.57	–

As of 05/31/2019

Ownership Zone: Giant, Large, Medium, Small, Micro; Deep Val, Core Val, Core Gro, High Gro

Weighted Average of holdings

75% of fund's stock holdings

Holdings Style

	Value	Blend	Growth
Large	29	30	30
Mid	4	4	2
Small	0	0	0

Portfolio Weight%: > 50%, 25–50%, 10–25%, 0–10%

2a

Investment Style History

Year	Style	% Equity
2019*		99.91
2018		99.50
2017		99.36
2016		98.68
2015		99.20

*As of 05/31/2019

Style Box Detail calculations d[illegible] the fund's short positions (if any).

Source: Morningstar 2019

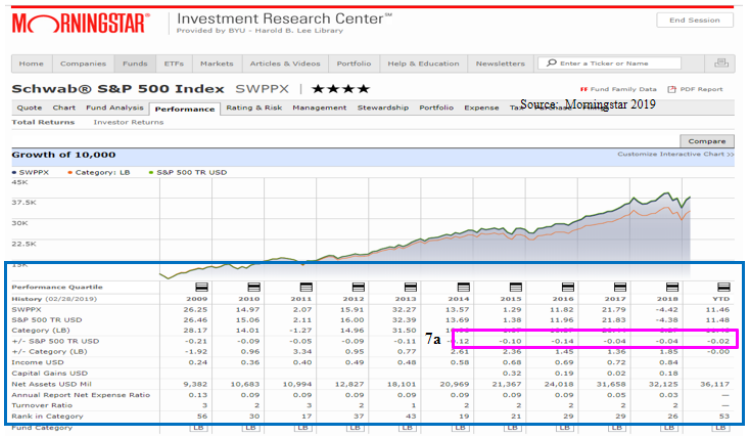
A fund's tracking error is usually listed in the prospectus section entitled "Tracking Error: Returns: Performance History" (see Table 7). You should look at three major parts of the section that deals with tracking error, "Tracking Error versus the Index," "Tracking Error versus the Category," and "Percent Rank in Category."

Tracking error versus the index (+/– index): This section shows the difference between the return on the fund and the return on the benchmark, or index. If tracking error is consistently small, it is likely you will consistently receive benchmark returns.

Tracking error versus the category (+/– category): Sometimes funds with similar objectives will have different benchmarks. This section combines all funds with similar objectives. This information indicates how well the fund performs in comparison with other funds in the same asset class (or category). A positive tracking error indicates that a fund has had higher-than-average returns as compared with other funds in the category.

Percent rank in category: This section shows the percentile in which a fund falls in a given category. A rank of 15 indicates that the fund is in the top 15th percentile of all funds; the lower the number, the better the performance of the fund compared to the performance of other funds in the category. Watch this percentage rank for consistency. A fund that is in the top-third of all funds year after year is a much better prospect than a fund that is the top performer one year and a mediocre performer for several years. Remember that winners rotate, and last year's best-performing fund is unlikely to be this year's best-performing fund. Consistency is a critical factor.

Table 7. Morningstar Website: Tracking Error



Using Databases to Select Funds

Now that you understand the parameters you should adhere to when selecting mutual funds, you can set your criteria and then use a database to get a list of all the funds that meet your criteria. For example, you can use Morningstar and Using Morningstar to Select Funds (LT07) to set your criteria for stocks, bonds, and other financial assets. To aid you in your selection, we have created a Mutual Fund Selection Worksheet (LT07B) that includes the criteria discussed and where to find it on Morningstar.

While there are many different resources for finding mutual funds, the Premium Fund Screener from Morningstar is one of the better resources. You will need to set up an account and a password. The cost of using Morningstar on the Internet is $125 per year. This service is available for free for some college students, such at BYU.

Why Index or Exchange Traded Funds

Index funds are mutual funds that hold the same proportions of specific shares as that held by a specific benchmark or index. Exchange-traded funds (ETFs) are mutual funds that are very similar to index funds, except that instead of being traded only once a day like a mutual fund, they can be purchased and sold at any time the market in which they trade is open. The goal of index funds and ETFs is to match the benchmark performance of a specific asset class. There are nearly 1,000 different index funds and over 500 different ETFs, and they all follow different indices or benchmarks related to geography, maturity, capitalization, and style.

Index funds and ETFs were created because some investors were concerned that actively managed funds were not always able to beat benchmarks after the effects of fees, taxes, and other expenses. By purchasing an index fund, investors stop trying to beat the benchmark: instead, they accept the benchmark's return and risk. Interestingly, index funds have tended to outperform most actively managed mutual funds over the long term.

ETFs were created because index funds trade only once per day at the fund's ending net asset value. Some investors wanted to trade index funds throughout the day. In addition, although the management fees on index funds were low, some people thought they should be even lower. Hence, many ETFs have lower management fees than many index funds. However, since ETFs trade on a market just like a stock, investors in ETFs need to factor in the additional cost of buying and selling the shares into the total cost calculation.

Active management tends to hurt a mutual fund's performance because excessive trading generates taxes and fees. Actively managed funds also have much higher management fees than index funds. (The average index fund charges 18 basis points, while the average actively managed mutual fund charges 80 to 200 basis points).

Index funds and ETFs use a passive investing strategy that requires very little time to maintain. Passive investment does not require you to know much about valuation, security analysis, or other company-specific information. You just need to be willing to accept the general market return for the asset classes included in your index fund or ETF. Although returns on index funds vary from year to year (just as returns on benchmarks vary from year to year), they still yield a consistent, respectable return. Jason Zweig, a senior writer for *Money* magazine, said the following about index funds:

> With an index fund, you are 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]

Index funds have become the standard against which other mutual funds are judged. If an actively managed mutual fund cannot perform better (after taxes and fees) than an index fund (index funds are very tax-efficient), then investors should lean toward purchasing the index fund. Warren Buffet wrote the following in 1993, and I believe his statement still applies today, "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] He also said, "Doing reasonably well investing in stocks is very, very easy. Buy an index fund, preferably over time, so you end up owing good businesses at a reasonable average price. If you own a cross-section of American businesses, you are going to do well."[5]

In addition, the amount of time necessary to invest in index funds and ETFs is significantly less than the time needed to analyze, evaluate, value, and purchase individual stocks. In general, most actively managed funds and brokerage accounts tend to under-perform index funds in the long run after all taxes, costs, and fees. Invest accordingly.

The competition in stock-market research is intense and will get more competitive in the future. This will help make markets more efficient and indexing even more attractive. Market indexing or "passive investing" is a free ride on the competition; it takes very little time and contributes to

a “sleep-well” portfolio.

Many dislike indexing because passive investing is boring, selecting stocks can be intellectually challenging, sharing investment “war” stories with friends is fun, and doing “nothing” about your investments is unnerving. Reasons to use index funds include immediate diversification, generally superior long-run performance, tax-efficient strategy, and time efficiency, which allows you to spend more time on the things that are important to you, such as family and friends, helping others, and doing well at work, instead of spending time analyzingflog individual companies.

Understand How to Pick Your Mutual Funds

Once you have done your research and have completed your Investment Plan, the process to pick YOUR mutual funds is simply:

1. Determine the asset classes needed for your Plan and choose the appropriate benchmarks. This you have already done.

2. Determine what makes a good mutual fund and which asset classes you need exposure. You have determined your criteria and know what makes a good mutual fund.

3. Using a database program (we use Morningstar in the class), set those criteria and evaluate each of the potential mutual funds.

4. Select the best mutual funds using Using Morningstar to Select Funds (LT07) and Mutual Fund Selection Worksheet (LT07B) (with hints on the “Filled in” tab).

5. Now put your Investment Plan together.

Assume your asset class was Large Cap, and you choose SWPPX for your fund. What next?

1. Go to Morningstar, and type the ticker “SWPPX” in upper right box

- Where it says PDF Report (if available), print off this report. If there is no PDF Report, just print off the entire “Quote” Page. Include these in your Investment Plan as Exhibit III. Fund Support Exhibits. If you need help, see Mutual Fund Selection Worksheet (LT7B), Filled In for possible fund ideas and tickers

2. Download the Investment Process Spreadsheet (LT13)

- For most, the first 4-10 asset tab will be sufficient.
- Put in your Salary and emergency fund goal and percentage.
- It will automatically determine your target portfolio fund size (your emergency fund amount divided by your bonds/cash percentage).

- Assuming a salary of $60,000 and a 25% allocation to bonds and cash. Your target portfolio size would be $100,000.

3. Add data to the Investment Process Spreadsheet (LT13)

- Put in your asset classes and benchmarks, and percentages in Panel I. Use the dropdown boxes for asset classes and benchmarks
- Then put in the tickers and Fund names

4. Print off all your Exhibits

Print off your filled in Exhibit I. Expected Return Simulation and Benchmarks (LT27)

- Print off your filled in Exhibit II. Investment Process Spreadsheet (LT13)
- Print off Exhibit III. Mutual Fund Pages from Morningstar. There should be a minimum of 4 funds from 4 different asset classes
- Include these with your completed and filled in Investment Plan and you should be good.

Understand Plans and Strategies for Selecting Financial Assets

Following are a few ideas for plans and strategies for picking financial assets.

Investing

General Investing

- Decide whether to use mutual funds or individual stocks and bonds to invest
  - I recommend mutual funds as they give immediate diversification and low cost
  - With a broadly diversified fund, you will get the performance of the asset class and do not need to know much about each stock individually
  - Most students, including business students, have not yet developed the skills necessary to purchase individual stocks and bonds
- Decide whether to invest passively (using index funds), actively or both
  - I recommend index funds for diversification, low cost, tax efficiency and consistent returns versus the index
  - Broadly diversified index funds eliminate most of the required work to understand the individual stocks and bonds in the portfolio
  - If you choose to invest actively, monitor performance versus benchmarks over 24 and 36 months
- Determine your target asset allocation and follow it
  - Ensure your chosen assets give exposure to the asset classes you need
- Follow the principles of successful investing
  - Know yourself, your vision and goals
  - Seek, receive and act on the Spirit's guidance
  - Invest low cost and tax efficiently
  - Minimize turnover and invest long-term

- Know and follow what makes a good mutual fund
- Minimize cash drag
- Be diversified in all you do
- Ensure no style drift
- Monitor performance.

Summary

Your portfolio is likely to be most successful if you build it gradually, adding a small amount money to your investments each month. This chapter provides a detailed framework for selecting mutual funds but only briefly discusses a framework for picking stocks. Adding individual stocks to your portfolio before it has become large enough violates four principles of successful investing: stay diversified; invest low-cost; know what you are investing in; and don't spend too much time, energy, and money trying to beat the market. Individual stocks are not a necessary part of a successful portfolio, but many people enjoy picking individual stocks.

The Internet contains much information related to financial assets and investing. Many companies provide investing information online, hoping that investors who use the information will buy their products or use their services. Unfortunately, much of this information is biased, flawed, or even incorrect. It is important to use reliable resources.

Before picking funds to invest in, you must understand how to pick good mutual funds:

Steps one and two were to determine the asset classes your portfolio should contain and the appropriate benchmarks for these asset classes. For steps three and four, you determine key parameters for evaluating mutual funds of specific asset classes and use a database program to set those parameters and evaluate potential candidates. In steps five and six, you select and purchase the best funds.

Table 8: Taxes on Securities Earnings Including Qualified Dividends (LT32)

Taxes on Different Types of Earnings - 2019 (LT32)
for Stocks, Bonds, and Mutual Funds

Types of Investment Earnings:	Federal Tax Rate	State Tax Rate **
Stocks:		
Capital Gains		
Short-term capital gains	Marginal Tax Rate	Marginal Tax Rate
Long-term capital gains *	15% or 0%	Marginal Tax Rate
Long-term capital gains (TI>$488MFJ) *	20% +	Marginal Tax Rate
Dividends		
Stock Dividends: Qualified ***	15% or 0%	Marginal Tax Rate
Stock Dividends: Ordinary/Not Qualified	Marginal Tax Rate	Marginal Tax Rate
Bonds and Savings Vehicles:		
Capital Gains		
Short-term capital gains	Marginal Tax Rate	Marginal Tax Rate
Long-term capital gains *	15% or 0%	Marginal Tax Rate
Long-term capital gains (TI>$488MFJ) *	20% +	Marginal Tax Rate
Interest/Coupon Payments		
Interest Payments	Marginal Tax Rate	Marginal Tax Rate
Treasury-bills/bond Interest	Marginal Tax Rate	0%
Muni-bond Interest (bonds from your state)	0%	0%
Muni-bond Interest (bonds from another state)	0%	Marginal Tax Rate
Mutual Funds (Pass Through Vehicles):		
Distributions:		
Capital Gains for Stocks/Bonds/Municipals		
Short-term capital gains	Marginal Tax Rate	Marginal Tax Rate
Long-term capital gains *	15% or 0%	Marginal Tax Rate
Long-term capital gains (TI>$488MFJ) *	20% +	Marginal Tax Rate
Stock Dividends		
Stock: Dividends: Qualified ***	15% or 0%	Marginal Tax Rate
Stock Dividends: Not Qualified/Ordinary	Marginal Tax Rate	Marginal Tax Rate
Interest/Coupon Payments		
Bond: Interest	Marginal Tax Rate	Marginal Tax Rate
Treasury-bills/bonds Interest	Marginal Tax Rate	0%
Muni-bond Interest (bonds from your state)	0%	0%
Muni-bond Interest (bonds from another state)	0%	Marginal Tax Rate

Chart 1. 2019 Tax Brackets, Capital Gains and Dividends, and Medicare Tax Rates (000s)

Taxable Inc. Filing Single^	Married Filing Jointly^	Head of Household^	Ordinary Income	Cap. Gains & Dividends Tax Rate	Medicare Tax Rate Earned Income*	Medicare Tax Rate Net Invest. Inc. Tax	Total Cap Gains & Medicare
-	-	-	10%	0%			
9,700	19,401	13,851	12%	0%	2.9%	0.0%	2.9%
39,476	78,951	52,851	22%	0%	2.9%	0.0%	2.9%
39,376	78,751	52,751		15%	2.9%	0.0%	17.9%
84,201	168,401	84,201	24%	15%	2.9%	0.0%	17.9%
200,001	250,001	200,001		15%	2.9%	3.8%	21.7%
160,726	321,451	160,701	32%	15%	2.9%	3.8%	21.7%
204,101	408,201	204,101	35%	15%	2.9%	3.8%	21.7%
434,551	488,851	461,701		20%	3.8%	3.8%	27.6%
510,301	612,351	510,301	37%	20%	3.8%	3.8%	27.6%

^ The beginning of the tax bracket. * Combined rate = 1.45% employer contribution.

Net Investment Income Tax is calculated on your MAGI and Investment Income being above the Threshold. MAGI is AGI + foreign income + a few other areas. Your tax is on the excess above that threshold amount.

You should consider a number of factors when selecting mutual funds, including diversification, costs, turnover, un-invested cash, manager style drift, and tracking error.

Now that you understand the parameters for selecting mutual funds, you can set your criteria and use a database, such as Morningstar, and Using Morningstar to Select Funds (LT07), to get a list of all the funds that meet your criteria.

Index funds and exchange-traded funds (ETFs) hold the same proportions of specific shares as a specific benchmark does. Their goal is to match the benchmark performance of a specific asset class. Nearly 1,000 different index funds and over 500 different ETFs follow different indices related to geography, maturity, capitalization, and style.

Index funds and ETFs were created because actively managed funds do not always beat benchmarks after fees, taxes, and other expenses. With an index fund, investors stop trying to beat the benchmark and instead accept the benchmark's return and risk.

The challenge is getting and keeping your finances (and your life) under control.

Assignments

Financial Plan Assignments

Continue to work on your Investment Plan. As you do, it your challenge now is to begin building your portfolio. When you are starting to invest, you will have only a few assets, but you must still apply the principles of building a successful portfolio regardless of the size of your investment portfolio or the number of assets invested in. How do you apply these principles?

Diversification is critical to building a successful portfolio. Single assets do not add much

diversity to your portfolio. Most mutual funds hold multiple assets and may already be diversified. Consider purchasing mutual funds as your first financial assets. What factors make a good mutual fund? What factors are important to you? What are your thoughts on index funds and ETFs (exchange-traded funds)? What tools are available to help you choose candidates for your portfolio?

This chapter gives you the opportunity to choose your financial assets and to develop your investment strategy. To choose your financial assets, read Using Morningstar to Select Funds (LT07), which explains how to access the Morningstar database and how to set up criteria to select the best mutual funds in your chosen asset classes. If you like, you can look at Mutual Fund Selection Worksheet (LT7B) which helps with criteria for determining a good mutual fund and gives a few ideas.

Using these tools, determine which assets you should purchase to give you exposure to your desired asset classes. What are the minimum purchase amounts, management fees, 12b-1 fees (if any), loads (loads are sales charges and are generally not recommended), and other critical areas of the assets you are considering? Select a minimum of four assets you will initially include in your investment portfolio.

The first asset for your portfolio should be for your emergency fund. Choose a liquid, no-load fund that has a low minimum balance requirement yet still yields positive returns. It could be a money market mutual fund, intermediate-term bond fund, Internet bank deposit, or other liquid investment.

Your second asset should be a core mutual fund. Select a fund that is inexpensive, has low turnover, and is tax-efficient. This fund should also offer you exposure to your main equity market. I personally like index funds for core allocations because they are low cost and tax-efficient and generate good returns. I also like the broadest index funds I can get that offer exposure to the total market, i.e., both large and small stocks.

Your third and fourth assets should be funds that broaden and deepen your portfolio. Broaden your portfolio by adding new asset classes to your portfolio: these assets could include international stocks or bonds, emerging market stocks or bonds, and real estate investment trusts (REITs).

To deepen your portfolio, add more companies to your core allocation or your main asset class. You might also include a U.S. small-cap or mid-cap fund or a fund that offers exposure to all the stocks in the U.S. market, such as the Wilshire 5000 index, which includes most of the listed stocks in the United States.

Once you have determined which assets to include in your portfolio, print off the “Snapshot” page for each of your assets. This page includes information on pricing, size, fees, total return, and return versus benchmarks. These pages will be included in your financial plan.

Then use Investment Process Spreadsheet (LT13). Open the spreadsheet and determine which

tab to use. If you own no financial assets or have only a few in your portfolio (fewer than 10 financial assets), use Tab "Inv. Process (4–10 Assets)." If you have more than 10 assets, use tab "Inv. Process (4–42 Assets)." Assets include stocks, bonds, mutual funds, savings, CDs, and other financial assets.

Add your expected annual salary after you get out of school to cell G11. It will calculate a three- to six-month estimate. Looking at these ranges, type in your emergency fund goal in cell G14. This is the amount you want to save before you begin investing.

Add in your asset classes consistent with your phases in column D in the light-green rows from Section III.B.1. Add the benchmarks in column D from the same section.

Once you have selected a minimum of four assets (one for each asset class), type in the name of the financial assets in the dark-green section.

Finally, type in the percentage allocation in columns F and G, with F being the taxable accounts and G being retirement accounts. The sum of the taxable and retirement accounts should be added to your total allocations as stated in Section III.B.1.

Notice that Investment Process Spreadsheet (LT13) automatically calculates your initial target portfolio size goal, or your first goal for investing. It takes the amount of your emergency fund and divides this by the percentage you allocate to bonds and cash. For example, if your emergency fund goal were $20,000 and you allocated 25 percent to bonds and cash, your initial target portfolio size would be $80,000, or $20,000 / .25. This is just one way of calculating your first goal for investing, but it is a good starting point. Once you achieve this first target portfolio size, you will add an amount to this goal, say $100,000; type the new amount directly over the formula in cell L12 and begin working on your new targets.

Learning Tools

Using Morningstar to Select Funds (LT07)

This tool gives instructions on how to use Morningstar, a company that tracks mutual fund and financial asset performance. Using this tool and your criteria that you determined as to what makes a good fund, you can find mutual funds that match your criteria.

Mutual Fund Selection Worksheet (LT7B)

This worksheet lists the criteria for what makes a good mutual fund so you can compare various mutual fund within specific asset classes. If filled out correctly, it is a good tool to determine which mutual better meets your criteria and needs.

Investment Process Spreadsheet (LT13)

This Excel spreadsheet helps you determine how much you should invest in different assets based on the asset-allocation targets in your Investment Plan. It

can also help you as you work toward reaching your investment targets by showing you the target amount for each asset, the amount you have invested thus far, and the amount that remains for you to reach your target.

Key Sources of Financial Information (LT10)
This document gives suggestions on finding quality sources of financial information.

Taxes on Security Earnings – Qualified Dividends (LT32)
This tool helps you determine the taxes on the different types of earnings. It also explicitly shares your capital gains and dividend taxes on earnings, depending on your taxable income and AGI.

Expected Return Simulation and Benchmarks (LT27)
This spreadsheet helps you see the impact of various investment strategies as well as the volatility of different asset classes. It also shows you the historical impact of different asset-allocation decisions.

Review Materials

Terminology Review

% Rank in Category. This is the number the fund ranks in its category or versus the benchmark. It is the top percentile, i.e., the lower the number the better.
Actively managed funds. These are funds where the portfolio managers try to beat the performance of a benchmark through the active purchase and sell of securities in their asset class. Actively managed funds generally have higher management fees which must be overcome through higher returns
Benchmark. This is the relevant index for the specific category tracked by Morningstar or other fund monitoring company.
Capital gains taxes. Capital gains are realized earnings from selling a financial asset at a profit. It is the sale price less the purchase price, and are divided into short-term and long-term. Short-term capital gains are gains from the sale of an asset where the asset was held for less than 366 days and is taxed at your marginal tax rate. Long-term capital gains are gains on the sale of an asset where the asset was held for more than 366 days and is taxed at a preferential federal rate.
Category. These are all funds in the same category as established by Morningstar.
DALBAR. A firm that produces the book titled Quantitative Analysis of Investor Behavior which tracks the performance of individual investors over succeeding 20 year periods.
Diversification. Diversification is the process of "not putting all your eggs in one basket." It is your key defense against market risk. Pick a fund with many companies in their portfolios within each asset class.
Index funds. These are mutual funds or ETFs which hold specific shares in proportion to those held by a specific index, i.e., the S&P 500 or Russell 2000. Their goal is to match the benchmark performance. Index funds have become the standard against which other mutual funds are judged.
Interest/coupon payments. These are payments received as part of the contractual agreement to receive interest payments from a bond. Bonds which have preferential interest tax treatment, i.e.,

muni's and Treasuries, must still pay capital gains taxes.
Cost. These are the fees and expenses you pay to own a mutual fund or asset. Invest low cost. In a world where investment returns are limited, investment costs of any kind reduce your returns. We recommend you invest in no-load mutual funds to reduce costs.
Manager Style Drift. This is a check on the management style. Make sure the managers investment style remains constant. Investment fund managers have no authority to change the asset class. If you purchase a small cap fund, the manager should purchase small cap shares. The fund's prospectus should clearly define the market, size company, and portfolio style tilt.
Potential Cap Gains Exposure. This is an estimate of the percent of a funds asset's that represent capital gains. If this is high, the probability is high that these may come to the investor as capital gains.
Stock dividends. Stock dividends are dividends received from a company from the ownership of the company shares. Stock dividends are of two types, qualified or ordinary/not qualified. A qualified dividend is a dividend paid by a U.S. corporation where the investor held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (see Teaching Tool 32). An ordinary dividend is a dividend that is not qualified, i.e., you have not held the stock for a long enough time period to get the Federal preferential tax rate.
Tax Cost Ratio. This is the percent of nominal Fund return attributable to taxes, assuming the fund is taxed at the highest rate. If a fund had an 8.0% return, and the tax cost ratio was 2.0%, the fund took home (1 + return) * (1 – tax cost ratio) -1 or (1.08*.98)-1 or 6.00%.
Tax Efficiency. Invest in taxable funds with an eye to obtaining high returns while keeping taxes low. Taxes reduce the amount of money you can use for your personal and family goals. Watch the historical impact of taxes, for it will likely continue. Remember it is not what you earn, but what you keep after taxes that makes you wealthy.
Tax-adjusted Return. This is your return after taxes
Taxes on mutual funds. Mutual funds are pass through vehicles, which means that taxes are not paid at the Fund level but are passed through to the individual shareholders who must pay the taxes. Mutual fund taxes are mainly capital gains, stock dividends and interest/coupon payments. They are handled the exact same way as the taxes for stocks and bonds discussed earlier.
Tracking Error. This is the return on the fund less the return on the benchmark. This tracking error should be small versus your benchmark. Tracking error is the historical difference between the return of a fund (i.e. a mutual fund) and its specific market/sector benchmark or index. The smaller the tracking error, the better the performance of the Index fund relative to the benchmark. However, you won't complain if the tracking error is positive (i.e., your fund had higher returns than the index or benchmark).
Turnover. This is the amount of the portfolio that is bought and sold during a specific period. Keep turnover low, as turnover is a proxy for fund expenses and taxes. The costs associated with turnover are hard to quantify and may not be disclosed in the prospectus. These costs include commissions, bid-ask spreads, and market impact.
Un-invested Cash. This is the amount of cash in the portfolio. High cash levels in the portfolio are drags on performance so keep un-invested cash low.

Review Questions

1. What advice does L. Tom Perry give in regard to building an emergency fund and retirement savings?
2. What four principles of successful investing would you break by investing in

individual stocks before completing the other steps outlined in the previous chapters?
3. What are six good sources of information for researching individual stocks?
4. In regard to mutual funds, what is turnover? Why is turnover an important consideration when buying a mutual fund?
5. What is an index fund? What is the goal of any given index fund?

Case Studies

Case Study 1

Data

You already have your emergency fund but are concerned that you have only $50 per month to invest. You would like to find an index fund that follows the large-cap stocks, and your chosen benchmark is the S&P 500 Index. You have determined your criteria as large-cap stocks, index funds that have a minimum purchase of $50, an asset size greater than $750 million, and a lack of sales charges (i.e., a no-load fund), with fees and expenses less than .10% that a retail investor can invest in.

Application

Using either Morningstar at your local library or Morningstar on the Internet, determine how many funds meet these criteria. Which fund(s) would you choose?

Case Study 1 Answers

Go to the library edition of Morningstar, and go to the screeners (see Using Morningstar to Select Funds (LT07)). Set up the problem with the following criteria:

- Fund Category = U.S. Equity; your category is Large Blend
- Special Fund Types and Index Funds = Yes
- Minimum Purchase and ≤ $50
- Fund Size (Total Assets) and Value ≥ $750
- Fees and Expenses and No-Load Fund = Yes
- Fees and Expenses and Expense Ratio ≤ .10
- Minimum Purchase, Institutional Investor = No

As of July 31, 2019, there were 8 index funds that matched your criteria.

- Fidelity ZERO Large Cap Index
- Fidelity ZERO Total Market Index
- Fidelity SAI US Large Cap Index
- Schwab 1000 Index
- Schwab Total Stock Market Index
- Schwab S&P 500 Index
- TIA-CREF Equity Index W

Which fund you choose will depend on which factors you consider most important, such as tenure of managers, expense costs, asset size, and tax position.

Please note that after doing the analysis in Morningstar, you need to call each fund family to make sure the information is correct. Toll-free numbers are available under the Purchase Info tab.

Case Study 2

Most index funds are low cost. This was not one of the chosen index funds. Why? What fees and loads does it have?

DWS S&P 500 Index A SXPAX | ★★★★

Quote Chart Fund Analysis Performance Rating & Risk Management Stewardship Portfolio

Minimum Investments SXPAX

	USD
Initial	1,000
Additional	50
Initial IRA	500
Additional IRA	50
Initial AIP	500
Additional AIP	50

Contact Information SXPAX

Telephone	800-728-3337
Website	dws.com

Review Other Classes SXPAX

Fund Name	Front Load	Deferred Load	Expense Ratio	Min. Init. Purchase	12b-1 Actual	Purchase Constraint	Shareclass Attributes
DWS S&P 500 Index A	4.50	—	0.57	1,000	0.24	—	—
DWS S&P 500 Index C	—	1.00	1.28	1,000	1.00	—	—
DWS S&P 500 Index R6	—	—	0.24	0	—	A	—
DWS S&P 500 Index S	—	—	0.32	2,500	—	A	—

Purchase Constraint: Institutional, T, Qualified Accounts, A, Closed to New/All Investments - C/L.
Shareclass Attributes: Available for 529 Only - N, Indirect Use Only - U.

Case Study #2 Answers

You can find the expenses on Morningstar, but you should also confirm them with the mutual fund company by calling them before you invest.

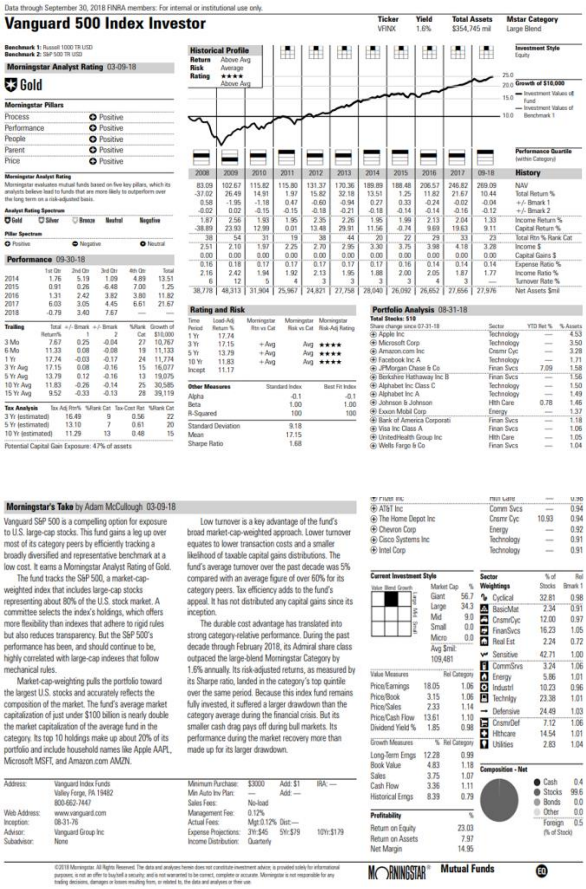
This fund, depending on your class of share, has a 4.5% front end load, 1.0-4.0% deferred load, expense ratios between .32 and 1.28%, and 12b-1 fees from 0-1.0%. This index fund will cost you a lot in expenses.

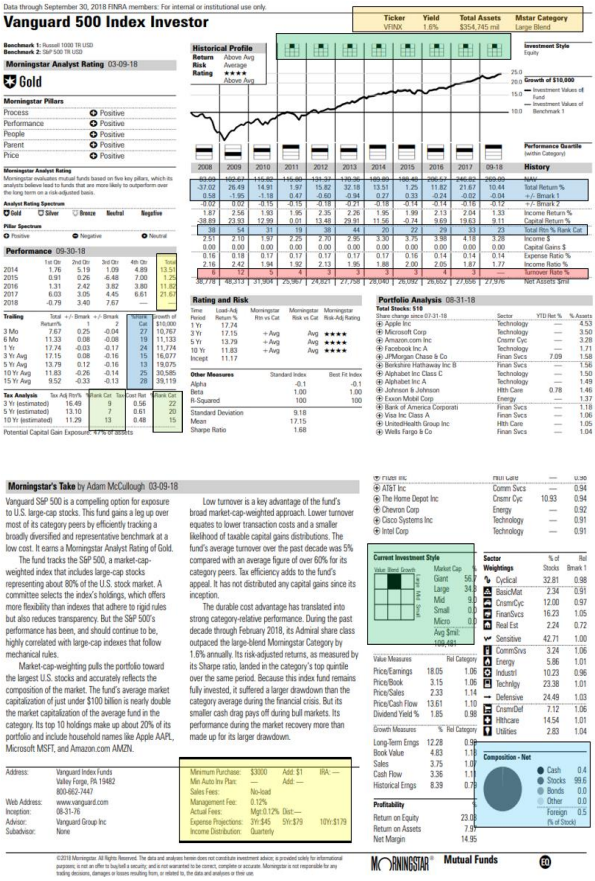
Case Study 3

Given the Morningstar report for VFINX (see Table 9 below), highlight the areas where you find the critical information below (with the colors listed):

1. Diversification (orange)
2. Costs and Fees (orange)
3. Taxes (light green)
4. Turnover (red)

5. Un-invested cash (blue)
6. Style and style drift (green)
7. Tracking error and performance (blue)





[1] "Becoming Self-Reliant," *Ensign*, Nov. 1991, 64.
[2] http://library.morningstar.com/Education/MLE_Glossary_T_Z.html#TrailingReturnCategory
[3] "Indexing Lets You Say Those Magic Words," *CNN Money*, Aug. 29, 2001.
[4] *Letter to Berkshire Hathaway Shareholders.*
[5] "Warren Buffet: Top 3 Investment mistakes to Avoid," USA Today, October 26, 2013.

26. Investing 9: Understanding Portfolio Performance, Rebalancing, and Evaluation

Introduction

In addition to the steps you have taken to build your portfolio, you must repeat three steps throughout the life of your portfolio in order for it to be a success. First, you must monitor your portfolio's performance and compare asset performance to benchmarks; second, you must evaluate asset performance; and third, you must rebalance your portfolio as necessary to keep it within the targets for risk defined in your Investment Plan. This chapter will begin with a discussion of benchmarks and will then explain each of the three steps that must be repeated throughout the life of your portfolio.

Objectives

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

A. Understand portfolio rebalancing
B. Understand the importance of portfolio management and evaluation
C. Calculate risk-adjusted performance measures.

Understanding how and when to rebalance and evaluate your portfolio is an important part of successful investing.

Understand Portfolio Rebalancing

Portfolio rebalancing is the process of buying and selling assets to align your portfolio with the target asset-allocation percentages you determined in your Investment Plan. Over time, a portfolio can become unbalanced, or different from your target asset allocations, due to changes in asset and asset class performance, changes in your personal objectives or risk-tolerance level, and the introduction of new capital or new asset classes that you consider attractive.

It is important to rebalance your portfolio to ensure you continue moving toward your personal goals at an acceptable level of risk. The challenge of rebalancing is that each time you sell a security, you incur transaction costs; if the account is taxable, you also create a taxable event.

Portfolio Rebalancing Strategies

There are many different strategies for rebalancing a portfolio. In this chapter we will discuss two strategies: periodic-based rebalancing and percent-range rebalancing.

In **periodic-based rebalancing** (also called calendar-based rebalancing), you must decide how often you will rebalance your portfolio—monthly, quarterly, or annually. After each designated period of time, you will rebalance your portfolio to make it consistent with the target asset-allocation percentages listed in your Investment Plan. Allowing longer periods of time to pass between each rebalancing entails lower transaction costs but higher tracking error (the difference between the return you actually receive and the return you would have received if your portfolio had been at its target asset allocations).

The advantage of periodic-based rebalancing is that it is a simple method. The disadvantage is that it does not account for current market performance, which influences overall portfolio performance.

In **percent-range rebalancing** (also called volatility-based rebalancing), you rebalance your portfolio every time the portfolio's target asset-allocation percentages stray a predetermined percentage from your target percentages (e.g., plus or minus five percent). A higher percentage will reduce transaction costs but raise tracking error, while a smaller percentage will reduce tracking error but raise transaction costs.

The advantage of this method is that it is easy to implement because asset performance will indicate when you should rebalance. The disadvantages include that it is difficult to set an ideal range and that assets with higher target percentages and more volatility will have to be rebalanced more often than assets with lower target percentages and less volatility.

New money/donations (NMD) addendum: Regardless of which rebalancing strategy you use, I recommend you also consider using an NMD addendum. Since most of you pay yourselves monthly, donate to charities on a monthly basis, and use caution in your selection of assets, you are in a strong position to combine the aforementioned strategies with an NMD strategy.

An NMD addendum may be used when the following situation applies: in the process of rebalancing, you may find that you need to sell assets on which you have large capital gains. If this is the case, you may want to use the NDM addendum to donate the appreciated asset instead of selling the asset and paying taxes on the capital gains.

You can donate appreciated assets to churches and other qualified charities tax free. For members of the Church of Jesus Christ of Latter-day Saints, you can donate to tithing, fast offerings, missionary fund donations, and almost any other type of donation listed on the ward donation slips. This may be the same for other churches as well. The "donation-in-kind" of an appreciated asset can take the place of your tithing, fast offerings, or other charitable contributions. Then, since you have paid your tithes and offerings through donated securities, you can use the cash you would have paid for your contributions to buy securities to rebalance your portfolio back to your asset-allocation target percentages. (For more information on how to donate appreciated assets to the Church of Jesus Christ of Latter-day Saints, please see the website at ChurchofJesusChrist.org.) Within about four to six weeks of donating an asset to the Church, you will receive a donation-in-kind receipt (see Tithing Share Transfer Example

(LT08)). Keep this receipt as well as a copy of the *Wall Street Journal* to verify the value of the assets on the day you made your donation. You can then use these two documents to report a charitable donation on your tax return next year.

The key to rebalancing is minimizing market impact, transaction costs, and taxes due. By donating assets "in-kind," you eliminate capital gains taxes on your donated assets, minimize transaction costs and market-impact costs, contribute to a reputable charity (the charity must be a 501(c)(3) organization), and get a tax deduction.

Which rebalancing method is best? For most people, the strategy that is easiest for them will likely be the strategy that is most useful for them. A combination of periodic-based rebalancing and percent-range rebalancing usually works well, especially for smaller portfolios. These strategies can also be combined with the new money/donations addendum to minimize tax implications.

Managing the Costs of Rebalancing Your Portfolio

When you rebalance your portfolio, pay attention to the cost basis of the assets you plan to sell. The cost basis is the amount you paid for the assets. If you sell assets at a loss—in other words, if you sell the assets for less than the amount you paid for them—you will not incur any taxes by selling. Keep good records of the assets you sell at a loss because you can use capital losses to offset capital gains. If you have more capital losses than capital gains, you can deduct the excess (up to $3,000 per year) from your taxable income in 2018. By rebalancing your portfolio through selling assets at a loss, you can avoid paying taxes on capital gains, you can deduct the capital loss on your income taxes, and you can buy the assets you need to rebalance your portfolio while minimizing market impact, taxes, and transaction costs.

Understand the Importance of Portfolio Management and Evaluation

Portfolio management is the process of developing and maintaining your portfolio as a means of achieving your financial goals. Performance evaluation is the process of analyzing your portfolio's return performance with the goal of identifying your key sources of return. These two processes are somewhat complicated, but both are critical to successful investing.

Portfolio Management Styles

In **active portfolio management**, investors use publicly available data to make decisions about actively buying and selling financial assets. The goal of this investment strategy is to beat the benchmarks after all transaction costs, taxes, management fees, and other expenses have been accounted for. This strategy can be considered successful only if it works consistently year after year—not if the strategy works for one lucky trade. Active management is expensive: management fees for actively managed mutual funds that consistently outperform benchmarks are 5 to 25 times higher than the management fees for passively managed mutual funds (18 basis points for an index fund versus 250 basis points for an actively managed fund).

In **passive portfolio management**, you buy a well-diversified portfolio of financial assets (usually a broad market index) and do not attempt to outperform the market by buying underpriced securities or selling over-priced securities. Most actively managed funds fail to outperform their benchmarks, especially after transaction costs and taxes have been accounted for. Many investors have realized that the saying "if you can't beat them, join them" applies well to investing, so they buy low-cost, passively managed index funds, which consistently match their benchmarks and minimize taxes.

Factors That Lead to Above-Benchmark Returns

Two main factors lead to above-benchmark returns: superior asset allocation and superior stock selection.

Superior asset allocation requires you to be sensitive to changes in the market and adjust your portfolio's asset allocations accordingly: you must change allocations from poorly performing asset classes to high-performing asset classes to receive above-benchmark returns. You must shift your portfolio's allocations among stocks, money market funds, bonds, and other asset classes based on your expectations for return from each of these asset classes. Superior asset allocations yield higher returns with lower risk. If assets are not allocated well, the result is lower returns, higher transaction costs, and higher taxes.

Superior stock selection requires you to pick sectors, industries, or companies that correspond to a specified benchmark and together outperform the specified benchmark. To build an investment portfolio that earns returns in excess of the benchmark, you must carefully buy or sell undervalued stocks while working to purchase securities in an index that contains stocks with the highest growth potential. Superior stock selection yields higher returns with lower risk. Poor stock selection yields lower returns, higher transaction costs, and higher taxes.

Performance Evaluation

Performance evaluation, or portfolio evaluation, is the process of monitoring the performance of your financial assets by comparing them to the relevant benchmarks. Unless you regularly monitor your portfolio's performance, you will not know how well you are moving toward achieving your personal goals. If an asset in your portfolio consistently underperforms its benchmark, you may want to sell that asset and purchase another asset that more closely follows its benchmark. By making adjustments to your portfolio along the way, you can achieve your financial goals more quickly.

To evaluate your portfolio's performance, calculate the following:

1. The period returns on each asset (the return after all taxes and fees have been accounted for)
2. The index returns on each asset's benchmark (the return on the benchmark whose performance most closely mirrors the performance you are trying to achieve)
3. The difference between the asset returns and benchmark returns

4. The weight of each asset or fund in the overall portfolio
5. The overall portfolio return

With this information, you can evaluate how each of your funds or assets is performing compared to its benchmark and how well the portfolio is performing as compared to the goals outlined in your Investment Plan.

Portfolio Reporting

Thomas S. Monson gave the following counsel, "When performance is measured, performance improves. When performance is measured and reported, the rate of improvement accelerates."[1] Although he was speaking about a different type of activity, his counsel is still important.

Portfolio reporting is the process of reviewing your portfolio's performance with everyone who is affected by the portfolio's performance. This would include you, your spouse if married, and any other individuals affected. If you are responsible for managing your family's portfolio, you should report performance to your spouse (and perhaps older children) at least quarterly. If others are helping you manage your portfolio, they should report performance to you and your spouse at least monthly and quarterly as well.

Calculate Risk-Adjusted Performance

As you analyze the returns on the various assets in your portfolio, how can you tell how well you are doing? Is only the total return on each asset important, or should you consider other factors to determine whether each asset performed as well as it should have? How do you determine whether a portfolio manager is generating excess returns (returns that are higher than the portfolio's benchmarks)? Is performance just a matter of high returns, or should you also be concerned about risk?

It is important to understand risk in managing portfolios. For example, two portfolios have the same 5 percent annual return. One is 100 percent invested in Treasury bonds, and the other is 100 percent invested in small-cap stocks. With the Treasury portfolio, there is very little risk or volatility in returns. With the small-cap portfolio, there is very high risk and extreme volatility in returns. Clearly, risk matters.

One of the easiest and most popular ways of comparing risk is to compare the return rates of investment funds that have similar investment objectives and similar risk characteristics. For example, all large-cap "blend" mutual funds are grouped in the same category, all small-cap "growth" mutual funds are grouped in another category, and all international stocks are grouped in a third category. The average return on each fund within a specific category is calculated, and each fund is given a percentile ranking depending on its relative performance within the category and within the same time period. Generally, the lower the percentile ranking (the range is between 1 and 100), the better the performance. If your fund's percentile ranking is 16, that fund is in the top 16 percent of all mutual funds within its category. To see an example of a mutual

fund and the performance tab giving its relative ranking, see Chart 1, which is a Morningstar Mutual Fund Performance tab, from the Morningstar Library Edition, 2019, or which can also be found at www.morningstar.com. The chart shows the fund's total return, the fund's return minus the category average, and the return minus the index return. The "percent rank in category" shows the fund's percentile ranking for each year that the fund has reported its performance to mutual fund reporting companies.

Comparing the managers of similar investment groups is another useful first step in evaluating performance, but the numbers may be misleading. Some managers may concentrate on very narrow sub-groups of their investment objectives, so portfolio characteristics may not be comparable. For example, in the large-cap "blend" category, some managers may concentrate on high beta (more volatile) stocks, while others may take a more balanced approach. In addition, some managers may change style. Managers may watch the performance of growth stocks versus value stocks and invest in the style that is currently performing the best.

There are a number of accepted ways of measuring portfolio performance: the most widely used measuring tools include the Sharpe measure, the Treynor measure, and the Jensen measure. Each of these measures means little in and of itself; rather, they have meaning when compared to the measure of the relevant market benchmarks.

Sharpe Measure

The Sharpe measure is a ratio of your portfolio's excess return divided by your portfolio's standard deviation. The portfolio's excess return is found by subtracting the risk-free rate (the rate of return you are guaranteed to make with limited risk) from the amount of the portfolio's actual return. The risk-free rate is the benchmark over which all other financial or real assets are compared. The rate is considered by most investment professionals as the amount of return you receive on a 6- or 12-month Treasury bill. Since these bills are default-free, they are considered a proxy for the risk-free rate. The difference between an asset's return and the risk-free rate is called the risk premium, or excess return. The Sharpe measure is calculated as follows:

$$(r_p - r_f) / s_p$$

r_p = the average return on the portfolio
r_f = the risk-free rate
s_p = the standard deviation of portfolio returns

The Sharpe measure is found by dividing the portfolio risk premium, or the return on the portfolio minus the risk-free rate, by the portfolio risk as measured by the standard deviation.

An asset's Sharpe measure in isolation means little. It must be measured against the market's Sharpe measure, which is calculated the same way: by dividing the market risk premium, or the return on the market minus the risk-free rate, by the standard deviation of the market. If the asset's Sharpe measure is greater than the market's Sharpe measure, the asset has outperformed

the market on a risk-adjusted basis.

Because Morningstar does not calculate the Sharpe and Treynor ratios versus the index, we do not have a totally correct ratio. However, they do calculate them versus all companies in their respective asset class, which is an acceptable proxy for the index. The Sharpe ratio is in blue (see Chart 1). Morningstar is as of June 27, 2017.

Chart 1. Performance History

MPT Statistics SWPPX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Index	R-Squared	Beta	Alpha	Treynor Ratio	Currency
vs. Best-Fit Index						
SWPPX	S&P 500 TR USD	100.00	1.00	-0.05	–	USD
vs. Standard Index						
SWPPX	S&P 500 TR USD	100.00	1.00	-0.05	12.67	USD
Category: LB	S&P 500 TR USD	98.80	0.90	-1.33	11.21	USD

06/30/2019

Source: Morningstar Library Edition, 2017

Volatility Measures SWPPX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Standard Deviation	Return	Sharpe Ratio	Sortino Ratio	Bear Market Percentile Rank
SWPPX	12.18	14.13	1.03	1.53	–
S&P 500 TR USD	12.19	14.19	1.03	1.53	–
Category: LB	12.48	12.53	0.90	1.34	–

06/30/2019

Treynor Measure

The Treynor measure is similar to the Sharpe measure, but the Treynor measure uses the portfolio's beta instead of the portfolio's standard deviation. The Treynor measure is calculated as follows:

$$(r_p - r_f) / ß_p$$

r_p = the average return on the portfolio
r_f = the average risk-free rate
$ß_p$ = the weighted average beta of the portfolio

The Treynor measure is found by dividing the portfolio risk premium by the portfolio risk as measured by the beta.

An asset's Treynor measure in isolation also means little. It must be measured against the market's Treynor measure, which is calculated by dividing the market risk premium, or the return on the market minus the risk-free rate, by the beta of the market, which is 1.0. If the asset's Treynor measure is greater than the market's Treynor measure, the asset has outperformed the market on a risk-adjusted basis. See Chart 1, in red.

Jensen Measure

The Jensen measure is the ratio of your portfolio's return minus the portfolio's expected return as determined by the Capital Asset Pricing Model (CAPM). The CAPM is an economic theory that describes the relationship between the risk of assets and the pricing of those assets. This theory suggests that the only risk that should be priced by investors is risk that cannot be eliminated through diversification. In its most simple form, the CAPM shows that the expected return of an asset or portfolio is equal to the rate on a risk-free security plus the asset's risk premium multiplied by the asset's beta, or, in mathematical terms: $[r_f + ß_p (r_m – r_f)]$.

The Jensen measure incorporates the CAPM into its calculation. The Jensen measure is calculated as follows:

$$a_p = r_p – [r_f + ß_p (r_m – r_f)]$$

a_p = the alpha for the portfolio, or the return over and above your benchmark
r_p = the average return on the portfolio
$ß_p$ = the weighted average beta of the portfolio
r_f = the average risk-free rate
r_m = the average return on the market index

This measure is the portfolio's performance (r_p) minus the expected portfolio return as determined by CAPM.

Note that this measure can also be used to determine risk-adjusted performance. Since we know the market's beta is 1.0 (by definition), and since we both add and subtract the risk-free rate, the CAPM return is just the market return. So if the Jensen measure is positive, the asset has outperformed the market on a risk-adjusted basis. See Chart 1, in green.

Which measure is most appropriate?

Because different risk-adjustment measures can give different implications about a portfolio's performance, it is important to choose the appropriate measuring tool for your particular portfolio.

Generally, if a portfolio represents an individual's entire investments, or if there are few financial assets in the portfolio, many academics and practitioners consider the Sharpe measure to be the best measurement option. Use the Sharpe measure if you are concerned with the overall

variability of the portfolio.[2] Remember, the portfolio's Sharpe measure must be compared to the market's Sharpe measure to measure performance.

If your portfolio comprises many different assets and asset classes, or if you are evaluating only a portion of your portfolio, most recommend the Jensen or the Treynor measures. If your portfolio is well diversified, your main concern will generally be non-diversifiable risk (the risk you cannot eliminate through diversification). Of these two measures, the Treynor measure is more complete because it adjusts for non-diversifiable risk (ibid.).

The assumptions that underlie risk-adjustment measures limit their usefulness. Understanding these assumptions is important. For example, these measures assume that a portfolio is basically stable: however, when the portfolio is actively managed, basic stability requirements for some statistical measures are not met. Risk-adjustment measures should be used with caution.

In addition to using risk-adjustment measures, investors should measure performance by comparing their portfolios with portfolio benchmarks as well as with the portfolios of other investors in the same investment-objective category.

Summary

Portfolio rebalancing is buying and selling of assets to align your portfolio with the target asset-allocation percentages in your Investment Plan. Over time, a portfolio can become unbalanced due to changes in asset and asset class performance, changes in your personal objectives or risk-tolerance level, and the introduction of new capital or new asset classes. Rebalancing your portfolio helps ensure that you are moving toward your personal goals and have a comfortable level of risk. However, each time you sell a security you incur transaction costs and, if the account is taxable, you create a taxable event. In this chapter, we discussed two strategies for rebalancing a portfolio: periodic-based rebalancing and percent-range rebalancing.

Portfolio management is the process of developing and maintaining your financial assets. Performance evaluation is the process of analyzing your portfolio's performance to identify your key sources of return. These two processes are complicated but critical to successful investing. The most widely used tools for measuring portfolio performance include the Sharpe measure, the Treynor measure, and the Jensen measure. These measures are then compared to the measures of the relevant benchmarks.

Assignments

Financial Plan Assignments

Continue to work on your Investment Plan. As you do, select your portfolio rebalancing method and include this in Section IV.B. Generally, the easiest method of rebalancing is periodic-based rebalancing.

Second, I encourage you to use the new money/donations addendum to minimize market impact, transaction costs, and taxes on your portfolio. Use new money to purchase your underweight asset classes. This way you do not need to sell your overweight asset classes.

Third, determine how often you will monitor and report on your portfolio and include that information in Section IV.A.

Finally, determine how you will communicate the results of the portfolio performance to everyone who is affected by the portfolio's performance. These are your accountability partners.

Once you have completed your Investment Plan, review it and make sure it is consistent with your vision, goals, plans and strategies. It is a challenging Plan to put together, but its dividends are more than money.

Learning Tools

Tithing Share Transfer Example (LT08)

This document is an example of a form you can use to pay your tithes and other offerings with appreciated stocks or mutual funds.

Portfolio Attribution Example – Illustration Only (LT17)

This Excel spreadsheet helps you perform a simple portfolio attribution analysis based on your asset-allocation targets and benchmarks. This analysis will help you understand the distribution of return in your portfolio. It is for illustration only.

Review Materials

Terminology Review

Active portfolio management. It is the process of using publicly available data to actively manage a portfolio in an effort to beat the benchmark after all transactions costs, taxes, management, and other fees. However, to do this successfully you must do this consistently year-after-year, and not just from luck.

Jensen's Alpha. This is a risk-adjusted performance measure. This is the ratio of your portfolio return less CAPM determined portfolio return, or alpha = rp - [rf + ßp (rm – rf)] where ap = alpha for the portfolio, rp = average return on the portfolio, ßp = Weighted average Beta, rf = average risk free rate, and rm = average return on market index port. It is portfolio performance less expected portfolio performance from CAPM model.

Monitor performance. The process of understanding and reviewing the performance of a portfolio. Unless you monitor performance, you will not know how you are doing in working toward accomplishing your objectives. You need to know how every asset you own is performing, and performing versus its benchmark, so you can determine how well you are moving toward your goals.

NMD (New Money / Donations) Addendum. This is a way to rebalance using either of the rebalancing methods. Rebalance as determined previously, but pay your charitable donations

using appreciated assets, and use the money you would have spent on charity to purchase the "underweight" assets, so you do not have to sell and incur transactions costs or taxable events.
Passive portfolio management. It is the process of buying a diversified portfolio which represents a broad market index (or benchmark) without any attempt to outperform the market or pick stocks. Since most active managers fail to outperform their benchmarks, especially after costs and taxes, investors have realized that if you can't beat them, join them, so they buy low-cost passive funds which meet their benchmarks consistently and minimize taxes.
Percent-range-based rebalancing. This is the process of rebalance the portfolio every time actual holdings are +/-5% (or +/-10%) from target ratios. Rebalance whenever you are outside this range. It is easy to implement and wider ranges will reduce transactions costs (at the expense of higher tracking error).
Performance evaluation. It is the process of evaluating a portfolio's performance with the goal of understanding the key sources of return.
Periodic-based rebalancing. This is the process of rebalancing where you specify a time period, i.e. bi-annually, annually, etc. After each time period, rebalance the portfolio back to your original asset allocation targets. It is the most simple of the methods, and longer periods have lower transactions and tax costs (but higher tracking error costs).
Portfolio attribution. It is the process of separating out portfolio returns into their related components, generally attributable to asset allocation, securities selection, industry, and currency.
Portfolio evaluation. The process of monitoring financial asset performance, comparing asset performance to the relevant benchmarks, and determining how well the fund is meeting its objectives.
Portfolio management. It is the development, construction, and management of a portfolio of financial assets to attain an investor's specific goals.
Portfolio rebalancing. It is the process of bringing portfolios back into given target asset allocation ratios. Changes in allocation occur due to changes in asset class performance and investor objectives or risk, or introduction of new capital or new asset classes.
Portfolio reporting. The process of reviewing portfolio performance with the necessary participants, i.e. your spouse or your investment advisor.
Risk-adjusted Performance. It is the process of determining performance after adjusting for the risk of the portfolio.
Sharpe Index. This is a risk-adjusted performance measure. It is the ratio of your "excess return" divided by your portfolio standard deviation, i.e., your (rp – rf)/sp where rp = Average return on the portfolio, rf = your riskfree rate, and sp = Standard deviation of portfolio return. The Sharpe Index is the portfolio risk premium divided by portfolio risk as measured by standard deviation.
Style analysis. It is another way of obtaining abnormal returns is by analyzing the investment style pf the portfolio. You can decompose returns by attributing allocation to style, and style tilts and rotation are important active portfolio strategies.
Taxable accounts. There are investment vehicles without tax advantages.
Tracking error. Tracking error is the return that is lost from your portfolio being different from your target asset allocation.
Treynor Measure. This is a risk-adjusted performance measure. This is similar to Sharpe but it uses the portfolio beta instead of the portfolio standard deviation, or (rp – rf)/ ßp where rp = average return on the portfolio, rf = average risk free rate, and ßp = weighted average b for portfolio. It is the portfolio risk premium divided by portfolio risk as measured by beta.

Review Questions

1. What is portfolio rebalancing?
2. What two strategies for rebalancing portfolios are mentioned in this chapter?
3. Why is it important to pay attention to the cost basis when you sell an asset?
4. What is portfolio management? What is portfolio evaluation?
5. What are the two types of portfolio management styles? Which is more costly?

Case Studies

Case Study 1

Data

Steve and Suzie, both 45 years old, are aggressive investors; they have an investment portfolio worth over $250,000. Their target asset allocations are 60 percent equities and 40 percent bonds and cash; they have invested these assets in 10 mutual funds. Their actual asset class weights differ from their targets because of the underperformance of the equity part of their portfolio.

Asset Class	Actual	Weight Target	Weight Difference
Equity	70%	60%	10%
Bonds	20%	30%	–10%
Cash	10%	10%	0%

Application

When should Steve and Suzie rebalance their portfolio, and how should they do this?

Case Study 1 Answers

The decision of when to rebalance should be part of Steve and Suzie's Investment Plan. They need to determine the best time to rebalance and the most cost-effective means of rebalancing. The key to rebalancing is minimizing transaction costs and turnover while maintaining adequate diversification and return.

A possible strategy for rebalancing is the NMD strategy: Steve and Suzie can donate appreciated assets to charity and use new money to rebalance their portfolio. If they donate their appreciated equity assets (e.g., donations-in-kind to a charity, see Tithing Share Transfer (LT08)), they can use the money they would have spent on their charity donations to purchase more of their underweight assets, in this case, they would likely purchase bonds.

Case Study #2

Data

Steve is reviewing the performance of his largest asset, the actively managed Fidelity Magellan Fund (FMAGX) for the most recent 3 and 5 year periods (ending 3/14/2017). The T-bill rate during the period was 0.8%.

	3 Yr-FMAGX	SPX	5-Yr FMAGX	SPX
Average return	9.4%	6.5%	13.1%	13.5%

Beta	1.08	1.0	1.06	1.0
Std. Deviation	9.8%	9.2%	11.4%	10.4%

Calculations and Application

a. Calculate the Sharpe, Treynor, and Jensen performance measures for the Fund for the 3 and 5 year periods

b. On a risk-adjusted basis, did it outperform the market?

c. Which risk-adjusted measure should Steve use?

Case Study #2 Answers

	3 Yr-FMAGX	SPX	5-Yr FMAGX	SPX
Average return	9.4%	6.5%	13.1%	13.5%
Beta	1.08	1.00	1.06	1.00
Std. Deviation	9.8%	9.2%	11.4%	10.4%
T-Bill rate	0.8%			

a. Performance measures

Sharpe = (rp – rf)/ sd	3 Year	5 Year
Portfolio (9.4-.8)/.098 =	.88	1.08
Market (6.5-.8)/.092 =	.62	1.23

Treynor = (rp – rf)/ ßp

Portfolio (9.4-.8)/1.08 =	.08	.116
Market (6.5-.8)/1.0 =	.06	.128

Jensen's alpha = rp – [rf + ßp (rm – rf)]

3 Yr Alpha = .094 – [.8 + 1.08 (.065-.008)] = 3.3%

5 Yr Alpha = .131 – [.8 + 1.06 (.135-.008)] = -0.4%

b. Steve's Fund risk adjusted performance:

	3 Year	5 Year
Sharpe Ratio	.88 vs .62 (Y)	1.08 vs 1.23 (N)
Treynor measure	.08 vs .06 (Y)	.116 vs .128 (N)
Jensen's Alpha	3.3% (Y)	-.04% (N)

c. Which measure is most appropriate?

Generally, if the portfolio represents the entire investment for an individual, the Sharpe Index compared to the Sharpe Index for the market is best. This is not the case here.

If many alternatives are possible, or if this is only part of the overall portfolio, use the Treynor measure versus the Treynor measure for the market, or the Jensen's alpha

Of these two, the Treynor measure is more complete because it adjusts better for risk

Case Study #3

Data

You have five mutual funds in your portfolio, an emergency bond fund (VIPSX), a large cap index fund (SWPPX), a small cap fund (FSCRX), an emerging markets fund (SSEMX), and a REIT (VGSIX). How have they done versus their benchmarks (or categories) over the past three years?

Calculations

Using the data from Morningstar at the BYU Library, type in the ticker and go to the Risk tab for each fund. Look at their 3 year performance versus their categories (as a proxy for the market). Did they outperform their benchmarks?

Did these funds outperform over the past three years on a risk-adjusted basis?

Case Study #3 Data

MPT Statistics VIPSX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Index	R-Squared	Beta	Alpha	Treynor Ratio	Currency
vs. Best-Fit Index						
VIPSX	BBgBarc US Treasury US TIPS TR USD	98.47	1.03	-0.18	–	USD
vs. Standard Index						
VIPSX	BBgBarc US Agg Bond TR USD	65.65	0.95	-0.48	0.08	USD
Category: IP	BBgBarc US Agg Bond TR USD	49.60	0.79	-0.42	0.17	USD

02/28/2018

Volatility Measures VIPSX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Standard Deviation	Return	Sharpe Ratio	Sortino Ratio	Bear Market Percentile Rank
VIPSX	3.18	0.62	0.04	0.06	–
Bloomberg Barclays US Aggregate Bond TR USD	2.68	1.14	0.23	0.33	–
Category: IP	3.11	0.57	0.04	0.07	–

02/28/2018

MPT Statistics SWPPX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Index	R-Squared	Beta	Alpha	Treynor Ratio	Currency
vs. Best-Fit Index						
SWPPX	S&P 500 TR USD	100.00	1.00	-0.06	–	USD
vs. Standard Index						
SWPPX	S&P 500 TR USD	100.00	1.00	-0.06	10.54	USD
Category: LB	S&P 500 TR USD	91.04	0.98	-1.53	8.88	USD

02/28/2018

Volatility Measures SWPPX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Standard Deviation	Return	Sharpe Ratio	Sortino Ratio	Bear Market Percentile Rank
SWPPX	10.13	11.05	1.04	1.87	–
S&P 500 TR USD	10.16	11.14	1.04	1.89	–
Category: LB	10.47	9.21	0.85	1.48	–

02/28/2018

MPT Statistics FSCRX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Index	R-Squared	Beta	Alpha	Treynor Ratio	Currency
vs. Best-Fit Index						
FSCRX	Morningstar US Small Cap TR USD	90.13	0.89	-0.80	–	USD
vs. Standard Index						
FSCRX	S&P 500 TR USD	50.49	0.85	-3.08	6.31	USD
Category: SB	S&P 500 TR USD	54.93	0.97	-2.81	7.15	USD

02/28/2018

Volatility Measures FSCRX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Standard Deviation	Return	Sharpe Ratio	Sortino Ratio	Bear Market Percentile Rank
FSCRX	12.19	5.92	0.49	0.85	–
S&P 500 TR USD	10.16	11.14	1.04	1.89	–
Category: SB	13.36	7.37	0.56	0.97	–

02/28/2018

MPT Statistics SSEMX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Index	R-Squared	Beta	Alpha	Treynor Ratio	Currency
vs. Best-Fit Index						
SSEMX	Morningstar EM GR USD	95.18	0.86	-5.73	–	USD
vs. Standard Index						
SSEMX	MSCI ACWI Ex USA NR USD	78.20	0.99	-3.85	1.48	USD
Category: EM	MSCI ACWI Ex USA NR USD	72.60	1.03	1.69	7.12	USD

02/28/2018

Volatility Measures SSEMX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Standard Deviation	Return	Sharpe Ratio	Sortino Ratio	Bear Market Percentile Rank
SSEMX	14.02	2.01	0.17	0.26	–
MSCI ACWI Ex USA NR USD	12.46	6.24	0.51	0.80	–
Category: EM	15.13	7.90	0.54	0.90	–

02/28/2018

MPT Statistics VGSIX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Index	R-Squared	Beta	Alpha	Treynor Ratio	Currency
vs. Best-Fit Index						
VGSIX	S&P United States REIT TR USD	99.86	0.99	0.00		USD
vs. Standard Index						
VGSIX	MSCI ACWI NR USD	24.13	0.63	-4.75	-0.96	USD
Category: SR	MSCI ACWI NR USD	29.19	0.64	-4.41	0.23	USD
02/28/2018						

Volatility Measures VGSIX

3-Year | 5-Year | 10-Year | 15-Year

3-Year Trailing	Standard Deviation	Return	Sharpe Ratio	Sortino Ratio	Bear Market Percentile Rank
VGSIX	13.78	-0.07	0.02	0.03	–
MSCI ACWI NR USD	10.83	8.34	0.75	1.22	–
Category: SR	12.94	0.48	0.07	0.12	–
02/28/2018					

Case Study #3 Answers

We will use the category as the proxy for the market (as of March 12, 2018)

	3 Year		5 Year		Outperformed*	
Name	Sharpe	Category	Treynor	Category	Sharpe	Treynor
VIPSX	.04	.04	.08	.17	E	N
SWPPX	1.04	.85	10.54	8.88	Y	Y
FSCRX	.49	.56	6.31	7.15	N	N
SSEMX	.17	.54	1.48	7.12	N	N
VGSIX	.02	.07	-.96	.23	N	N

* Y = yes, N = no, E = Equal

[1] "Sheep, Shepherds, and Sheepherders," *New Era*, Jun. 1977, 20

[2] Zvi Bodie, Alex Kane, Alan Marcus, *Essentials of Investment*, 6th Edition, McGraw-Hill Irwin, New York, 2007, 579

27. Retirement 1: Understanding Retirement Basics

Introduction

People are living longer in modern times than they did in the past. Experts project that as life spans continue to increase, the average individual will spend between 20 and 30 years in retirement. With fewer traditional pension plans available and smaller payouts from traditional government and private plans, retirement planning is an increasingly important part of personal investment planning.

Most people want to be financially secure during retirement. This chapter on retirement planning is divided into four parts that will help you achieve financial security during retirement: (1) retirement basics, (2) Social Security, (3) employer-sponsored retirement plans, and (4) individual and small-business retirement plans. The sooner you begin planning and saving for retirement, the more likely it is that you will be financially secure during retirement.

Ezra Taft Benson gave the following counsel, "*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."[1]

Retirement planning includes answering three important questions:

1. How much money do I need to have available at retirement to allow me to reach my retirement goals?
2. How do I tell if I am on track to reach my retirement goals?
3. What are the major retirement vehicles available to me, and how can I use them to reach my retirement goals?

This first chapter gives general guidelines on answering the first two questions. The remaining chapters discuss the major retirement vehicles available to you. We have put together a document on the 30 Key Decisions for Retirement that ties in what you have learned thus far with your Retirement Plan.

The purpose of this chapter is to help you lay the foundation for a successful retirement plan and encourage you to follow your plan. This chapter reviews and builds upon concepts discussed in earlier chapters. You should read this chapter before reading the succeeding chapters in this course.

Objectives

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

A. Understand why retirement planning is critical and the principles of successful retirement planning
B. Understand the steps, stages and payout options at retirement
C. Understand one method of monitoring your retirement-planning progress
D. Understand and create your Retirement Plan.

Understanding the basics of retirement planning is important to planning, constructing, and managing a portfolio to achieve your retirement-planning goals.

Understand Why Retirement Planning is critical and the Principles of Retirement Planning

You have the responsibility to take care of yourself and your family. No one will assume that responsibility for you. Building an adequate retirement fund will ensure that you will be able to fulfill this responsibility even after you stop working. By planning ahead, you will help to ensure a better future for you and your family.

Life Expectancy

The following are some interesting statistics on aging from *Kiplinger Magazine* (Feb. 2001):

- There are an estimated 67,000 Americans who are at least 100 years old. This is a 130 percent increase from 1990.
- The number of people over the age of 100 is expected to rise to 834,000 by 2050.
- Of these people over the age of 100, 82 percent are likely to be women.
- In 1900, the life expectancy at birth for men and women was 46 and 48, respectively. In 1997, the life expectancy at birth for men and women was 74 and 80, respectively, and rising

We do not know how long each of us will live. We can gain information from the lives of our parents and family. We can also get estimates from others. We recommend you get a few estimates from the below websites which may indicate how long, based on their algorithms, you may be expected to live.

- Social Security estimates you will live this long based only on date of birth and gender, see Social Security Life Expectancy Calculator
- Northwestern Mutual Life Insurance provides a Longevity Quiz.
- Blueprint Income has their How Long Will You Live.
- Bankrate.com gives a Life Expectancy Calculators

As the average life expectancy rises, the need to save for longer periods of retirement becomes more important. As we discussed earlier in the chapters on the time value of money, the sooner you invest your money and the more time your money has to compound, the larger your nest egg

will be when you retire.

Getting Started

You should begin planning for retirement today. Retirement may seem to be a long way off, but it isn't! You may think your employer or the government will provide the funds to help you through retirement, but this is typically not the case anymore. Employer-sponsored retirement benefits are changing, being reduced, or being eliminated altogether, and the future of government programs, particularly Social Security, is uncertain. Even if Social Security is still available when you retire, it will probably not provide enough money for you to live on exclusively. You need to be aware of these changes in employer-sponsored retirement benefits and government programs and plan accordingly.

Principles of Retirement Planning

There are generally six key principles to successful retirement planning:

1. Know Yourself, Your Vision, Goals and Plans. It is critical that you know yourself. You must have our vision of what your retirement will be like, and then develop your personal and family goals and your plans to achieve them. If you have not written your goals down, you should do so now. Know what you want out of life. Understand what kind of retirement you want. And most importantly, be willing to work toward the kind of retirement you want.

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the Retirement-Planning Vehicles Available to You. The government offers a number of retirement vehicles that have specific tax advantages to help you as you save for retirement. Understand them carefully and utilize them to your best advantage.

Understand the government retirement plan, which is Social Security. Social Security promises specific retirement benefits. It is up to you to understand what you are entitled to and the steps you must take to receive those benefits.

Understand the numerous employer-qualified retirement plans, including 401(k), Roth 401(k), 403(b), Roth 403(b), or 457 retirement plans for the employee. Understand these plans and use them to your best interest.

Understand individual and small-business retirement accounts. These include traditional IRAs, Roth IRAs, Keoghs, and SEPs and SIMPLEs for the self-employed.

Finally, once you understand these vehicles, use the highest priority money first, which will help you achieve your financial goals the fastest.

4. Choose Financial Assets Wisely. To help you reach your goals, choose the financial assets that will earn the highest after-tax returns. Follow the principles of successful investing discussed earlier and invest wisely.

5. Follow the Retirement Planning Steps. Follow the steps to successful retirement planning, which will be discussed next. Plan your retirement and live your plan.

6. Develop a Good Retirement Plan and Follow It Closely. Develop a good retirement plan and write it down. Follow it closely, and include ways to check your progress toward your goals. Check yourself regularly to make sure you are on track to meet your goals. Monitor your performance, and re-balance and re-evaluate as needed.

7. Start Now. The longer you wait to start, the more money you will need to invest for retirement. Start investing early so your money will be earning money to help you reach your retirement goals.

Finding Balance

As you work on creating your Retirement Plan, finding balance among doctrines, principles and application is important. We have shared some ideas for principles, and below are a few ideas for doctrines on which the principles are based. As you strive to increase your ability and effectiveness in preparing for retirement, I recommend you study and ponder the doctrines and principles supporting this.

Principles	Doctrines
Know yourself, your vision, goals and plans	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Understand retirement vehicles	Stewardship
Choose assets wisely	Accountability
Know the steps for retirement planning	Agency
Develop and follow your plan	Agency
Start today	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just preparing for retirement, which is an application. From a higher perspective, or with increased vision,

> We are children of God (identity), living worthy of the Spirit (obedience), learning about key areas, steps and strategies of retirement (stewardship) so we can make wise decisions

about our future (agency) which will allow us to save and invest appropriately (accountability) to accomplish our personal and family vision and goals.

Understand the Steps, Stages and Payout Options at Retirement

There are a number of factors that determine how much you will need to save for retirement, including your anticipated retirement age, your desired retirement income (be realistic), your other sources of retirement income (for example, Social Security, investment accounts, real estate, your home), and your tax rate before and during retirement. Other factors include the expected rate of inflation both before and during retirement and the expected return on your retirement savings accounts both before and during retirement. Each of these factors will help you decide how much you must save in order to have sufficient financial resources during retirement. There are seven steps to successful retirement planning:

1. Catch your vision and set retirement goals and estimate how much money you will need at retirement.
2. Estimate how much income you will receive annually during retirement based on your current investments.
3. Estimate your total retirement needs after accounting for inflation.
4. Determine how much you have already saved for retirement.
5. Estimate the value of your home.
6. Determine how much money you still need to save at an expected rate of return to meet your total retirement needs.
7. Determine your optimal investment vehicles and begin saving.

Each of these steps is described in detail below. This process of successful retirement planning mirrors Retirement Planning Needs Spreadsheet (LT06) in the Learning Tools section of the website.

Before you begin the retirement process, you must make five critical estimates.

1. Estimate how many years you have left until you want to retire. While many people retire at age 65, others retire earlier or later. A possible key to successful retirement planning is to achieve your personal financial goals so you can retire with no change in lifestyle.

2. Estimate how long you will be in retirement. Although it is challenging to estimate how long you will live, take the challenge seriously. This estimate has a major bearing on how much money you will need for retirement. You may be able to call your life insurance broker and ask him or her what the actuarial tables predict your lifespan will be.

3. Estimate the average rate of return you will receive on your investment portfolio before retirement and the rate of return you will receive on your investment portfolio

during retirement. Be conservative in making these estimates. As you enter retirement, you will most likely reduce the amount of risk in your portfolio, phasing out higher-risk, higher-return financial assets for lower-risk, lower-return financial assets. These estimates should come from Section 1 of your Investment Plan developed in the investments chapters. I strongly recommend you use conservative estimates (which are generally significantly less than 8 percent).

4. Estimate what the rate of inflation will be both before you retire and while you are in retirement. Inflation will have a major impact on the amount you will need to save for your retirement needs, especially if you have many years left until you retire. See Expected Return Simulation and Benchmarks (LT27) for 1-, 5-, 10-, 25-, 50-, 75-, and 85-year inflation data.

5. Estimate the average tax rate you will likely pay during retirement. While some retirement assets are tax-eliminated (you pay taxes on the asset before you invest) and you eliminate all future taxes on earnings and principal, most individuals have a large percentage of their assets in tax-deferred accounts; these individuals must pay taxes on the funds when they are withdrawn for retirement. When making this estimate, assume that most of your retirement assets are tax-deferred assets rather than tax-eliminated assets.

Step 1: Catch Your Vision and Set Retirement Goals for What you Want

The most important question you must ask yourself is how you want to live when you retire. Will you need more or less money than you are earning now? Be realistic in answering this question. Examine your own situation, estimate how much retirement income you will need, and then work toward achieving that goal.

To make your estimation, start with the amount of money you currently earn on an after-tax basis. Then multiply this amount by the percentage of your income you expect to need for basic living expenses annually during retirement; these are your mandatory costs in retirement and include housing, food, health-care, transportation, etc. This amount is usually between 70 and 90 percent of your current income. Some of your retirement goals may require you to save an annual amount in addition to this base amount—these goals may include visiting your grandchildren, going on vacations, and so on. Add this additional amount to your base amount to estimate your after-tax annual living expense.

Next, use the estimation of what your tax rate will be during retirement to calculate your before-tax annual living expense. For most of the funds in your retirement accounts, you will need to pay taxes when you make withdrawals. Estimate conservatively. To calculate the amount you will need for your before-tax annual living expenses during retirement, divide your annual living expense estimate by the result of one minus your estimated tax rate. This calculation will give you an estimate of your before-tax annual living expense in today's dollars. From the Tax Planning section of your Personal Financial Plan, you know your current average tax rate. This is

a good starting point for estimating your tax rate in the future.

Finally, adjust this before-tax estimation to account for inflation both before retirement and during retirement. Using a financial calculator, solve for the amount you will need to save after inflation has been accounted for. Set the present value equal to the amount of before-tax annual income you will need during retirement, set N equal to the number of years before you retire, and set I equal to the estimated inflation rate. Then solve for the future value; the result will be the amount of money (in future dollars) you will need in the first year of retirement.

Step 2: Estimate Your Current Annual Income Available at Retirement

Once you know how much money you will need for retirement, you should decide which sources of retirement income are already available to you. Start with government resources (in most cases, Social Security). The amount of your Social Security benefit is determined mainly by two factors: (1) your average salary during the years you work and (2) when you begin receiving benefits. Most individuals become eligible to receive Social Security at age 67; however, if you defer receiving benefits until age 70, the amount of your monthly benefit will increase. Estimate how much money you will receive from Social Security each month and multiply that amount by 12. I recommend that you go to www.socialsecurity.gov and request information regarding your Social Security benefits.

Next, work with your company's benefits coordinator to determine how much you can expect to receive from any defined-benefit pension plans, which will be covered later. Estimate a payout amount based on your current age and earnings. Be conservative in this estimate.

Finally, using a financial calculator or spreadsheet program, solve for how much your retirement assets will be worth at retirement. This estimate will likely be different from your estimate of growth on your personal investments because you do not have control over your retirement assets. Set your present value equal to the current value of these assets, set N equal to the number of years before you retire, and set the interest rate equal to the estimated growth rate of these assets. Then solve for the future value. This calculation will reveal the amount of retirement money (in future dollars) that is available to you from your retirement assets.

Step 3: Estimate Your Total Retirement Needs after Inflation

Next, determine the inflation-adjusted shortfall, or how much additional money you will need for retirement after the effects of inflation have been accounted for. To calculate the annual inflation-adjusted shortfall, subtract the amount you expect to receive from Social Security, qualified retirement plans, individual retirement plans, and small-business retirement plans from the total annual amount you will need for retirement. Once you know your inflation-adjusted shortfall, the next step is to figure out how much money you will need to fund that shortfall each year.

You are now ready to calculate the total amount you will need to have invested by retirement in

order to receive your desired annual payment.

Use a financial calculator or spreadsheet to solve this problem. Set your payment (PMT) equal to your desired annual payment, set N equal to the number of years you will be in retirement, and set the interest rate equal to your real return rate. Then solve for the present value. The result of this equation will be the amount of money (in today's dollars) you will need to have invested by the time you retire in order to receive your needed annual payments. Once you retire, you will either live off the returns generated by your investments or use the money you have invested to purchase an annuity from a financial institution to receive your needed monthly amount.

Step 4: Determine How Much You Have Already Saved on a before-tax Basis

Now that you know how much money you will need to fund your retirement, you must determine how much you have already saved for this purpose. First, list the current value of all of your retirement accounts and taxable accounts. This list should include the value of 401(k) plans, IRAs, Keogh plans, and any other savings and retirement vehicles you own. Your next challenge is to determine how much these assets will be worth when you retire, assuming you do not make any withdrawals from these accounts.

Using your estimate of the number of years until you retire, your estimate of the average rate of return you will receive on your investment portfolio before you retire, and your estimate of the rate of inflation before you retire, calculate the real return on your investments. Now, solve for the future value of your investments using a financial calculator. Set the present value equal to the current value of your investments, set N equal to the number of years until you retire, and set the interest rate equal to your real rate of return. Then solve for the future value; the result will be an estimation of the future value of your current investments.

Step 5: Estimate the Contribution or Reduction to your Retirement Plans from Your Home

Your home may or may not be an important part of your retirement plan. In this step, you must decide whether your home will be an expense or an asset during retirement. If your home is not paid off when you retire, you will still need funds to pay the mortgage, and you will need an increased amount of income to pay off your loan. If your home is paid off, and it is larger than your needs require when your kids are gone, you may want to sell your home and downsize when you retire.

There are two ways you can sell your home. You can simply sell your home for cash (usually to another family), or you can sell your home through a reverse mortgage. With a reverse mortgage, the buyer (usually a bank or investor) pays for the home, and you, the owner, can stay in the home until your death.

If you want your home to be a part of your retirement plan, begin by determining the current value of the home. Current appraisals are good starting points. Next, estimate how much your home's value will increase by the time you retire. Again, be conservative in making your

forecast. For example, I usually forecast housing growth rates at below forecasted inflation rates. Finally, determine how much you will owe on the home when you retire. Many people have a goal to have their mortgages paid off before retirement. However, if you expect to still have a mortgage when you retire, allow for mortgage payments when calculating your retirement expenses. Some people plan to buy another home after they retire; this is an additional expense to consider.

To calculate how much money your home will contribute to your retirement plan, subtract the amount you still owe on your mortgage as well as the cost of a new home from the estimated value of your home at retirement.

Step 6: Determine How Much You Still Need to Save at an Expected Rate of Return to Meet Your Total Retirement Needs

This step brings all the calculations together. Begin with the total investment needed (see Step 3). Subtract the future value of your current investments (see Step 4) from the total investment needed. Then subtract the amount your home will contribute to your retirement plan (see Step 5). This will give you the final amount (in future dollars) you must invest, or the total investment shortfall.

Since you have already accounted for the impact of inflation both before retirement and during retirement, you can use a financial calculator to find out how much you will need to save each month. Set the future value equal to the total investment shortfall, set N equal to the number of years until you retire, and set the interest rate equal to the amount of your expected portfolio return before you retire. Then solve for the payment (PMT). This calculation will give you the amount of money you must save every month or year to achieve your retirement goals.

Step 7: Determine Your Preferred Investment Vehicles and Begin Saving Today

Finally, using the priorities of money and the investment hourglass, determine which investment vehicles and financial assets will help you achieve your retirement goals most efficiently. Then begin saving!

Stages and Strategies of Retirement Planning

There are three general stages in retirement planning: accumulation, retirement/annuitization, and distribution. It is important to develop goals and plans in each of these areas as you prepare for retirement.

Stage 1: Accumulation: This is your plan for how you will save money for your retirement before you retire. An example of accumulation might include saving 20 percent of every dollar you make after college. Of that 20 percent, 10 percent will go into your company 401(k) for retirement, 3 percent into a taxable account for missions, 2 percent into education funds for your children's education, and 5 percent into a taxable savings account to pay off your home early or

for other long-term family goals. Another strategy might be to convert funds from tax-deferred accounts into Roth accounts with minimum tax impact if doing so makes financial sense.

Accumulation strategies could include:

- Live on a budget and save 20%, always get the company match
- Save 20% of every dollar, 15% into your Roth 401k, 3% for other goals, and 2% for children's mission and education
- Save 15% of every dollar, with 10% into the Roth IRA for both you and your spouse, 3% for education and 2% mission
- Invest in Roth accounts while young and when rates are low. Use these to target your tax rate in retirement (to a low level)
- Even though you don't know tax rates, maximize investments in Roth vehicles as you are actually saving more for retirement
- Plan to have your house paid off before retirement. Do not go into retirement with a house payment
- Plan, if desired, to not take social security until 3 years past full retirement age to maximize benefits
- Have your house paid off, and live like a retiree before you retire.

Stage 2: Retirement/Annuitization: This is your plan for how your assets will be distributed at retirement (i.e., immediate annuity versus lump sum distribution that you invest) so you will have sufficient assets for your lifetime. An example might include the expectation of receiving $25,000 each year between Social Security and a defined benefit plan and the realization that you will need $40,000 each year to meet your minimum acceptable level of retirement income. When you retire, you will plan to purchase an immediate annuity to provide that $15,000 each year to bring you up to that minimum acceptable level of retirement income.

Retirement strategies might include:

- Calculate a minimum level of retirement income, and annuitize that amount (if you have sufficient assets). The process is:
    - Calculate your amounts from Social Security and any defined benefit plan(s)
    - Determine your minimum amount needed to live comfortably, and
    - Take a percentage of your assets at retirement (if sufficient) to purchase an immediate annuity to give you the minimum amount needed (b-a) to receive your minimum acceptable level of income
- If you can, retire at 3 years beyond Full Retirement Age to get the maximum you can from Social Security
- Have your house and all debts paid off before you retire
- Have both Roth and traditional retirement assets so you can target your tax rates in retirement

Stage 3: Distribution/Disposition/Decumulation: This is your plan for how best to take distributions from your remaining retirement and taxable accounts to minimize taxes and maximize the availability of your assets after you retire. An example might include taking a maximum distribution of 3.6 percent of your total retirement assets based on the asset value as of the previous December, or to only take out earnings from investments for the previous year.

Distribution strategies might include:

- Set up a framework where you will not outlive your assets. Recommendations include:
- Take out a max distribution of 3.6% of assets each year
- Take out earnings from investments of previous year
- Have taxable (tax now), Roth (rarely taxed) and traditional (taxes later) vehicles to target your tax rate in retirement
- Set a target tax rate, then pull traditional assets up to that specific amount, then Roth assets afterwards to reduce taxes
- Make sure to pay your Required Minimum Distributions
- During your later years which your income is less, i.e., during missions, transfer money from your tax-deferred to tax-eliminated accounts
- Use this time to move assets into Roth accounts with as little tax consequences as possible

Realize that these are general but important stages to think about in retirement planning. It is important to develop plans and strategies for each of these areas.

Payout Options Available at Retirement

Before deciding on the manner in which you want to receive your retirement payouts, make sure you understand the tax consequences of your decision. Look at all of your investment payouts and retirement payouts together. Consider the pros and cons of an annuity versus a lump-sum payout. Plan your payouts to minimize your taxes.

Types of Retirement Payouts

There are several types of retirement payouts available to you when you retire. A single life annuity provides equal payments for as long as you live.

A life annuity with certain period provides payments as long as you live; however, with this option, when you die, your heirs receive payments until the end of the specified or guaranteed period.

A joint and survivor annuity means that payments will continue as long as you or your spouse is alive. In some cases, the benefits may be reduced when you die, so review your options carefully.

A lump-sum payout is a single payment of all principal and accumulated interest that is paid to you when you retire.

Deciding how you want to receive your payout is critical, and once the decision is made it usually cannot be changed. Do not make the decision until you have done as much research as possible. When making this decision, you should account for your goals, budget, family situation, and current health.

Tax Treatment of Payouts

Different types of payouts are taxed differently. Annuity payments are taxed as normal income—annuity payments are the most expensive payout option. A lump-sum payout is normally taxed as ordinary income; however, the payout is taxed as if you had received the money over a 10-year span, which reduces taxes slightly. You are still liable for all taxes on a lump-sum payout immediately. One advantage of a lump-sum payout is that it can be rolled over into a traditional IRA if you want to avoid immediate taxes and continue tax-deferred growth. You can then pull the money out of the IRA as needed and pay taxes on these withdrawals. It is important that you understand the tax implications of whatever payout choice you make.

Understand One Method of Monitoring Your Retirement-Planning Progress

Retirement planning is not easy, but it is an important and worthwhile objective. There are a few key points you should remember when planning for retirement. First, remember to plan for inflation. Changes in inflation can have a drastic effect on the amount of money you need to save for retirement. Watch inflation carefully and plan accordingly.

Second, recognize that once you retire, you may still live for a long time. Plan accordingly, and be prudent in your estimation of how long you will live after you retire.

Third, do not neglect your insurance coverage. Health-care costs can quickly reduce a good retirement plan to nothing if you do not have sufficient insurance.

Fourth, monitor the progress you are making toward your goals, and make changes to your plans and goals as necessary. Review and evaluate performance annually.

Monitoring Progress

Evaluating how well you are doing in preparing for retirement is a major challenge. One method of monitoring your progress is to review your progress every year using Retirement Planning Needs Spreadsheet (LT06)**.** This method is useful, but keep in mind that it does not account for large-ticket expenses, such as a home, nor does it allow you to see where you should be in the retirement-planning process based on your age. In addition to these disadvantages, this Learning Tool does not allow you to see the impact changes in interest rates can have on your available savings at retirement.

An article by Jonathan Clements entitled "Ugly Math: How Soaring Housing Costs Are Jeopardizing Retirement Savings"[2] proposes an interesting idea. Using guidelines put together by Charles Farrell, Clements proposes that individuals and families can determine how close they are to achieving their retirement goals by looking at three specific factors: (1) the amount saved in their taxable and retirement vehicles, (2) the amount of their overall debt, and (3) the amount of their annual earnings. By looking at the ratios of year-end savings-to-annual income and year-end debt-to-annual income, you can see whether or not you are on track to achieve your retirement goals based on a table shown in Clements's article (see Table 1).

These guidelines are a reality check in today's spending frenzy because they show the relationship between savings and debt—you must manage both variables, not just one. The article also encourages you to reduce debt while at the same time increasing savings. Clements' article has three main assumptions:

1. Investors will earn 5 percent more than inflation. While I think this assumption is reasonable, 5 percent might be on the high side for older investors who are primarily invested in fixed-income assets.

2. Investors ages 30 to 65 will save about 12 percent of their pre-tax income every year. Currently, the average individual in the United States is saving significantly less than this amount—between 0 and 8 percent (some are even negative). Individuals need to increase the amount they save.

3. Investors will withdraw 5 percent of their portfolio's value each year in retirement. This is probably an acceptable assumption.

While these assumptions are fairly reasonable, the targets proposed in Table 1 are likely too soft. Both Clements and Farrell state that these targets should probably be made more stringent. Overall, this is a great article and a good resource to help you understand where you are and where you want to be in terms of retirement planning.

Table 1. Key Ratios

Age	Savings-to-Income	Debt-to-Income
30	0.1	1.70
35	0.9	1.50
40	1.8	1.25
45	3.0	1.00
50	4.5	0.75
55	6.5	0.50
60	8.9	0.20
65	12.0	0.00

Are there tools that can help you figure out where you are now and where you want to be as you work toward retirement? One suggestion is). In this spreadsheet, I took the framework proposed by Jonathan Clements and Charles Farrell and developed a chart to help you plan and chart your progress. This chart Retirement Planning Ratio Forecasts (LT25) assumes basic information that can be changed depending on your current situation and age. It can help reveal weaknesses in your current plan and help you monitor your progress. The major disadvantage of this spreadsheet is that it assumes earnings and other factors increase each year at a specific rate, and it is only as accurate as the respective inputs. I make five assumptions in this spreadsheet:

1. Housing payments are expenses, and investors can handle housing payments in amounts up to the "back-end ratio" used by many banks: 36 percent of gross salary. Inputs include not only the interest rate and the number of years left on the loan but also annual property costs and insurance costs. If your housing costs are greater than 36 percent, you will get an error message telling you to reduce the cost of the mortgage.

2. Additional payments for housing expenses, such as pre-payments, come out of money earmarked for savings. If you decide to pre-pay your housing loan, the money you have put in savings is diverted to pay off your mortgage. There is a relationship between mortgage payments and savings. The more you pay in mortgage payments, the less you will be able save for your other goals.

3. Individual inputs are consistent and achievable. Any program is only as good as an individual's forecasts. I encourage you to be conservative with your forecasts.

4. Tax savings on interest payments are considered part of expenses. While this spreadsheet accounts for tax rates in retirement, it does not account for a tax shield on interest payments before retirement.

5. The amount of retirement savings desired is a multiple of income. I have included an input for your estimated market interest rate at retirement. You may decide to use your savings to purchase an annuity when you retire. This spreadsheet will estimate the amount of the annual payment you will receive during retirement based on that estimated market rate.

If used correctly, this spreadsheet can help you represent your current situation.

Example

Suppose you are 26 years old and have an annual income of $50,000. You expect to retire at age 65, and you forecast market interest rates to be 4 percent at that time. You estimate you will be in retirement for 30 years, you will save 5 percent of your salary every year until retirement, you will earn 8 percent on your investments, and inflation will be 3 percent each year. You do not anticipate any real growth in income. You estimate that you will buy a home in 4 years, and you will pay $270,000 for the home with a $20,000 down payment. You will finance $250,000 of the home at 7 percent for 30 years, and you will pay $250 per month in property taxes and insurance.

You will pay off the home in 30 years, and the home's value will grow at 3 percent, consistent with inflation.

Age at beginning of employment	26
Starting income	$50,000
Average annual increase in income	3.0%
Age at retirement	65
Estimated market rates at retirement	4%
Years in retirement	30
Annual percent of salary saved	10.0%
Return on investment	8.0%
Assumed inflation rate	3.0%
Age when you will purchase a home	30
Cost of the home	$270,000
Down payment	$20,000
Mortgage amount	$250,000
Taxes and insurance ($250 per month)	$3,000
Mortgage interest rate	7.0%
Mortgage term	30
Years to pay off loan	30
Assumed growth in home prices	3.0%

Based on the above information, the Learning Tool gives the following information: the first column shows your age, the second and third columns show the savings and debt ratios (.59 = 59 percent) recommended by this Learning Tool, and columns four and five show the savings and debt ratios recommended by the *Wall Street Journal* article.

	Estimated Savings and Debt-to-Income Ratios		**Article-Recommended Ratios**	
Age	Savings-to-income	Debt-to-income	Savings-to-income	Debt-to-income
30	0.59		0.10	1.70
35	1.34	3.79	0.90	1.50
40	2.29	3.06	1.80	1.25
45	3.50	2.37	3.00	1.00
50	5.03	1.73	4.50	0.75
55	6.97	1.11	6.50	0.50
60	9.43	0.50	8.90	0.20
65	12.54		12.00	

	Retirement	Annuity Payment	5% Payout
Total savings	$1,985,902	$114,845	$99,295
Savings to income / % of salary	12.5%	73%	63%
Total inflation adjusted savings	$959,082	$37,005	$47,954
Savings to income / % of salary	6.06%	76%	99%

The benefit of this spreadsheet is that it gives you an idea of where you are in your retirement-planning process. If you had input the information in the previous chart and noticed that the 5 percent payout was only 64 percent of your desired annual income stream, you might have decided you needed a higher percentage. By changing the amount saved, you can see how increasing your savings will lead to an increase in the annual amount available for retirement. For example, by increasing your savings from 10 percent to 15 percent, the 5 percent payout amount increases from 64 percent of your income at retirement to 94 percent of your income at retirement. If you want to receive a payout of 100 percent of income, you can adjust the savings percentage to give you 100 percent of salary at retirement by increasing your savings percentage to 16 percent.

Monitoring your progress toward retirement is an important but challenging responsibility. Nevertheless, this responsibility must be assumed if you are to achieve your financial goals and retire in a manner you desire.

Understand and Create Your Retirement Plan

It is not easy to come up with a retirement vision. It is very difficult because we all have different visions, goals, and plans. While it is difficult to develop, it is something that we should think about to give us motivation to prepare for retirement. Following are a few ideas that may be helpful.

Vision

- From your Plan for Life. It may also include:
    - As children of God, our time on earth is limited. As such, retirement will be a good time for my wife and I to give back.
        - We will serve 5 missions, the first at age 65.
        - We will visit the grandkids every year and will serve where needed.
    - We will likely stay where we are, and eventually downsizing our home (no new debt).
    - With our goal to save, we will have a sufficient retirement portfolio to meet our needs for the rest of our lives and will not be a burden on our children.
    - I will plan well so my spouse has sufficient to live on if I pass first.

Goals

- Upon retirement, we will take a portion of our taxable assets and purchase an immediate annuity, which with Social Security and our defined benefit plan will be sufficient to give us a minimum level of income each year.
- That portfolio will include Social Security, a defined benefit plan, and additional investment vehicles including traditional, Roth, and taxable accounts.
- I will take social Security at 3 years beyond full retirement age, and my spouse at full retirement age.

- Our defined benefit payments will be for joint and survivor 75%, so that when I die my spouse will still have sufficient.
- Our home is paid for and we will have no debt as we will pay cash for all vehicles and keep them 10 years.
- Our retirement portfolios will be 40% tax-deferred, 30% Roth, and 30% in taxable accounts to allow us to target our tax rates in retirement.

Plans and Strategies:
Accumulation Stage: Age 23-65

- We will continue to live on a budget and save and invest 20% of all earnings, with 15% going into retirement consistent with our risk tolerance and according to our Investment Plan.
- We will invest in Roth accounts when we are young and tax rates are low.
- We will try to maximize investments in Roth accounts as we are saving more for retirement (we are paying the taxes outside the retirement vehicles)
- 2% will go into our children's education and mission accounts consistent with our Mission and Education Plans.
- The final 3% we will use to pay down the mortgage on our home with a goal is to have it paid off by the time I turn 45.
- We will pay all tithes and offerings and rebalance our investment portfolio to asset allocation targets with appreciated securities.
- We plan to have our house paid off before retirement. We will not go into retirement with debt.

Retirement Stage Age 65 – 70.

- We will strive to live like a retiree before we retire, so we have fewer fixed expenses
- Upon retirement, we will take a portion of our assets and purchase an immediate annuity, which with Social Security and defined benefit payments, be sufficient to give our minimum required level of retirement income each year.
- I will take Social Security at 3 years beyond Full Retirement Age (FRA), and my spouse at FRA.
- We will strive to save 5% during this period, although overall resources will be diminished due to helping to pay for our children's education and missions.
- We will go on our first mission at age 65, and will use this as a time to convert traditional retirement accounts into Roth accounts.
- We will likely come back to teaching until age 70, then go on four other missions, subject to our health.
- We will not have mortgage debt when we retire so we have fewer fixed assets
- We will have a balance among taxable, tax-deferred and tax-eliminated accounts to target our taxes during retirement.

Distribution Stage: Age 70 - 97

- I will take social Security at 3 years beyond full retirement age, and my wife at full retirement age.
- Our work defined benefit payments will start at age 70, and will be for joint and survivor 75%.
- Our home is paid for and we will have no debt as we will pay cash for all vehicles and keep them a minimum of 10 years.
- We will continue to pay tithes and offerings with appreciated securities and will enjoy life to the fullest.
- We will set up a framework to not outlive our assets. We will take a maximum of 3.6% of our total assets each year for retirement
- We will use our tax-deferred accounts and pay our tithes and offerings with appreciated securities, which will also account for our Required Minimum Distributions (RMDs)

Constraints

- The following are the key risks to our retirement plans:
  - Budget. We will continue to live on a budget and save for our individual and family vision and goals
  - Saving. We will continue to save 20% of gross income per year, with 15% going into retirement vehicles
  - Health. We will always have sufficient health coverage, through both government and private coverage
  - Sin. We will guard against loss of the Spirit, testimony and eternal lives. We will continue serving in the church, reading our scriptures, attending the temple each week, spending time with our extended family and friends, and doing our home and visiting teaching, all to help us become more like the Savior

Accountability

- We will share our vision with these partners:
  - Heavenly Father. We will share with Heavenly Father our plans daily and weekly in our weekly companionship stewardship prayer
  - Spouse. We have worked together to put our vision, goals, and plans together and have completed our spiritual creation. Our goal is now the physical creations, to see this retirement plan come to pass
  - Children. We will let our children know our retirement plans. We will help them with missions and education as planned. They know we will not sacrifice our retirement to help our children financially. They will know that our first priority is to my spouse and then children

Summary

You have the responsibility to take care of yourself and your family. No one will assume that responsibility for you. Building an adequate retirement fund will ensure that you will be able to

fulfill this responsibility even after you stop working. By planning for the future, you will ensure a better future.

Before you plan for retirement, you should know your budget, your personal goals, and your needs. You must also ask yourself two questions: What kind of retirement are you planning for? How much money will you need each year?

You should be aware of which investment vehicles are available to you; they may include Social Security, employer-sponsored plans, small-business plans, and individual plans. Once you know which investment vehicles are available to you, you must decide which financial assets should be included in these investment vehicles to most effectively help you achieve your goals. As you make your retirement plan, select the investment vehicles and financial assets that will give you the highest after-tax returns and therefore allow you to reach your personal and retirement goals.

There are seven steps of successful retirement planning:

1. Set retirement goals and estimate how much money you will need at retirement.
2. Estimate how much income you will have annually at retirement based on your current investments.
3. Estimate your total retirement needs after accounting for inflation.
4. Determine how much you have already saved for retirement.
5. Estimate the value of your home.
6. Determine how much money you still need to save at an expected rate of return to meet your total retirement needs.
7. Determine your optimal investment vehicles and begin saving.

Before deciding on the manner in which you want to receive your retirement payouts, make sure you understand the tax consequences of your decision. Look at all of your investment payouts and retirement payouts together. Consider the pros and cons of an annuity versus a lump-sum payout. Plan your payouts to minimize your taxes.

Retirement planning is not easy, but it is an important and worthwhile objective. Finally, we gave an examples of a Retirement Plan.

Assignments

Financial Plan Assignments

One of the most challenging aspects of retirement planning is deciding what kind of retirement you would like. This is where your vision of your retirement comes in. What would you like your retirement to be? What are you spending this year for basic needs? How much money will you need each year in retirement to maintain your lifestyle? Is this amount more or less than what you are currently spending? These are not easy questions, but they are important questions.

Your assignment is to make a first pass at answering these questions. Using Retirement Planning Needs Spreadsheet (LT06), determine how much you must save each month to achieve your specific lifestyle at retirement based on your estimates of years until retirement, expected return, inflation, and tax rates.

To see the impact of inflation on the amount you must save, increase your forecast for inflation by just one percent both before and during retirement and see how much this affects the amount you must save each month. Likewise, decrease your forecast for inflation by one percent both before and during retirement and see how much this affects the amount you must save each month.

Learning Tools

The following Learning Tools may be helpful for this chapter:

Retirement Planning Needs Spreadsheet (LT06)
This Excel spreadsheet helps you determine how much you must save each month to achieve a specific lifestyle at retirement based on your estimates of years until retirement, expected return, inflation, and tax rates.

Retirement Planning Ratio Forecasts (LT25)
This spreadsheet is an Excel template that will help you determine where you are in your progress toward achieving your retirement goals. By inputting the relevant information, you can estimate whether you are on track for reaching your retirement goals, based on your age and income.

Expected Return Simulation and Benchmarks (LT27)
This spreadsheet helps you see the impact of various investment strategies as well as the volatility of different asset classes including inflation. It also shows you the historical impact of different asset-allocation decisions.

Review Materials

Terminology Review

Accumulation Stage (of retirement). This first stage of retirement begins when you first begin to work and is the time where you accumulate assets which you will later use for retirement needs.
Accumulation strategies. These are possible strategies to use while you are in the accumulation stage of retirement.
Annuities. These are financial products developed and sold by insurance companies designed to accept and grow funds, and then, upon annuitization, pay out a stream of payments for a specified length of time.
Annuitization. The process of determining what percent of retirement assets should be annuitized to ensure sufficient funds for the recipients life.
Annuity types. These are the different types of annuities.

- Deferred. Payments are deferred until the specified time the investor elects to begin receiving the payments.
- Fixed. Payments are a fixed amount, and are made to the investor until the end of the contract, usually till the investor dies.
- Immediate. Payments begin immediately upon receiving the funds.
- Life. Payments are fixed and are made each period until the end of the investor's life.
- Period Certain. Payments are made for a specific period, regardless of the investor's life span
- Variable. Payments are variable based on a specific asset's performance as specified in the contract. Variable payments are made to the investor until the end of the contract.

Distribution Options. This is the decision as to how a distribution or payout is to be received. Make sure you understand the tax consequences of any payout or distribution option chosen.
Distribution/disposition/decumulation Stage (of retirement). This stage begins after you have retired. This is your plan as to how best take distributions from your remaining retirement and taxable accounts to minimize taxes and maximize the availability of your assets.
Distribution/disposition/decumulation strategies. These strategies help you set up a framework where you will not outlive your assets.
Retirement/Annuitization Stage (of retirement). This stage begins when you retire. It is your plan on how your assets will be distributed at retirement. Your goal should be to have sufficient assets for your lifetime to enable you and your spouse to live like you want in retirement.
Retirement/Annuitization strategies. These are strategies to use while you are in the retirement stage.
Retirement vehicles. These are a specific type of investment vehicles which are related to retirement. These include qualified retirement plans such as both traditional and Roth 401k, 403b, and 457 plans; Individual retirement plans such as Roth and traditional IRAs; and small business plans such as SEPs, Simple, and Keogh plans.
Shortfall. This is the difference between what you have now saved for retirement and what you think you need for retirement.
Retirement Payout Options. These are the types of annuity distribution payouts available at retirement. Investors and spouses jointly determine the types of payments at retirement.

- Joint and Survivor. You receive payments for as long as both you and your spouse live. Benefits may be reduced for your spouse when you die, depending on the contract specifics.
- Life with "certain period". You receive payments for as long as you live; however, if you die before the certain period, payments continue until the end of the certain period.
- Lump-sum. You receive a single payment of all principal and interest at retirement that you are responsible to manage.
- Single life. You receive payments for the rest of your life only—not including your spouse's life.

Shortfall. This is the difference between what you have and what you need for retirement.
Social Security. Social security is a government funded investment plan where individuals pay into the system for a specific number of years and then are promised benefits according to a specific formula set by the government.

Review Questions

1. Before you begin the retirement-planning process, what are the five critical estimates you must make?
2. What is the first of seven steps to retirement planning as mentioned in this chapter?
3. Why is it important to include inflation when calculating how much money you will need to save for retirement?
4. What are the two ways in which you can sell your home in retirement?
5. What is your investment shortfall?

Case Studies

Case Study 1

Data

Clint and Abby, both age 30, recently reviewed their future retirement income and expense projection. They hope to retire in 35 years at age 65. They determined they would have a retirement income of $15,000 each year in today's dollars before tax ($10,000 from Social Security and $5,000 from their savings), but they would actually need $60,000 before tax in retirement income to retire comfortably.

Calculations

How much must Clint and Abby save annually for 30 years of retirement if they wish to meet their income projection, assuming a 2 percent inflation rate both before and after retirement, a 7 percent return on investments before retirement and 6 percent during retirement?

Case Study 1 Answers

First, draw the diagram discussed earlier in the chapter.

1. Calculate the shortfall.
2. Inflation-adjust the shortfall.
3. Calculate the real return and the annuity.
4. Calculate the period payment.

Time	35 years	30 years
Now	Retirement	Death
	Return 7%	Return 6%
	Inflation 2%	Inflation 2%

1. Calculate the shortfall (all on a before-tax basis as stated):
   The shortfall is $60,000 – $15,000 = ?
   Clint and Abby's shortfall is $45,000 before-tax.
2. Calculate the inflation-adjusted shortfall (end mode):
   The adjustment is PV = $45,000, I = 2%, N = 35, FV = ?
   Clint and Abby need $89,995 each year (you can round to the closest dollar).
3. Calculate the real return and annuity in retirement:
   The real return is (1 + nominal return) / (1 + inflation) – 1, or (1.06)/(1.02) – 1= ?
   The real return is 3.92%.

To calculate an annuity (remember you will want the payments at the beginning of the period, use the begin mode on your calculator)
To get an annuity of $89,995 for 30 years at a 3.92% return, set PMT = $89,995, N = 30, I = 3.92%, and solve for PV.
Clint and Abby need $1,632,737 to be available in 35 years to give them the annuity for 30 years.

4. Calculate the period payment (use end mode):
To get this future amount, set the FV = $1,632,737, N = 35, I = 7%, and calculate the PMT = ?
Clint and Abby need to save $11,811 each year ($907 per month) to meet their retirement goal.

From Retirement Needs Worksheet (LT06)

Determining Your Retirement Needs Worksheet (LT06)
Before Tax Analysis
Personal Finance: Another Perspective

Directions: Fill the green cells with your data. Be careful not to modify the blue cells. Percentages must be converted to decimal form. Be careful with before- and after-tax amounts.

Key Data:

Amount Needed and Expected Annually	
a. Desired before-tax Amount of Money Needed at Retirement	60,000
b. Before-tax Money expected at retirement (SS, DBP, earnings)	15,000
Before Retirement	
c. Number of Years Till Retirement that Investments Will Grow	35
d. Estimated Average Growth Rate of Investments Until Retirement	7.0%
e. Estimated Average Annual Rate of Inflation Until Retirement	2.0%
Retirement	
f. Number of Years In Retirement	30
g. Estimate Growth Rate of Investments During Retirement	6.0%
h. Estimated Annual Rate of Inflation During Retirement	2.0%
i. Estimated tax rate in retirement	20.0%

Step 1: Calculate Your Shortfall

A. Desired before-tax Amount of Money Needed at Retirement	60,000
B. Before-tax money expected at retirement (includes Social Security, D	15,000
C. Calculate your Shortfall in today's dollars	45,000

Step 2: Inflation Adjust Your Shortfall

A. Number of Years Till Retirement	35
B. Inflation Rate until retirement	2.00%
C. The Inflation Adjusted shortfall?	89,995

The calculation is PV = $45,000 I = 2.00%, N = 35, Solve for FV

Step 3: Calculate Your Real Return and Annuity

A. Nominal return during retirement	6.0%
B. Inflation during retirement	2.00%
C. Real return [(1 + nominal return)/(1 + inflation)] - 1	3.92%
D. Amount needed each year in retirement	$89,995
E. Number of Years In Retirement	30
F. Annuity needed to provide this benefit?	$ 1,632,737

The calculation is PMT = $89,995., I = 3.92%, N = 30 (begin mode), Solve for FV

Step 4: Calculate your Amount Needed to Save Each Month

A. Target amount needed at retirement	$ 1,632,737
B. Number of Years Until Retirement	35
C. Estimate Growth Rate of Investments Before Retirement	7.0%
D. Total Investment Amount needed each month in today's dollars	$907

The calculation is FV = $1,632,737, N = 35*12, I = 7.00%/12, Solve for PMT

E. Total Investment Amount needed annually in today's dollars	$11,811

The calculation is FV = $1,632,737, N = 35, I = 7.00%, Solve for PMT

Step 5. Start saving now!!!!!!!!

Case Study 2

Data

Kevin and Whitney, both age 35, recently reviewed their future retirement income and expense projection. They hope to retire in 25 years. They determined they would have a retirement income of $25,000 each year in today's dollars before tax ($10,000 from Social Security and $15,000 from their savings), but they would actually need $67,500 before tax in retirement income to retire comfortably.

Calculations

How much must Kevin and Whitney save annually for 30 years of retirement if they wish to meet their income projection, assuming a two percent inflation rate both before and after retirement, and an 6.5 percent return on investments before retirement and 5.5 percent during retirement?

Case Study 1 Answers

First, draw the diagram discussed earlier in the chapter.

1. Calculate the shortfall.
2. Inflation-adjust the shortfall.
3. Calculate the real return and the annuity.
4. Calculate the period payment.

Time	25 years	30 years
Now	Retirement	Death
	Return 6.5%	Return 5.5%
	Inflation 2%	Inflation 2%

1. Calculate the shortfall (all on a before-tax basis as stated):

   The shortfall is $67,500 – $25,000 = ?

   Kevin and Whitney's shortfall is $42,500 before-tax.

2. Calculate the inflation-adjusted shortfall (end mode):

   The adjustment is PV = $42,500, I = 2%, N = 25, FV = ?

   Kevin and Whitney need $69,726 each year (you can round to the closest dollar).

3. Calculate the real return and annuity:

   The real return is (1+nominal return) / (1 + inflation) – 1, or (1.055)/(1.02) – 1= ?

   The real return is 3.43%.

   To calculate an annuity (remember you will want the payments at the beginning of the period, use the begin mode on your calculator)

   To get an annuity of $69,726 for 30 years at a 3.43% return, set PMT = $69,726, N = 30, I = 3.43%, and solve for PV.

   Kevin and Whitney need $1,337,882 to be available in 25 years to give them the annuity for 30 years.

4. Calculate the period payment (use end mode):

   To get this future amount, set the FV = 1,337,882, N = 25, I = 6.5%, and calculate the PMT = ?

   Kevin and Whitney need to save $22,719 each year ($1,787 per month) to meet their retirement goal.

From Retirement Needs Worksheet (LT06)

Determining Your Retirement Needs Worksheet (LT06)
Before Tax Analysis
Personal Finance: Another Perspective

Directions: Fill the green cells with your data. Be careful not to modify the blue cells. Percentages must be converted to decimal form. Be careful with before- and after-tax amounts.

Key Data:

Amount Needed and Expected Annually

a. Desired before-tax Amount of Money Needed at Retirement	67,500
b. Before-tax Money expected at retirement (SS, DBP, earnings)	25,000

Before Retirement

c. Number of Years Till Retirement that Investments Will Grow	25
d. Estimated Average Growth Rate of Investments Until Retirement	6.5%
e. Estimated Average Annual Rate of Inflation Until Retirement	2.0%

Retirement

f. Number of Years In Retirement	30
g. Estimate Growth Rate of Investments During Retirement	5.5%
h. Estimated Annual Rate of Inflation During Retirement	2.0%
i. Estimated tax rate in retirement	20.0%

Step 1: Calculate Your Shortfall

A. Desired before-tax Amount of Money Needed at Retirement	67,500
B. Before-tax money expected at retirement (includes Social Security	25,000
C. Calculate your Shortfall in today's dollars	42,500

Step 2: Inflation Adjust Your Shortfall

A. Number of Years Till Retirement	25
B. Inflation Rate until retirement	2.00%
C. The Inflation Adjusted shortfall?	69,726

The calculation is PV = $42,500 I = 2.00%, N = 25, Solve for FV

Step 3: Calculate Your Real Return and Annuity

A. Nominal return during retirement	5.5%
B. Inflation during retirement	2.00%
C. Real return [(1 + nominal return)/(1 + inflation)] - 1	3.43%
D. Amount needed each year in retirement	$69,726
E. Number of Years In Retirement	30
F. Annuity needed to provide this benefit?	$ 1,337,882

The calculation is PMT = $69,726., I = 3.43%, N = 30 (begin mode), Solve for FV

Step 4: Calculate your Amount Needed to Save Each Month

A. Target amount needed at retirement	$ 1,337,882
B. Number of Years Until Retirement	25
C. Estimate Growth Rate of Investments Before Retirement	6.5%
D. Total Investment Amount needed each month in today's dollars	$1,787

The calculation is FV = $1,337,882, N = 25*12, I = 6.50%/12, Solve for PMT

E. Total Investment Amount needed annually in today's dollars	$22,719

The calculation is FV = $1,337,882, N = 25, I = 6.50%, Solve for PMT

Step 5. Start saving now!!!!!!!!

AGE	SAVINGS-TO-INCOME	DEBT-TO-INCOME
30	0.1	1.70
35	0.9	1.50
40	1.8	1.25
45	3.0	1.00
50	4.5	0.75
55	6.5	0.50
60	8.9	0.20
65	12.0	0.00

Source: Dorman Farrell LLC

Case Study 3

Data

Kevin and Whitney are now 45 years old and have six kids. They are 20 years into their retirement plan and are making $82,000 per year. They have $115,000 in savings, and their remaining balance on their home mortgage and credit card debt is $150,000. They have saved only five percent per year and have earned seven percent on their savings, which they felt was sufficient.

Calculations

A. Are they on track for retirement or not?

B. Calculate their income/debt ratios based on the information in the *Wall Street Journal* article (this chart is from Doman Farrell, LLC as quoted in: Jonathan Clements, "Ugly Math: How Soaring Housing Costs are Jeopardizing Retirement Savings," Wall Street Journal, 23 March 2005, p. D1.

Application

How are they doing, and what more should they be doing?

Case Study 3 Answers

Calculations

Are they on track? You can't tell until you calculate their ratios.

Current	Salary		Savings	Debt
Age 45	$82,000		$115,000	$150,000
Ratios	Current	Recommended		
Savings Ratio	1.40	($115/82)	> 3.0	
Debt Ratio	1.83	($150/82)	< 1.0	

They are way behind on their savings and debt goals for retirement. They need to increase their savings to a minimum of 20 percent.

Application

They have too little savings and too much debt.
They need to save an even bigger percentage of their salary (20 percent).
They need to work harder if retirement is really a goal.
They may need to sell assets to reduce debt.
They may need to downsize.

Retirement Planning Forecasts Ratio (LT25) may be a useful tool for different financial situations and goals.

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[1] "To the Elderly in the Church," *Ensign,* Nov. 1989, 4
[2] March 25, 2005 issue of the *Wall Street Journal*, D1

28. Retirement 2: Understanding Social Security

Introduction

For many of the 40 million Americans who are 65 and older, Social Security is the primary source of retirement income. Social Security is the first resource most Americans turn to when saving for retirement; however, most younger Americans, who will not face retirement for many years, might not have access to the benefits of the Social Security program, at least not in its present form. The Social Security Administration has given the following forecast:

> Social Security is a compact between generations. For decades, America has kept the promise of security for its workers and their families. Now, however, the Social Security System is facing serious financial problems, and action is needed soon to make sure the system will be sound when today's younger workers are ready for retirement.
>
> Without changes, by 2033 the Social Security Trust Fund will be able to pay only about 77 cents for each dollar of scheduled benefits. We need to resolve these issues soon to make sure Social Security continues to provide a foundation for future generations.[1]

It is important for you to understand Social Security, its history, its processes, and its current form. Likewise, it is important for you to understand the challenges related to Social Security. The purpose of this chapter is to help you understand these topics.

Social Security is not an investment. Social Security is a social insurance program that provides not only retirement income but survivors insurance for children and spouses, disability insurance for people who are unable to work, and Medicare insurance for the elderly.

You are eligible to receive Social Security benefits if you have paid money into the Social Security program through your employment. Most experts expect Social Security to replace only about 42 percent of your current average earnings; therefore, although Social Security may be the first resource you turn to for retirement income, it should definitely not be your only source of retirement income.

Objectives

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

A. Describe how the Social Security program works and the benefits of the Social Security program
B. Answer frequently asked questions about Social Security and the future of Social Security

C. Understand plans and strategies for Social Security.

Describe How the Social Security Program Works and the Benefits of Social Security

Prior to 1935, retirement assistance was solely the responsibility of the individual, and the government did not provide financial help to retired workers. However, when the stock market crashed in 1929 and the gross domestic product (GDP) of the United States fell 48 percent in five years (from $105 billion to $55 billion), many individuals and families were left economically devastated. Millions of Americans were laid off, over 9,000 banks failed, and depositors lost over $7 billion in assets. In an attempt to ensure that this type of depression did not happen again, Franklin D. Roosevelt signed the Social Security Act in 1935 to aid individuals who were displaced and unemployed.

The Social Security Program

The Social Security program was designed to be a pass-through account. This means that the taxes you pay for Social Security (through the Federal Insurance Contribution Act, or FICA) are used to pay benefits to those who are currently retired, disabled, widowed, or orphaned. Because there are currently more people paying into Social Security than there are people receiving Social Security benefits, the tax reserves are maintained in interest-earning government bonds held by the Social Security Trust Fund. There was no investment or savings component to Social Security when it was originally set up because the government assumed that there would always be enough people in the working generation to pay for the retired generation's benefits. In 1935, there were 17 workers for each retiree who received benefits. Today, it is estimated that there are only 3.4 workers for each retiree who receives benefits.

Financing for Social Security is roughly split evenly between the employee and employer. All employees pay at least 7.65 percent of their wages in FICA taxes, which are used to pay for Social Security and Medicare. This FICA tax comprises a Social Security tax of 6.20 percent and a Medicare tax of 1.45 percent. If your adjusted gross income (AGI) is larger than $250,000 (Married Filing Jointly), then the taxpayer is required to pay an additional 0.9 percent in Medicare tax. Also any investment income is taxed an additional 3.8 percent. Since 1937, the government has made major changes in the Social Security tax rate. Table 1 shows how the Social Security tax rate has changed from 1937 to 1990.

Table 1. Social Security Tax Rate Changes

Year	Amount
1937	1.0%
1954	2.0%
1960	3.0%
1971	4.7%
1984	5.8%
1990	6.2%

There is a limit on the amount of wages that are subject to Social Security taxes; this limit changes each year. In 2018, the maximum amount of wages subject to the Social Security tax was $127,200. There is no limit, however, on the amount of earnings that is subject to the Medicare tax. In other words, in 2018, any earnings in excess of $128,400 are exempt from the Social Security tax but not from the Medicare tax. Table 2 shows a historical perspective on changes to this limit.

Table 2. Maximum Wage Amount Subject to Social Security Taxes

Year	Limit
2014	$117,000
2015	$118,500
2016	$118,500
2017	$127,200
2018	$128,400
2019	$132,900

Employers must provide a dollar-for-dollar match to the funds employees pay in Social Security and Medicare taxes. Self-employed individuals are required to pay both the employee's part of the FICA tax and the employer's part of the FICA tax. This means that self-employed individuals pay 12.4 percent on the first $128,400 of their net earnings for Social Security and 2.9 percent on all taxable earnings for Medicare (3.8 percent if AGI is higher than $250,000). However, self-employed individuals may deduct up to half of their Social Security taxes as an adjustment to taxable income on their federal income tax returns.

OASDI-HI, which is the official name of Social Security, stands for "Old Age, Survivors, and Disability Insurance and Hospital Insurance." Individuals must pay Social Security taxes only on taxable wages. Taxable wages include salaries; bonuses; commissions; the value of employer-provided meals and lodging; sick pay during the first six months of illness; employer-paid group life insurance premiums in excess of $50,000; salary reductions from 401(k), 403(b), and 457 plans; nonqualified deferred compensation that is no longer at risk; nonqualified stock options; vacation pay; and severance pay. Nontaxable wages include sick pay after six months, payments made by an employer for medical or hospital expenses, and employer contributions to qualified retirement plans.

Key Terms

In order to understand Social Security, you should understand a number of key terms:

Average indexed monthly earnings (AIME) is calculated using your top 35 highest earning years. It entails adjusting each year's earnings total for inflation to reflect its value in the year in which eligibility is requested.

Primary insurance amount (PIA): Your primary insurance amount is the basic unit used to express the amount of a worker's benefit at their full retirement age (FRA). The calculation of a

worker's PIA is based on the average indexed monthly earnings (AIME), which is split into three segments and multiplied by specific percentages for each segment and summing the parts. Calculating your PIA from your AIME is divided into three separate calculations (the numbers are for 2018). These numbers are called "bend points" (see Table 3).

1. 90% of the amount for the first $926
2. 32% of earnings from $926 - $5,583, and
3. 15% of earnings above $5,583 subject to a maximum.

If your AIME was $5,000 per month, the amount is:

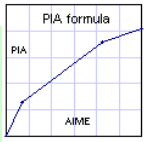
- 90% of the first $926 – ($926*.90) $833.40
- 32% of $5,583 - $926 ($4,074*.32) $1,303.68
- 15% of amount over $5,000 ($0*.15) $0.00

Your total PIA would be $2,137.08

Table 3: PIA Benefit Formula Bend Points[2]

PIA Benefit Formula Bend Points

	$ in PIA Formula		$ in Max Family Benefits		
Year	First	Second	First	Second	Third
2011	749	4,517	957	1,382	1,803
2012	767	4,624	980	1,415	1,845
2013	791	4,768	1,011	1,459	1,903
2014	816	4,917	1,042	1,505	1,962
2015	826	4,980	1,056	1,524	1,987
2016	856	5,157	1,093	1,578	2,058
2017	885	5,336	1,131	1,633	2,130
2018	895	5,397	1,144	1,651	2,154
2019	926	5,583	1,184	1,708	2,228



Full retirement age (FRA) is the age at which retirees will receive 100 percent of the benefits (PIA) to which they are entitled. If individuals choose to receive benefits prior to reaching the FRA, they will receive a reduced amount. Individuals can begin receiving benefits as early as age 62, even though they are not yet at full retirement age. If individuals choose to delay receiving benefits until after they reach the FRA, they will receive an increased amount of benefits. The full retirement age can be calculated using Table 4.

Fully Insured: A worker is only entitled to receive benefits if that worker is fully insured. In 2019, workers are only considered fully insured if they have worked at least 40 quarters of work (a quarter is three months) and earned at least $1,360 per quarter (see Table 5).

Currently Insured: To have currently insured status, workers must have worked a minimum of 6 quarters in the previous 13 quarters.

There are four main types of Social Security benefits: retirement, disability, survivors', and

Medicare benefits. These four main types are discussed in detail in the following paragraphs.

1. Retirement Benefits

Retirement benefits are available to four classes of people: workers, spouses, children, and single parents who have a child under the age of 16.

Table 4. Full Retirement Age:

Birth Year	Year at Age 62	Full Retirement Age
1937	1999	65
1938	2000	65 + 2 mo.
1939	2001	65 + 4 mo.
1940	2002	65 + 6 mo.
1941	2003	65 + 8 mo.
1942	2004	65 + 10 mo.
1943–1954	2005–2016	66
1955	2017	66 + 2 mo.
1956	2018	66 + 4 mo.
1957	2019	66 + 6 mo.
1958	2020	66 + 8 mo.
1959	2021	66 + 10 mo.
1960	2022	67
1961 +	2023 +	67

Table 5. Quarters of Coverage

Year	Amount
2014	$1,200
2015	$1,220
2016	$1,260
2017	$1,300
2018	$1,320
2019	$1,360

Worker's benefit: Workers may receive retirement benefits beginning at any month between the time they turn age 62 and the time they reach full retirement age. Benefits received up to 36 months before FRA will be reduced by 5/9 of 1 percent per month for each month you began receiving benefits before your FRA, for a maximum reduction of 20 percent. Additional reductions of 5 percent per year will be effective when the full retirement age exceeds age 65. Note that once you begin receiving benefits, this reduction will remain through the rest of your life.

For example, if your full retirement age is 66, and you begin retirement at age 62, your benefits will be reduced by 20 percent for the first three years and 5 percent for the fourth year; your benefits will be reduced by 25 percent total.

Delaying payment beyond full retirement age results in a benefit increase for each year of delay. You may delay benefits after age 67 up to age 70 and receive credits amounting to a specific percentage increase for each year of delay (see Table 6). For example, if your FRA is 67 and you begin receiving benefits at age 70, your PIA will be increased by 24 percent (three years multiplied by 8 percent).

Table 6. Percentage Increase per Year for Delaying Benefits

Year Born	Percentage Increase
1935-36	6.0%
1937-38	6.5%
1939-40	7.0%
1941-42	7.5%
1943 or later	8.0%

You may work while you are receiving benefits. Earnings you receive during or after the month in which you reach full retirement age will not reduce your Social Security benefits. However, if you choose to continue working while receiving benefits before your full retirement age, your benefits will be reduced. In 2018, earnings you receive in the year you reach your FRA will be reduced by $1 in benefits for every $3 you earn above the annual limit of $45,360; your earnings will only be reduced until the month you reach full retirement age. In the years before you reach full retirement age, your earnings will be reduced by $1 in benefits for each $2 you earn above the limit ($17,640 in 2019). Note that these limits change each year (see Table 7).

Spouse's benefit: The spouse of a fully insured worker is eligible to receive a retirement benefit of 50 percent of the worker's PIA, subject to the family maximum. This benefit is reduced by up to 25 percent for three years if it is received while the spouse has not reached his or her FRA. Once the spouse has reached age 65, a reduction of 5/12 of 1 percent per month, or 5 percent per year, is imposed for each of the remaining months the spouse is below the FRA. Any reductions to the worker's benefit resulting from early retirement will not affect the amount of the spouse's retirement benefit. If a spouse is entitled to benefits from his or her own employment, that spouse will receive 100 percent of his or her own PIA or 50 percent of his or her spouse's PIA, whichever is larger.

Child's benefit: Any child who is under 18 (19, if the child is still in high school), is eligible to receive a benefit of 50 percent of the retired worker's PIA (this amount is subject to a family maximum).

Mother's or father's benefit: The spouse of a fully or currently insured worker is eligible to receive a benefit of 75 percent of the worker's PIA if the spouse is caring for a child under age 16 or a child who was disabled before age 22.

2. Disability Benefits

Worker's Benefits: Workers who qualify for disability benefits are entitled to receive 100 percent

of their PIA until one of the following situations occurs: the disability ends (benefits are terminated in the second month after the end of the disability); the worker dies (benefits are terminated in the month after the worker dies); or the worker attains full retirement age (disability benefits convert to retirement benefits). Note that it is very challenging to qualify for disability benefits.

Table 7. Benefits Withheld for Earnings

Before You Reach Full Retirement Age: One dollar in benefits will be withheld for every $2 in earnings above the limit:

Year	Benefit Amount
2015	$15,720
2016	$15,720
2017	$16,920
2018	$17,040
2019	$17,640

Year You Reach Full Retirement Age: One dollar in benefits will be withheld for every $3 in earnings above the limit:

Year	Benefit Amount
2015	$41,880
2016	$41,880
2017	$44,880
2018	$45,360
2019	$46,920

There is no limit on earnings made during the month when an individual reaches FRA.

Spouse's Benefit: The spouse's disability benefit is either 50 percent of the worker's benefit or the spouse's own Social Security benefit, whichever is larger. Retirement or disability benefits paid to a spouse who is 62 years old will be reduced by a maximum of 25 percent each year. If the worker's benefit is decreased, the benefit paid to the worker's spouse is also decreased.

Child's Benefit: Any child who is under 18 (19 if the child is still in high school), is eligible to receive a benefit of 50 percent of the disabled worker's PIA.

Mother's or Father's Benefit: The surviving spouse of a fully or currently insured worker is eligible to receive a benefit of 75 percent of the worker's PIA if he or she is caring for a child under age 16 or a child who was disabled before age 22.

Maximum family benefit: When more than one family member is eligible to receive benefits (e.g. the worker, his or her spouse, and children), a family maximum applies. This maximum applies to all benefits paid to the family. For disability benefits, the family maximum is either 150 percent of the worker's disability benefit or 85 percent of the AIME used to calculate the worker's benefit, whichever is smaller. This maximum will not be less than the benefit paid to

the worker.

3. Survivor Benefits

Lump-sum benefit: If the deceased worker was fully insured (40 quarters of credits) or currently insured (6 quarters of credits), a lump-sum survivor benefit will be paid to eligible survivors. A monthly lump sum is available to the surviving resident spouse, nonresident spouse, or eligible children.

Widow(er)'s benefits: A benefit of up to 100 percent of the fully insured, deceased spouse's PIA will be paid to the surviving spouse who is at least age 60 and who was married to the deceased spouse for at least nine months. The surviving spouse is generally eligible if he or she is not remarried and is not entitled to retirement benefits (for his or her covered employment) in at least the amount of the deceased spouse's PIA. If the worker dies before receiving retirement benefits, the surviving spouse of full retirement age is entitled to a benefit of 100 percent of the deceased worker's PIA.

A surviving spouse between the ages of 60 and 65 (below the FRA) would receive reduced benefits of 19 to 40 percent per month each month until the spouse turned 65. If a worker dies after Social Security benefits have begun, the surviving spouse's benefit cannot exceed the amount being paid at the time of death. A widow(er)'s benefit terminates at death or at eligibility for an equal or greater retirement benefit.

Child's benefits: Child's benefits terminate at age 18, at marriage, or at death. The dependent child of a fully or currently insured worker will receive a benefit of 75 percent of the worker's PIA (this amount is subject to the family maximum) under at least one of the following circumstances: if the child is under age 18 (or age 19 if the child is a full-time high school student) and not married, or if the child is over age 18 and has been disabled since before age 22.

Mother's or father's benefit: The surviving spouse of a fully or currently insured worker is eligible to receive a benefit of 75 percent of the worker's PIA if that surviving spouse is caring for a child who is under age 16 or a child who was disabled before age 22 (the benefit amount is subject to the family maximum). The benefit is paid until the youngest child reaches 16 or marries or until the surviving spouse dies or remarries.

4. Medicare Benefits

The Medicare hospital insurance (HI) portion of Medicare, also known as Part A, is largely funded by the 2.9 percent HI tax on earnings. Part A is compulsory insurance. Part B of the Medicare program, supplemental medical insurance (SMI), is financed by premiums paid by participants and by federal government funding.

Individuals who are at least age 65 and who are eligible for Social Security retirement benefits on their own behalf are entitled to coverage under Medicare Part A. If the individual has applied

for Social Security retirement benefits, no separate application is required. If the individual continues to work after age 65 and is not receiving Social Security benefits, an application must be filed in order for the individual to receive Medicare Part A coverage. Recipients of disability benefits are eligible for Part A coverage after they have been eligible for disability benefits for 24 months.

Survivors and dependents of individuals who are entitled to Part A coverage must be at least 65 years old to be eligible for Part A coverage. U.S. citizens who are not eligible for Part A coverage but who are enrolled in Part B may pay a monthly premium to enroll in Part A. Individuals are automatically enrolled for Part B coverage when they become eligible for Part A coverage. Part B coverage can be waived by completing the necessary forms. Any individual may enroll in Part B coverage if he or she is at least age 65 and has been a citizen or resident for five years.

Answer Frequently Asked Questions about Social Security

There is a great deal of important information about Social Security that may be of interest to you. The following are a few of the more frequently asked questions and their answers.

If I have a full-time job and I have a small business on the side, how much do I pay for Social Security? If you have both a full-time job and you have a small business on the side, no more than $132,900 of your combined earnings is subject to the FICA tax in 2019. However, any additional wages are subject to the Medicare tax.

How does Social Security account for the increasing cost of living expenses? Benefits are increased annually on January 1 to reflect increases in the cost of living.

Do unearned income and asset ownership affect how much one pays in Social Security? Unearned income, such as interest earned on investments and assets, has no effect on eligibility for Social Security benefits.

How does earned income affect Social Security before age 65? Earned income has an effect on retirement benefits and survivor benefits paid to individuals who are under age 65 if such earnings exceed their earnings limitations. When individuals begin to take advantage of retirement benefits, the earnings limit is applied as a monthly amount in the months preceding the 65th birthday.

How do I qualify for benefits? To qualify for full benefits, you must meet the quarters-of-coverage requirement, which means you must earn at least the required minimum during each calendar quarter (every three months). For 2019, the quarters-of-coverage minimum was $1,360. You need to meet this minimum for at least 40 quarters to qualify for full benefits; this is equivalent to 10 years of work. Earning beyond 40 quarters will not increase your benefits.

What is an annual Social Security statement, and when will I receive it? An annual Social

Security statement shows your quarters-of-coverage credit, the amount you have paid in Social Security taxes, and the amount of your estimated benefit. You must be at least 18 years old to receive a statement. The statement is sent to you each year three months before your birthday, or may be reviewed online at www.ssa.gov.

How can I apply to receive benefits? You can complete the application process at a Social Security office, over the telephone, or via the Internet. When you apply, you may need to show verification of your age by providing your birth certificate or your Social Security card.

When will I receive my retirement benefits? Benefits are paid once a month on either the second, third, or fourth Wednesday of the month, depending on your birth date. You can choose to receive your payment as a check or through direct deposit.

Do I have to pay federal income taxes on my retirement benefits? About 20 percent of those who receive Social Security benefits must pay some federal taxes on the benefit, when they earn substantial income (including pension and wages) in addition to the Social Security benefit. See an accountant to discuss your personal situation.

Describe the Future of Social Security

The Social Security program is currently collecting more money than it is paying out. In 2012, the program collected $840.2 bn (versus $784.9 bn in 2007) and paid out $785.8 bn in benefits ($495.7bn in 2007) to 56.8 mn people (54.7mn).[3]). Note that income is growing 1.4% per year over this period and expenses are growing 9.7% over the same period.

Today, it is estimated that there are 2.8 workers per recipient of Social Security (see Chart 1). However, by the year 2075, it is estimated that there will be only 2.0 workers per recipient of Social Security. Clearly, the program must undergo some changes to accommodate this major shift in demographics.

According to government projections, Social Security benefits can be paid solely from tax revenues until 2015. From 2016 to 2025, Social Security benefits will likely have to be paid with the interest from government bonds. From 2026 to 2033, the Social Security Trust Fund may have to redeem its bonds to pay Social Security benefits. Current projections estimate that Social Security funds will be exhausted in 2033.

Plans and Strategies for Social Security

Following are a few ideas of plans and strategies for Social Security, part of your Retirement Plan. We have developed Social Security Spreadsheet (LT36) to help as you calculate your Primary Insurance Amount, Family Maximums, Spouse's benefits, Children's benefits, as well as determine your breakeven years for taking different benefit options (see Breakeven tab).

As a starting point, you should have a rough idea of how long are you expecting to live. I recommend you take some life expectancy quizzes to help you in this area. With this information, you would take benefits earlier than later if:

- You do not expect to live to the Social Security determined life expectancy
- You are no longer working and can't make ends meet without benefits
- You are in poor health, and don't expect to live to an average life expectancy
- You are the lower earning spouse and the higher-earning can wait to file for higher benefit.

You would take benefits later than sooner if:

- You are in good health and expect to live longer than the normal social security determined life expectancy
- You are still working and make enough to impact the taxability of benefits (at least wait till FRA so your benefits are not further reduced)
- You are the higher earning spouse and want to be sure your surviving spouse received the highest possible benefit.

Using Social Security Spreadsheet (LT36), you can determine your breakeven age, the point where if would be more beneficial for you to wait to take benefits, based on your age, full retirement age, and your NPV assumptions including cost of living adjustments and interest rates. Again, this is an approximation only.

Following are Social Security plans and strategies for the accumulation, retirement and distribution stages.

Plans and Strategies

Accumulation

- If health is poor, life expectancy low, or needs are great, begin taking benefits as soon as possible
- Continue to work and contribute to the SS system as benefits are based on top 35 earning years
- If possible, don't take benefits before full retirement age as there is a tax penalty on benefits if your earnings are above a specific amount before FRA
- If needed, you can take benefits up to 5 years before FRA; however, once you start taking benefits you cannot change that choice!

Retirement

- The higher-earning spouse should take retirement as late as possible. This would increase benefit and would maximize the amount the lower-earning spouse would have after the higher-earning spouse passes. Once the higher-earning spouse passes, the remaining spouse receives the higher of their amount or the higher-earning spouses amount

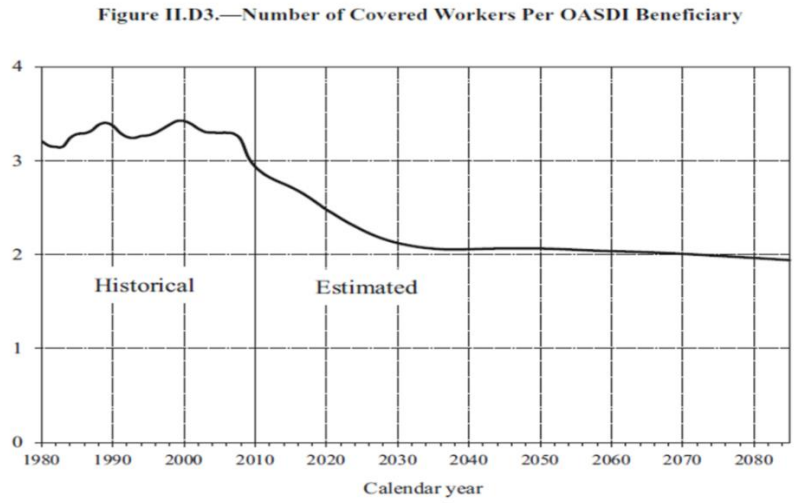
- If possible, don't take benefits before full retirement age as there is a tax penalty on benefits if your earnings are above a specific amount before FRA

Distribution

- Try to defer taking benefits as long as possible, especially if you expect to live longer than the SS system determined average.
- The longer you delay taking benefits, the greater your monthly benefit (up to 3 years beyond FRA)
- If you have extra money left over, roll over excess amounts into a Roth IRA to use later.

Summary

Chart 1: Number of Workers per OASDI Beneficiary[4]



Source: 2011 Social Security Trust Fund Reports, http://www.ssa.gov/oact/tr/2011/tr2011.pdf

For many of the 40 million Americans who are 65 and older, Social Security is the primary source of retirement income. However, most young Americans, who will not face retirement for many years, might not have access to the benefits of the Social Security program, at least not in its present form.

The Social Security program was designed to be a pass-through account; this means that the taxes you pay for Social Security (through the Federal Insurance Contribution Act, or FICA) are used to pay benefits to those who are currently retired, disabled, widowed, or orphaned. Because there are currently more people paying into Social Security than there are people receiving Social Security benefits, the tax reserves are maintained in interest-earning government bonds held by the Social Security Trust Fund. There was no investment or savings component to Social

Security when it was originally set up because the government assumed there would always be enough people in the working generation to pay for the retired generation's benefits.

Social Security should be the first component of your retirement plan, but it should not be the only one. To fully understand how Social Security can benefit you, you must understand what Social Security is, what Social Security does, and how your benefits will be calculated. You must also realize that the program is in transition and that you should include other retirement resources in your retirement plan accordingly.

Assignments

Financial Plan Assignments

Your assignment is to learn about the benefits you will receive from Social Security. Get a copy of your Social Security statement benefits by going to www.ssa.gov. Click on *Get a Copy of your Social Security Statement Online* near the middle left of the page, and then click on *Sign in or Create an Account*. Fill out your name, middle initial, last name, social security number, birthday, and other information that is requested. Follow the on screen instructions, and they will send you a copy of your Social Security statement. Use this statement as you work to determine how much you will need for retirement.

Learning Tools

The following learning tools may also be helpful as you prepare your Personal Financial Plan:

Retirement Planning Needs Spreadsheet (LT06)
: This Excel spreadsheet helps you determine how much you must save each month to achieve a specific lifestyle at retirement based on the following estimates: years until retirement, expected return, inflation, and tax rates.

Retirement Planning Ratio Forecasts (LT25)
: This Excel spreadsheet helps you determine where you are in your progress towards achieving your retirement goals. By inputting the relevant information, you can determine whether you are on track for reaching your retirement goals based on your age and your income.

Social Security Spreadsheet (LT36)
: This spreadsheet helps you calculate your Primary Insurance Amount and Maximum Family benefit from your Average Indexed Monthly Earnings, and how much you will receive at various ages. It also shows how the bend points have changed over time.

Review Materials

Terminology Review

Average Indexed Monthly Earnings (AIME). The average lifetime earnings indexed for inflation is your top 35 highest earning years. It entails adjusting each year's earnings total to reflect its value in the year in which eligibility is requested.

Bend Points. Calculating your PIA from AIME is divided into three calculations called "bend points" because the formula, when graphed, appears as a series of line segments joined at these amounts. These bend points change year to year.

Child's Benefit. Any child who is under 18 (19 if still in high school), is eligible for a benefit of 50% of the retired workers PIA, subject to a family maximum. Child's benefits terminate at age 18, marriage, or death. The dependent child of a fully or currently insured worker will receive a benefit of 75% of the worker's PIA (subject to family maximum) if the child is under age 18 (or age 19 is a full-time high school student), or is over age 18 and has been disabled since before age 22, and is not married.

Currently Insured Status. To be "currently insured", you must have at least 6 quarters of coverage in the previous 13 quarter period. Currently insured is adequate for eligibility for survivor benefits paid to children and for a surviving spouse caring for a qualifying child. Eligibility for other benefits generally requires fully insured status or 40 quarters of coverage

Delayed Retirement Credit. Delaying payment beyond full retirement age results in a benefit increase for each year of delay. With a delay the worker's PIA is not increased and the benefits to family members is not increased.

Disability Benefits. Workers who qualify for disability benefits are entitled to 100% of PIA until the earliest of the following: disability ends: benefits are terminated in the second month after the end of disability, or the workers dies: benefits are terminated in the month prior to the month the worker dies. If the worker attains full retirement age: disability benefits convert to retirement benefits.

Disabled Child. The disable child of a retired or disable worked is entitled to benefits past age 22 if the disability began before age 22.

Full Retirement Age (FRA). This is the age at which a retiree will receive 100% of their entitled benefits. Receiving benefits prior to FRA will result in a reduction in benefits. Receiving benefits after FRA will result in an increase of benefits.

Insured Worker. A worker is only entitled to receive benefits if that worker is fully insured. Workers are considered fully insured if they have worked forty quarters of work (a quarter is three months) and earned a specific amount of money per quarter.

Low Income Filer. This is a single filer with provisional income below $25,000 or married filing jointly (MFJ) with income below $34,000. None of the benefits are taxable.

Lump Sum Benefit. A lump sum of $255 is available to the surviving spouse, nonresident spouse, or to children eligible for the monthly benefits (for 2018).

Maximum Family Benefit. When benefits are payable to more than one family member, a family maximum applies. This includes all benefits paid to the family. For disability, the family maximum is the lesser of 150% of the workers disability benefit or 85% of the AIME used to calculate the benefit, but is not less than the benefit paid to the worker. When the worker is living, and benefits exceed the family maximum, the worker's benefit is not adjusted; rather, the reduction is made in other beneficiaries' payments.

Medicare Benefits. Medicate hospital insurance (HI) portion of Medicare, also known as Part A, is largely funded by the 2.9% HI tax on earnings. Part A is compulsory. Individuals at least age 65 and eligible for Social Security retirement benefits on their own behalf are entitled to coverage under Medicare Part A. If the individual has applied for Social Security (SS) retirement benefits,

no separate application is required.
Middle Income Filer. This is a single with income from $25,000 to $34,000 and MFJ with income from $32,000 to $44,000. Up to 50% of social security benefits are taxable.
Mother's or Father's Benefit. The surviving spouse of a fully or currently insured worker is eligible to receive a benefit of 75% of the worker's PIA if they are caring for a child who is under age 16 or who was disabled before age 22 (subject to family maximum).
OASDI – HI (Old Age, Survivors, and Disability Insurance and Hospital Insurance). This is payment for Social Security and Medicare taxes. The employee and employer each pay (assuming your Adjusted Gross Income (AGI) is less than $250,000: Social security tax (OASDI) of 6.20%, Medicare tax (HI) of 1.45%, for a total of 7.65% each. Self-employed individuals pay the whole 15.30%. OASDI-HI taxes are on taxable wages including wages, salaries, bonuses, commissions, value of employer provided meals/lodging, sick pay during first 6 months, employer paid group life insurance premiums in excess of $50,000, salary reduction from 401k, 403b, 457 plans, non-qualified deferred compensation no longer at risk, non-qualified stock options, vacation pay, and severance pay.
Primary Insurance Amount (PIA). Your PIA is the basic unit used to express the amount of a worker's benefit if they received benefits at their full retirement age (FRA). The calculation of PIA is based on the workers AIME, which is split into three segments and multiplied by specific percentages for each segment and summing the parts.
Retirement Benefits. Retirement benefits can either be reduced or increased depending on your PIA, your FRA and the date when benefits begin. You can begin receiving benefits as early as age 62. Benefits that begin 3 years before FRA will be reduced by a maximum of 20% (or 5/9% of 1% per month for each month benefits begin before FRA or 6.67% per year). Additional reductions of 5% per year are effective when FRA exceeds age 65.
Social Security. Social security is a government provided retirement, survivor, and disability benefits. Franklin D Roosevelt signed the Social Security Act in 1935 to Aid the displaced and out of work. Social Security is a pass-through account, which means that FICA taxes being paid by current workers provided the money for benefit payments to current retirees.
Spouses benefit. A fully insured worker's spouse age 65 (FRA) is eligible to receive a retirement benefit of 50% of the worker's PIA subject to the family maximum. This benefit is reduced by 25/36% of 1% for each of the first 36 months that the spouse is under FRA (25% for 3 years). Once the FRA > 65, a reduction of 5/12 of 1% is imposed for each month beyond 36 months the spouse is under the FRA. The reduction of benefit from early retirement will not affect the amount of the spouses benefit. Disability benefits for spouses are 50% of the worker's PIA, reduced if the spouse is under FRA, subject to a family maximum amount.
Supplemental medical insurance. The SMI portion of the Medicare program (Part B) is financed by premiums paid by participants and by federal government funding. Participation in Part B is voluntary.
Survivor Benefits. Deceased worker must had had fully insured status; other survivor benefit (mother's or fathers' child's lump sum) will be paid to eligible survivors of a fully or currently insured worker
Upper Income Filer. These are singles with income above $34,000 and MFJ with income above $44,000. 85% of Social Security benefits are taxable.
Widow(er)'s Benefits. A benefit of up to 100% of the deceased, fully insured PIA will be paid to the surviving spouse who is at least age 60 and who was married to the worker for 9 months. The surviving spouse is generally eligible if he or she is not remarried and is not entitled to retirement benefits (due to his or her covered employment) of at least the amount of the deceased workers

PIA. A widowers benefit terminates at death or at eligibility for an equal or greater retirement benefit.

Review Questions

1. What is the primary source of income for adults 65 and older? Is this a reliable source for the future?
2. What two people/entities finance Social Security and Medicare? What percentage does each pay?
3. What does it take to be fully insured in the Social Security program?
4. To which four classes of people are retirement benefits available?
5. Why is it advantageous to wait until you are 70 before withdrawing money from your social security account?

Case Studies

Case Study 1

Data

Bill was born in 1940. He plans to retire and begin receiving Social Security benefits at age 68 and 6 months. His AIME is $2,072, his PIA is $1,200 and he knows that his PIA will be increased by 7% for each year beyond FRA he takes retirement. His FRA is 65 and 6 months.

Calculations

What is his retirement benefit at 3 years beyond FRA?

Case Study 1 Answers

Since Bill was born in 1940, his full retirement age is 65 years and 6 months. At 68 years and 6 months, he would be three years beyond his FRA. He would have a benefit of 7.0 percent per year for waiting beyond his FRA to retire.

His retirement benefit is 3 * 7.0% = (21% + 1) * $1,200 = ?

He would receive $1,452 per month for a retirement benefit.

LT36

Tax Year	2019	FRA	65 + 6 mo.
Birth Year:	1940	Additional %	7.0%
Calc. Spouse's Benefit (50% of workers PIA)			No

Average Indexed Monthly Earnings (AIME)			$ 2,071.6
Weights:	SS Limits	Difference	Amounts
90%	926	926	833.40
32%	5,583	1,146	366.60
15%		-	-

Worker's Primary Insur. Amt. (PIA)	$ 1,200.00

Worker Period:	Age Begin SS Benefits	Monthly Payments
FRA - 5	60 + 6 mo.	840
FRA - 4	61 + 6 mo.	900
FRA - 3	62 + 6 mo.	960
FRA - 2	63 + 6 mo.	1,040
FRA - 1	64 + 6 mo.	1,120
FRA	65 + 6 mo.	1,200
FRA + 1	66 + 6 mo.	1,284
FRA + 2	67 + 6 mo.	1,368
FRA + 3	68 + 6 mo.	1,452

Case Study 2

Data:

Steve was born in 1960 and is thinking about perhaps retiring at age 62. He knows that his full retirement age is 67. He also knows that if he begins retirement 3 years before his FRA his AIME will be reduced by 20% and for each year before that, it will be reduced by 5%.

Calculations:

A. How much in percentage terms would his PIA be reduced if he was to begin receiving Social Security benefits at age 62?

B. If his AIME was $2,072 and his PIA was $1,200, how much would he receive each month if he retired at age 62?

Case Study 2 Answers

Bill's benefits would be reduced by 5/9 percent per month for the first 36 months prior to age 67 (20 percent for three years) and 5/12 percent for each month after those three years (5 percent per year for each year after that).

A. Calculate the benefit Bill would receive if he was to retire at age 62:

5/9 percent x 36 months =	20%
5/12 percent x 24 months =	10%
Total reduction in payments =	30%

B. Bill would receive 1,200 x .7 (1 – 30%) or $840 each month.

LT36

Tax Year	2019	FRA	65 + 6 mo.
Birth Year:	1940	Additional %	7.0%
Calc. Spouse's Benefit (50% of workers PIA)			No

Average Indexed Monthly Earnings (AIME)			$ 2,071.6
Weights:	SS Limits	Difference	Amounts
90%	926	926	833.40
32%	5,583	1,146	366.60
15%		-	-
Worker's Primary Insur. Amt. (PIA)			$ 1,200.00

Worker Period:	Age Begin SS Benefits	Monthly Payments
FRA - 5	60 + 6 mo.	840
FRA - 4	61 + 6 mo.	900
FRA - 3	62 + 6 mo.	960
FRA - 2	63 + 6 mo.	1,040
FRA - 1	64 + 6 mo.	1,120
FRA	65 + 6 mo.	1,200
FRA + 1	66 + 6 mo.	1,284
FRA + 2	67 + 6 mo.	1,368
FRA + 3	68 + 6 mo.	1,452

Case Study 3

Data

Sam was born in 1955 (FRA is 66 and 2 months), and his wife Ann was born in 1958 (FRA is 66 and 8 months). They plan to both begin receiving Social Security benefits when Ann reaches full retirement age (Sam will be three years beyond FRA; the percentage increase is 8 percent per year beyond FRA).

Calculations

A. Assuming Sam's PIA is $1,500, and Ann's PIA, because she has worked in the home, is only $600, how much would each receive at retirement?

B. What would is the combined amount they would receive each month?

Case Study 3 Answers

A. Since Sam was born in 1955, his full retirement age is 66 years and 2 months. At Ann's FRA of 66 and 8 months, Sam would be three years beyond his FRA. He would have a benefit of 8 percent per year of for waiting beyond his FRA for retirement.
His retirement benefit is 3 * 8.0% = (24% + 1) * $1,500 = ? or $1,860 per month.
His wife would receive the higher of half her spouse's PIA (before the increase) of $1,500 / 2 or $600, whichever was higher, subject to the family maximum. In this case she would take the $750.

B. Their combined benefit would be $1,860 + $750, or $2,610, per month.

<u>Case Study 4</u>

Data

Jenny and Steve were married for 15 years when Steve passed away. They have four children, all under age 12. Steve was a currently insured worker and had an AIME of $2,072 and a PIA of $1,200 when he passed away. The family maximum amount was $1,820.

Calculations

A. How much would Jenny receive from Social Security survivor benefits to help her raise her children after Steve's death?

B. How much would the children receive?

Case Study 4 Answers

A. Since Steve was a currently insured worker, Jenny would receive 75 percent of his PIA regardless of her age as there are children in the home under age 18. Jenny's survivor benefit would be 75 percent of Steve's PIA of $1,200, or $900 per month.

B. The children's benefit would also be 75 percent of Steve's PIA.
However, because Jenny had already received $900, the four children would only receive together the difference up to the family maximum of $968 ($1,868 family maximum less the $900 for Jenny), rather than 75 percent per child.

LT36

Tax Year	2019	FRA	65 + 6 mo.
Birth Year:	1940	Additional %	7.0%
Calc. Spouse's Benefit (50% of workers PIA)			No

Average Indexed Monthly Earnings (AIME)			$ 2,071.6
Weights:	SS Limits	Difference	Amounts
90%	926	926	833.40
32%	5,583	1,146	366.60
15%		-	-
Worker's Primary Insur. Amt. (PIA)			$ 1,200.00

Worker Period:	Age Begin SS Benefits	Monthly Payments
FRA - 5	60 + 6 mo.	840
FRA - 4	61 + 6 mo.	900
FRA - 3	62 + 6 mo.	960
FRA - 2	63 + 6 mo.	1,040
FRA - 1	64 + 6 mo.	1,120
FRA	65 + 6 mo.	1,200
FRA + 1	66 + 6 mo.	1,284
FRA + 2	67 + 6 mo.	1,368
FRA + 3	68 + 6 mo.	1,452

Calculating Family Maximum from your PIA - Survivor Benefits
Using Bend Points for 2019

Primary Insurance Amount (PIA)			$ 1,200.00
Weights:	SS Limits	Difference	Amounts
150%	1,184	1,184	1,776.00
272%	1,708	16	43.52
134%	2,228	-	-
175%	-	-	-
Maximum Family Benefit			$ 1,819.52

Survivor Benefits:

- Spouse: 75% of PIA with kids < 18
- Children: 75% of PIA, subj. to max

Calculations:

Spouse's Benefit (75% PI	$ 900
Child #1 Benefit (75% PI	900
Other Children's Benefit (	20

Case Study 5

Data

Jenny and Steve are both beyond FRA and received $11,000 in social Security benefits in 2019. Their AGI (taxable pensions, wages, interest and dividends) was $22,500. They had $1,500 in tax-exempt interest income from a mutual fund. (Remember provisional Income (PI) is your AGI (before Social Security) + tax-exempt interest + 50% of your Social Security benefits)

Calculations:

- A. Calculate their provisional income (Married Filing Jointly)
- B. How much of that $11,000 is taxable?

Case study 5 Answers

Low Income: Benefits not taxable

Single filer with PI < $25,000 ($32,000 MFJ)

Middle Income: Up to 50% of benefits taxable

Single filer with PI from $25,000 to $34,000 ($32,000 to $44,000 MFJ)

Upper Income: 85% of benefits taxable

Single filer with PI > $34,000 ($44,000 MFJ)

Their provisional income is $22,500 + $1,500 + ($11,000/2) = $29,500

Since they are married filing jointly, the $29,500 is less than the $34,000 base amount. Therefore, none of the benefits are taxable.

Case Study 6

Data:

Bob has an AIME of $5,500 per month.

Calculations

a. Based on 2019 bend points of $926 and $5,583, what would Bob's PIA be (his PIA is calculated from his AIME)? Remember the weights are 90% of the first bend point, 32% of the second and 15% of the remainder.

Case Study 6 Answers

a. Calculating Bob's PIA from his AIME in 2019 is divided into three calculations called "bend points"

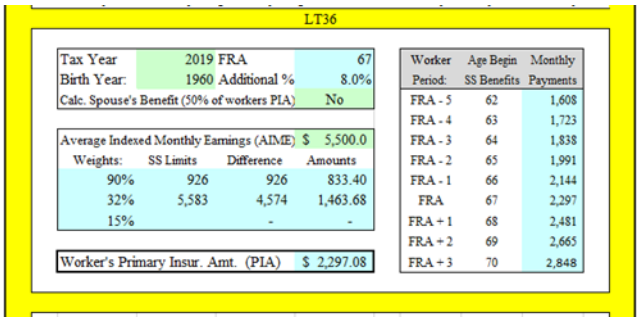
1. 90% of the amount for the first $926
2. 32% of earnings from $926 - $5,583, and
3. 15% of earnings above $5,583

Since Bob's AIME was $5,500 per month, the amount is:

90% of $926 or	$833.40
32% of $5,583 - $926 ($4,574) or	$1,463.68
15% of $5,500 - $5,583 ($0) or	$0.00
Bob's total PIA would be	$2,297.08

This is the sum of each of the bend calculations

This is the sum of each of the bend calculations



LT36

Tax Year	2019	FRA	67
Birth Year:	1960	Additional %	8.0%
Calc. Spouse's Benefit (50% of workers PIA)			No

Average Indexed Monthly Earnings (AIME)			$ 5,500.0
Weights:	SS Limits	Difference	Amounts
90%	926	926	833.40
32%	5,583	4,574	1,463.68
15%		-	-

Worker's Primary Insur. Amt. (PIA)	$ 2,297.08

Worker Period:	Age Begin SS Benefits	Monthly Payments
FRA - 5	62	1,608
FRA - 4	63	1,723
FRA - 3	64	1,838
FRA - 2	65	1,991
FRA - 1	66	2,144
FRA	67	2,297
FRA + 1	68	2,481
FRA + 2	69	2,665
FRA + 3	70	2,848

Case Study 7

Data:

Bob, born in 1972, has an AIME of $5,397 and a PIA of $2,246 per month.

Calculations

a. Based on 2019 family bend points, what would his family maximum be (the family maximum is calculated based on his PIA)? (For calculating family maximums, the weights are 150% of the first bend point, 272% of the second, 134% of the third, and 175% over the third bend point using the PIA).

Case Study 7 Answers

a. Calculating Bob's family maximum benefits in 2019 from his PIA is divided into four calculations

1. 150% of the amount for the first $1,184
2. 272% of earnings from $1,708 - $1,184
3. 134% of earnings from $2,154 - $1,708, and
4. 175% of earnings over $2,154

Since Bob's PIA was $2,246, the family maximum would be:

150% of $1,184 or	$1,776.00

272% of $1,708 - 1,184 ($524) or $1,425.28
134% of $2,154 - $1,708 ($520) or $696.80
175% of $2,246 - $2,154 ($36) $63.21
His family maximum amount would be $3,961.29

Calculating Family Maximum from your PIA - Survivor Benefits
Using Bend Points for 2019

Primary Insurance Amount (PIA)			$ 2,264.12
Weights:	SS Limits	Difference	Amounts
150%	1,184	1,184	1,776.00
272%	1,708	524	1,425.28
134%	2,228	520	696.80
175%	2,264	36	63.21

Maximum Family Benefit	$ 3,961.29

Survivor Benefits:

- Spouse: 75% of PIA with kids < 18
- Children: 75% of PIA, subj. to max

Calculations:

Spouse's Benefit (75% PI	$ 1,698
Child #1 Benefit (75% PI	1,698
Other Children's Benefit (	565

Case Study 8

Data:

Bob was born in 1960, has an AIME of $5,397 and a PIA of $2,264 per month. Assuming no time value of money (no interest rate) and no cost of living adjustment (COLA), after what breakeven age would it be more beneficial for Bob to wait for FRA+3 than to retire at his full retirement age.

Hint: Use Social Security Spreadsheet (LT36)

Social Security Benefits (LT36.2)
Breakeven Point for When to Take Benefits
Note: This does not take into account taxes on benefits

Graph Inputs:	
Tax Year	2019
Birth Year	1960
Primary Insurance Amount (PIA)	2,264
Interest Rate	0.0%
Cost of Living Adjustment (COLA)	0.0%

Retirement Age:		
Full Retirement Age (FRA)		67
Additional % beyond FRA		8.0%
Chosen Periods:		**Age:**
Chart #1 (Blue)	FRA-5	62
Chart #2 (Orange)	FRA+3	70
Breakeven Age		80

[1] Carolyn Davis, Acting Commissioner, as printed in individual Social Security Statements, January 2, 2014 from http://www.ssa.gov/myaccount/materials/pdfs/SSA-7005-OL.pdf
[2] http://www.ssa.gov/oact/COLA/bendpoints.html, August 14, 2014.
[3] 2011 Social Security Trust Fund Report of the Social Security Administration, 2011.
[4] Source: 2011 Social Security Trust Fund Reports, http://www.ssa.gov/oact/tr/2011/tr2011.pdf.

29. Retirement 3: Understanding Employer-Qualified Plans

Introduction

Employer-qualified retirement plans, also called employer-sponsored retirement plans, are the second source of income you should consider when planning for retirement. You can think of the payouts from these plans as a series of delayed payments you will receive during retirement for work you performed prior to retirement. There are many varieties of employer-qualified retirement plans; these plans can be an important part of your overall retirement plan.

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 require employee contributions that are employer matched. Employer-qualified retirement plans provide free money, which should be the highest priority for your retirement and investment funds.

Objectives

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

A. Understand employer-qualified retirement plans
B. Understand defined-benefit plans
C. Understand defined-contribution plans
D. Understand plans and strategies for employer qualified plans.

Understand Employer-Qualified Retirement Plans

There are many reasons why companies offer qualified retirement plans, including a desire to be competitive. Since most companies offer a qualified retirement plan, a company that does not is at a disadvantage. Most companies must offer benefits to attract and retain qualified personnel.

Money set aside in qualified plans has specific tax advantages. These tax advantages make retirement plans especially attractive to companies. Companies may be motivated to offer qualified retirement plans because the company owner may wish to use them to save money for retirement in a tax-efficient manner. These funds offer tax advantages to the company and may be tax-deferred for the employee as well.

Concern for employees may also be a reason that companies offer qualified retirement plans. Companies may reason that the better prepared for retirement employees are, the better the employees will perform their work.

There are two main types of employer-qualified retirement plans: defined-benefit plans and defined-contribution plans. Defined-benefit plans provide a predetermined payout based on specific employee data, such as years of employment and annual salary. With defined-benefit plans, the company bears most of the risk associated with funding a specific amount each year. Defined-contribution plans are investment plans in which both the employee and the employer contribute funds to the plan; the amount contributed by the employer is generally fixed. With defined-contribution plans, the employee bears most of the risk involved in funding the plan. Table 1 lists the major types of defined-benefit and defined-contribution plans.

Table 1. Retirement Plan Characteristics

Characteristic	Defined-Benefit	Defined-Contribution
Employer's contribution	Actuarially determined	Specified by formula
Benefit amount	Certain	Uncertain
IRC limit applicable	Maximum	Contributions
Types of benefits funded	Defined-benefit Cash balance	Profit sharing ESOP Stock bonus Target benefit Money purchase Employee contribution

Because of the tax advantages, there are limits to the amounts of money that may be contributed to defined-benefit and defined-contribution plans. These limits are set forth in Code 415 of the Internal Revenue Code. See Table 2 for the Code 415 contribution limits for 2018.

Table 2. Internal Revenue Code Limits in 2019

Plan Type	Participant Limit	Employer Limit
Defined-contribution:	100% or $56,000 (indexed) if less	25% of participant's total compensation
Defined-benefit:	100% or $225,000 (indexed) if less	Amount necessary to fund compensation
Profit-sharing:	100% or $56,000 (indexed) if less	25% of participant's total compensation

There are also limits to the types of retirement plans that can be used by different types of business entities. For a list of types, see Chart 1.

In recent years, there has been a significant shift away from defined-benefit plans and toward defined-contribution plans. Even companies that continue to offer defined-benefit plans have

tried to reduce their risk by reducing benefits. This change suggests that companies are shifting the responsibility of retirement planning onto individual employees. Because of this change, it is critical that you understand qualified retirement plans and make retirement planning an important part of your personal investment plan.

Chart 1. Business Forms and Retirement Plans

	Defined Benefit Plans		Defined Contribution Plans								
			Discretionary Contribution			Fixed Contribution		Employee Contribution			
Entity	Defined Benefit	Cash Balance	Profit Sharing	Stock Bonus ESOP	Money Purchase	Targt Benefit	Thrift Savings	Section 401k Provisions	TSA 403B	457 Plan	SIMPLE and SEP-IRA
C Corp.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
S Corp.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes
Prof. Corp.	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
Partnership	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	No	No	Yes
Sole Prop.	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	No	No	Yes
Tax-exempt	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Public School	Yes	Yes	Yes	No	Yes	Yes	Yes	No	Yes	Yes	Yes
S/L Govt.	Yes	Yes	Yes	No	Yes	Yes	Yes	No	No	Yes	Yes

Explain Defined-Benefit Plans

A defined-benefit plan (DBP), also called a pension plan, is a retirement plan funded entirely by an employer; the employee does not contribute to this type of plan. At retirement, the employee is promised a specific payout amount that is calculated using a formula set by the company.

Advantages and Disadvantages

One advantage of defined-benefit plans is that they often pay out a large percentage of an employee's final salary—as much as 30 to 50 percent—thereby making a significant contribution to that employee's retirement plan. Since you as the employee do not contribute to the plan, you bear no investment risk. Sometimes the benefits of these plans can even be extended to a spouse, depending on the type of retirement payout you choose.

There are also disadvantages of defined-benefit plans. One disadvantage is that the payout benefits are considered taxable income, and taxes can significantly diminish your net benefit. Another disadvantage is that your company can change its plan policies over time—even after you retire—so there is no guarantee your benefits will remain constant. Moreover, most plans require you to stay with the company for a specific length of time to become fully vested, or in other words, fully eligible for benefits. If you quit or lose your job before retirement, you may

lose your benefits.

It is important for you to remember that 9 out of 10 defined-benefit plans do not provide for a cost of living adjustment (COLA). This means that inflation could significantly reduce your purchasing power during retirement. You should also be aware that some plans are unfunded, which means the company does not put aside the money to pay retirement benefits but instead pays retirement benefits out of the company's current profits. If the company does not make the necessary profits, you may not get your retirement benefits. Finally, if you die before retirement, your surviving spouse will likely receive a reduced benefit.

Payout Formulas

With a defined-benefit plan, the company uses a payout formula to determine how much you will receive at retirement. This formula usually includes variables such as retirement age, average salary, and years of employment.

The following example shows a payout formula used by XYZ Corporation. Assume XYZ Corporation uses the following steps to calculate an employee's annual retirement payout:

1. Averages the employee's five highest annual salaries within the last 10 years
2. Determines the employee's total years of employment
3. Multiplies the average salary by 1.5 percent and by the total years of employment—a maximum of 33 years

Bill Smith has worked for XYZ Corporation for 25 years. The average of his five highest salaries over the last 10 years is $60,000. Using this information, XYZ Corporation calculates his retirement benefit as follows: $60,000 * 0.015 * 25 = $22,500.

When Bill retires at the end of next month, he will begin receiving $22,500 each year for as long as he lives. This means that Bill will receive 37.5 percent of his average salary each year throughout his retirement.

Time and Salary

One reason a company might provide a defined-benefit plan is to encourage employees to stay with the company over the long term. In most cases, it is easier to retain a good employee than to hire and train a new employee. Providing a good retirement program is an important means by which companies retain good employees. Table 3 shows the payouts of a pension plan based on the amount of time an employee has stayed with a company; the payout is shown for two different salary levels.

Cash-Balance Plans

A cash-balance plan is a type of defined-benefit plan that credits your retirement account based on a certain percentage of your salary each year (usually between 4 and 7 percent) plus a predetermined rate of interest. Employees have no control over the way this money is invested. The difference between cash-balance plans and plans based on a formula is that cash-balance plans grow at a predetermined rate regardless of how much money is in the account.

Table 3. Payouts Based on Time and Salary

Years of Employment	Average Salary	Payout
10 years	$55,000	$8,250
	$72,000	$10,800
20 years	$55,000	$16,500
	$72,000	$21,600
30 years	$55,000	$24,750
	$72,000	$32,400

There are several advantages of cash-balance plans. First, like basic defined-benefit plans, these plans are noncontributory, which means that, as the employee, you do not contribute funds to this plan. Funds contributed to a cash-balance plan are free money. Second, the rate of return on a cash-balance plan is constant and guaranteed. Third, your retirement benefits are much easier to calculate because you know all of the variables and the guaranteed rate of return. Fourth, cash-balance plans are portable. If you are fully vested, you can take your principal and earnings with you when you move to another company. Fifth, cash-balance plans are much cheaper for the company because the percentage of your salary and the guaranteed rate of return are generally low; funding these plans is not as much of a financial burden or risk to the company. One major disadvantage to employees is that the actual payouts are generally lower than the payouts of basic defined-benefit plans.

Payout Options

When you retire, you must choose from among several options of how you would like to receive your distributions. These options determine how long you will receive payments, how long your spouse or beneficiary will receive payments after you die (not all options allow this), and how much you will receive each month or year. Table 4 shows several payout options that may be offered by your company. Since different options insure more people and have guaranteed payments, the conversion factor relates the present value of the estimated payments compared to the standard benefit. For example, if you chose the Joint and Survivor 100-percent annuity (10-year certain), you would receive 88 percent of the standard payment but would have the guarantee that both you and your spouse would receive payments for the rest of your lives, with a minimum 10 years guaranteed even if you both died within 10 years.

The standard benefit gives you equal monthly payments for as long as you live. If you die within 10 years of the date you retire, payments will continue to your beneficiary until the 10 years are up. If you choose the 20-year certain and life option, payments are guaranteed for 20 years. A life annuity guarantees payments only for as long as you live.

If you are married when you retire, federal law requires that, at a minimum, your benefit be paid according to the qualified joint and survivor annuity payment option. This option provides equal payments for as long as you live, and 50 percent payments to your spouse for as long as he or she lives. A surviving spouse may also be eligible to receive a 10-year certain or a 75 or 100 percent annuity, but, if you die before retirement, your spouse will usually be restricted to the qualified joint and survivor annuity option.

Table 4. Payout Options and Conversion Factors

Payout Option	Conversion Factor
Standard benefit (10-year certain and life)	1.00
20-year certain and life	0.92
Life annuity	1.02
Qualified joint and survivor annuity (50 percent and no-term certain)	0.95
Joint and survivor 50 percent annuity (10-year certain)	0.95
Joint and survivor 75 percent annuity (10-year certain)	0.91
Joint and survivor 100 percent annuity (10-year certain)	0.88

Learning about Your Company's Plan

You should ask a number of questions when investigating your company's retirement plan or when considering new employment. You should also get it in writing, as benefits may change over time. The following are questions you should ask about your company's plan:

1. Does the company provide a defined-benefit plan?
2. Is the payout based on your average salary, your final annual salary, or some other amount?
3. How long is the vesting period?
4. What formula does the company use to calculate benefits?
5. What is the normal retirement age?
6. What happens to your payout amount if you retire earlier than the normal retirement age?
7. Is there any advantage to working past age 65?
8. Will the payout include a cost of living adjustment (COLA)?

Defined-benefit plans can be an important part of your retirement plan. However, you must understand the plan—its benefits, drawbacks, and requirements—so that you can receive the maximum amount at retirement.

Explain Defined-Contribution Plans

With a defined-contribution plan (DCP), your employer contributes a specific amount to your retirement plan while you are working; when you retire, your employer is absolved of any further responsibilities. In a defined-contribution plan, both you and your employer generally contribute to the fund. Your pension is determined by how much both you and your employer invest each year, how fast the investment grows, and how many years your investment is able to grow.

Advantages and Disadvantages

For employees, the advantages of defined-contribution plans include that they have strong growth potential, they are portable, and they provide you with greater control. These plans are also tax-advantaged in the sense that the contributions and earnings are tax-deferred money. The main disadvantage of these plans is that there is no guarantee as to the actual amount of money you will receive at retirement; in other words, defined-contribution plans shift the risk from your employer to you.

For employers, defined-contribution plans are advantageous because they are easier to manage, they have fewer government regulations, they provide a greater number of investment choices, and they come in many different types. The disadvantage to employers is that these plans take time and resources to manage.

Types of Defined-Contribution Plans

There are three types of defined-contribution plans: discretionary (or optional) contribution plans, fixed contribution plans, and salary-reduction plans. In discretionary contribution plans, contributions are made at the discretion of the employer. In fixed contribution plans, contributions are fixed by the employer. And in salary-reduction plans, employees' contributions are made on a before-tax basis. Contributions to a salary reduction plan reduce the amount of the employees' taxable income and remain tax-deferred until retirement. In salary-reduction plans, you can direct your funds into various investment options, including fixed-income securities, equities, money market funds, and guaranteed investment contracts (GICs).

There are three main types of discretionary contribution plans:

> In a **Profit Sharing Plan**, the employer's contribution varies from year to year depending on the firm's profitability. There may be no contributions made if the company has an unprofitable year.
>
> **Stock Bonus Plans** are a type of profit-sharing plan in which employer contributions are made in the form of employer-owned shares of stock. Employee stock-ownership plans (ESOPs) and leveraged ESOPs (LESOPs) are the most common types of stock-bonus plans. In an employee stock-options plan, retirement funds are invested in company

stock. This is a very risky and non-diversified plan because both your retirement and your job are dependent on the same company. Since you are already an employee of the company, if the company does well, you will also likely do well, i.e., keep your job. If the company does poorly, you may lose your job, and the value of your company stock is likely to decline as well.

In a **Money Purchase Plan**, the employer contributes a percentage of the employee's salary each year.

There are two main types of fixed contribution plans:

In a **Thrift and Savings Plan**, the employer matches a percentage of the employee's contributions. These contributions are free money.

A **Target Benefit Plan** is a defined-contribution plan that has a required contribution level so that the employee will be able to meet a target level of benefits. Employers set this target level when an employee is hired, and the employer contributes to the plan each year to help the employee reach that level.

There are several types of salary-reduction plans. These plans are categorized according to the type of company that installs the plan and whether the plan uses before-tax or after-tax dollars for funding. The main types of salary reduction plans are 401(k) plans, Roth 401(k) plans, 403(b) plans, Roth 403(b) plans, and 457 plans.

401(k) plans are set up by a private company. In a 401(k), you contribute a percentage of your salary up to a specified amount ($19,000 in 2019 or $25,000 if you are over age 50, see Table 6), and the money grows in a tax-deferred account until you retire. Your employer may or may not contribute a matching amount (free money). Because this money is tax-deferred, you do not have to pay taxes on the money until you withdraw it after you reach age 59½.

In **Roth 401(k) plans**, you contribute a percentage of your salary. The maximum contribution amount is the same as for 401(k) plans (see Table 6). Roth 401(k) plans are unique in that you contribute to the fund using after-tax dollars, or money on which you have already paid taxes. These plans are beneficial because the money grows until you retire, and you never need to pay taxes on the earnings and capital gains again if you withdraw it after age 59½.

403(b) plans are basically the same as a 401(k) plan; however, 403(b) plans are specifically designed for employees of nonprofit, tax-exempt companies and institutions (for example, schools). The maximum contribution amount is the same as for 401(k) plans (see Table 6).

Roth 403(b) plans are basically the same as a Roth 401(k) plan; however, they are specifically designed for employees of nonprofit, tax-exempt companies and institutions. Contributions are made with after-tax dollars, and individuals are not required to pay taxes on withdrawals after individuals reach age 55. The maximum contribution amount is the same as for 401(k) plans (see Table 6).

457 Plans are basically the same as a 401(k) plan, but they are specifically designed for state and municipal workers. The maximum contribution amount is the same as for 401(k) plans (see Table 6).

Matching Plans

In a matching plan, the employer matches all or a percentage of the contributions you make to your retirement fund. Less than 80 percent of all 401(k) plans include a matching component. Note that with a Roth 401(k) or Roth 403(b) plan, the employer contribution is made on a before-tax basis and not an after-tax basis. Funds the employer provides as a match are held in a separate tax-deferred account; taxes must still be paid on the matched amount at retirement. Always get the match!

Vesting Requirements

Vesting is the process through which your employer's contributions to your retirement fund become your property. You will typically become fully vested, or gain full ownership of the contributions, after you have worked for the company for a certain number of years. For example, you may own 60 percent of the employer's contribution after two years, 80 percent after three years, and 100 percent after four years. Vesting schedules vary depending on the company. Matching contributions must be vested according to the cliff schedule, which means that after a specific number of years, you are immediately vested, or to the graded schedule, which means you are partially vested after a specific number of years, and the vesting increases each year (see Table 6).

Contribution Limits

An annual contribution limit is the maximum amount you can invest in a particular retirement vehicle each year. In a 401(k) plan, you cannot contribute more than 25 percent of your before-tax income, and this amount cannot exceed the annual limits in Table 7. Employer contributions may exceed this limit. Annual contribution limits gradually increase each year. In addition to the limits listed in Table 7, a "catch-up" limit is available for those over age 50. If you are over age 50, your annual contribution limits are the normal contribution limit (i.e., $19,000 in 2019) plus the additional catch up contribution limit of $6,000, which adds up to $25,000.

Tax Implications of Defined-Contribution Plans

If your company offers a defined-contribution plan, there are several tax implications you should be aware of:

- Retirement income is taxed as ordinary income.
- If you make withdrawals from your defined-contribution plan before age 59½, you will be charged a 10 percent penalty to principal and earnings (there are some exceptions).
- There is a 20 percent withholding requirement on withdrawals made before age 59½ from qualified plans. This means that if you withdraw $20,000 before age 59½, you will only receive $16,000. The pension plan will keep the remaining 20 percent to submit to the Internal Revenue Service for tax purposes.
- Certain loan provisions may apply.
- Mandatory annual distributions begin after age 70½.

Table 5. Vesting Schedule for Matching Plans

	401(k) Plans		403(b) Plans	
Year	Cliff	Graded	Cliff	Graded
1	0%	0%	0%	0%
2	0%	20%	0%	0%
3	100%	40%	0%	20%
4	100%	60%	0%	40%
5	100%	80%	100%	60%
6	100%	100%	100%	80%
7	100%	100%	100%	100%

Table 6. Annual Contribution Limits for 401(k) Plans, 403(b) Plans, and 457 Plans**

Year	Contribution Limit	Catch-Up Contribution Limit*
2014	$17,500	$5,500
2015	$18,000	$6,000
2016	$18,000	$6,000
2017	$18,000	$6,000
2018	$18,500	$6,000
2019	$19,000	$6,000

* Catch-up contribution is for those over age 50.

** 457 plan participants also have the option of increasing their deferrals to the lesser of twice the normal limit ($38,000 in 2019) or the normal limit not applied in previous years; this option may be exercised in the final three years before retirement.

Required Minimum Distributions

When saving for retirement, remember that the benefit of deferred taxes is offset by the fact that

you must eventually pay taxes on your principal and earnings. Defined-contribution plans that defer taxes require that minimum distributions must begin by April 1 of the year following age 70½. The distribution amount is calculated by dividing the account balance on December 31 of the previous year by the life expectancy. Note that there is a 50 percent penalty on minimum distributions that are not taken (see Table 7).

Payout Options

Payout options are the ways you can receive your money at retirement. You can receive a lump-sum distribution, an annuity, periodic payments, or you can roll the money into an individual retirement account (IRA).

A **Lump Sum Distribution** gives you full control over future investing and spending. The disadvantage is that taxes are due immediately on the full amount of the distribution. In addition, this type of distribution will not necessarily provide you with income throughout your retirement.

Table 7. Life Expectancy and Age

Age	Life Expectancy
70	27.4
71	26.5
72	25.6
73	24.7
74	23.8
75	22.9
76	22.0
77	21.2
78	20.3

An **Annuity**, which may be purchased either through an investment company or through an outside company, provides fixed payments, usually for life. However, an annuity does not usually provide a cost of living adjustment (COLA), and you must pay taxes on the amount you receive each year.

Periodic Payments provide you with fixed payments at regular intervals. However, this type of distribution does not ensure that you will receive income throughout your retirement because the money may eventually run out if you live longer than your planned periodic payments. Also, if payments are large, your tax rate may be quite high.

Rolling into IRA allows you to continue to defer taxes until you make withdrawals. Once the money is in an IRA, you can direct the investment of the funds even more than when the funds were in a 401(k) plan. The only disadvantage of this option is that you must begin making withdrawals at age 70½ or you will incur a penalty.

Making Use of Your Defined-Contribution Plan

Once you know which investment vehicle is available to you through your employer's defined-contribution plan, the next step is to choose the appropriate financial assets to include in this plan. Most people invest about 75 percent of their retirement assets in equities; in general, mutual funds provide good diversification opportunities. Refer to the unit on investing for help in determining which assets to include in your retirement vehicle. Most company plans offer about 10 investment options, although some plans offer significantly more.

As you make investment decisions, it is important to remember the principles of successful investing, the priorities of money, your investment horizon, your financial goals, and your risk-tolerance level. You should also consider other important issues, such as annual expenses, administration expenses, transfer fees, and reallocation options and costs.

Plans and Strategies for Employer Qualified Plans

As you put your Retirement Plan together, it is important to think through some plans and strategies. Examples include:

Plans and Strategies

Accumulation

- Live on a budget, save 20%, always get the company match
- Save 20% of every dollar, 15% into your Roth 401k, 3% for other goals, and 2% for children's mission and education
- Invest in Roth accounts while young and when rates are low. Use these to target your tax rate in retirement (to a low level)
- Even though you don't know future tax rates, maximize investments in Roths as you are saving more for retirement

Retirement

- Calculate a minimum level of retirement income, and annuitize that amount (if you have sufficient assets). The process is:
    - a. Calculate Social Security and defined benefit plan(s)
    - b. Determine your minimum amount needed to live on
    - c. Take a percentage of EQP assets at retirement to purchase an immediate annuity to give you the minimum amount needed to have your acceptable level of income
- Have both Roth and traditional retirement assets so you can target your tax rates in retirement
- Donate assets from your traditional 401k/403b to pay tithes and offerings to eliminate your capital gains

Distribution

- Have taxable (tax now), Roth (rarely taxed) and traditional (taxes later) vehicles to target your tax rate in retirement
- Set a target tax rate, then pull traditional assets up to that specific amount, then Roth assets afterwards to reduce taxes
- Make sure to pay your Required Minimum Distributions
- During your later years which your income is less, i.e., during missions, transfer money from your tax-deferred to tax-eliminated accounts. Use this time to move assets into Roth accounts with as little tax consequences as possible
- After age 69.5, donate assets from your traditional 401k/403b to pay tithes and offerings, to eliminate your capital gains, and to fulfill your required Minimum Distribution amounts

Summary

There are three main types of employer-qualified retirement plans: defined-benefit plans, defined-contribution plans, and salary-reduction plans. Defined-benefit plans provide a predetermined payout based on specific employee data, such as years of employment and annual salary. Defined-contribution plans are investment plans in which both the employee and the employer contribute funds to the plan; the amount contributed by the employer is generally fixed. In salary-reduction plans, employees contribute a percentage of their salary to retirement vehicles each period.

A defined-benefit plan (DBP), also called a pension plan, is a retirement plan funded entirely by an employer; the employee does not contribute to this type of plan. At retirement, the employee is promised a specific payout amount that is calculated using a formula set by the company.

With a defined-contribution plan (DCP), your employer contributes a specific amount to your retirement plan while you are working; when you retire, your employer is absolved of any further responsibilities. Both you and your employer generally contribute to the fund. Your pension is determined by how much both you and your employer invest each year, how fast the investment grows, and how many years your investment is able to grow. With salary-reduction plans, employees' contributions are made on a before-tax basis. Contributions to a salary reduction plan reduce the amount of the employees' taxable income and remain tax-deferred until retirement. In salary-reduction plans, you can direct your funds into various investment options, including fixed-income securities, equities, money market funds, and guaranteed investment contracts (GICs).

Assignments

Financial Plan Assignment

If you have an employer-qualified plan, talk to your employer. Find out as much information as

you can regarding your plan. What type of plan is it? Is it a defined-benefit plan or a defined-contribution plan, or does your employer offer both?

If your company offers a defined-benefit plan, what are the requirements for the plan? What factors are included in the payout formula (number of years working, average salary, percentage of salary, etc.)? How long must you be with the company to receive benefits? At what age can you begin receiving benefits? Based on today's earnings, how much will you receive each month during retirement?

If your company offers a defined-contribution plan, what type of plan is it? Does it have a company matching option (free money)? Are you getting your full company match each year? How much do you currently have in the plan? Where is that money allocated? Is the allocation consistent with your risk level and the fact that the funds are long term? Have you followed the principles of successful investing in terms of diversification, low costs, low risk, and other key factors? Are you rebalancing back to your target allocations in a timely manner? Become aware of this information because it is important to your retirement planning.

Learning Tools

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

Retirement Planning Needs Spreadsheet (LT06)
: This Excel spreadsheet helps you determine how much you must save each month to achieve a specific lifestyle at retirement based on the following estimates: years until retirement, expected return, inflation, and tax rates.

Retirement Planning Ratio Forecasts (LT25)
: This spreadsheet is an Excel template that will help you determine where you are in your progress toward achieving your retirement goals. By inputting the relevant information, you can estimate whether you are on track for reaching your retirement goals, based on your age and income.

Roth versus Traditional: Which Is Better for You (LT28)
: This Excel spreadsheet helps you determine whether the traditional IRA or the Roth IRA is a better investment vehicle for you to use in saving for retirement. Note that this shares the 8 questions you should answer in deciding which to choose (see also Roth versus Traditional Accounts).

Review Materials

Terminology Review

401k Plans or Roth 401k Plans. These are defined contribution plans where employees contribute a percent of salary up to a specified amount. Employers may contribute a matching

amount (free money) to encourage participation.
403b Plans or Roth 403(b) Plans (also called Tax Sheltered Annuities). These are defined contribution plans, and are the same as 401k but for non-profit tax-exempt companies and institutions (i.e., schools).
457 Plans. These are defined contribution plans, the same as 401k plans but for state and municipal workers and tax-exempt organizations.
Average compensation. The average of the years of salary considered in making the defined benefit calculation.
Cash-Balance Plans. A type of DBP in which provides specific annual employer contribution (generally 4-7%) each year, plus a low but guaranteed rate of investment earnings. Accounts grow at a predetermined rate, regardless of how much is in the account. Employees do not make any investment decisions.
Defined Benefit Pension Plans. A Defined Benefit Pension Plan is a DBP where payments are based on a benefit payout formula. The formula is based on your salary, years worked and a company determined factor to calculate how much you will get each year. Employees do not contribute and bear no risk.
Defined Contribution Plan (DCP). A retirement plan where the employer contributes a specific amount to the employee's retirement funds while the employee is working and then has no responsibilities once the employee retires. Employer contributes to a fund, and then has no additional obligation when the employee retires. Employee may also contribute to the fund. Pension is determined by how much is invested by both the employer and employee, and how fast it grows.
Discretionary contribution plans. Retirement plans where contributions are at the employer's discretion. These include profit sharing plans, stock bonus or ESOP plans, and money purchase plans.
Distribution/Payout Options. These are options as to how you will take the benefits over your retirement.

- Life Annuities (guaranteed for the "certain" period). You receive benefits for as long as you live or for a certain guaranteed period, whichever is longer.
- Joint and Survivor Annuities (percent relates to the amount the spouse receives). You receive payment for as long as you live or for a certain guaranteed period, whichever is longer, and your spouse, after you die, receives that percent of your payment for as long as they live.
- Special Joint and Survivor Annuity (if there is a death in the marriage the benefit decreases). You receive payment for as long as you live or for a certain guaranteed period, whichever is longer, and your spouse, after you die, receives a percentage of that payment for as long as they live.

Employee Contribution (or Salary Reduction Plans). These are defined contribution plans where employees contribute before tax dollars reducing their taxable income and earnings accumulate tax deferred. The major plans are Roth or Traditional 401k and 403b plans and 457 plans. Employees direct the funds into different financial asset options provided by the company including mutual funds, index funds, fixed income, equities, money market funds, and GICs (guaranteed investment contracts). Companies have their list of approved investment assets. Employees choose where to invest their assets subject to the company list, and employees are not allowed to invest outside of approved investment assets.
Employer Qualified Retirement Plans. These are retirement plans, established by a company, that have specific tax and other benefits to both the company and the employee. Benefits include

competition, tax shelters, personal retirement for the owners, and personal retirement for the employees. They can be either defined benefit or defined contribution plans.
Fixed contribution plans. These are defined contribution plans where contributions are fixed by the employer. Examples are thrift and savings plans and target benefit plans.
Immediate Annuity Distribution. You can use your defined contribution plan to purchase an immediate annuity, either from your retirement Plan provider or from others outside the Plan.
IRA Rollover distribution (Be careful and don't touch the funds). You can roll over your distribution into an IRA. The benefits are you can defer taxes until you withdraw the funds, you can direct investment to different assets and asset classes, and you can continue to enjoy tax-deferred growth. The risks are that there is no guarantee that funds will last a lifetime and you must begin withdrawals at 70½ or 50% penalty is incurred.
Lump Sum Distribution. This is taking the entire retirement account at retirement. You are responsible to ensure this amount lasts your entire life. The benefits are you can take the money out as you need it, and can invest/gift/use it elsewhere. The risks are that plans only allow distributions every 3 months, taxes are incurred immediately, and if you do not plan well, may not have sufficient money for retirement.
Money Purchase Plans. These are defined contribution plans where the employer contributes a percentage of employee salary each year, not dependent on company profits. Employees do not contribute.
Periodic Payments distribution. With this distribution, you can plan for regular payments at regular intervals, and can ensure that payments are available for a specific period of time. However, there is no assurance of lifetime income, and your tax rate may be high due to the amount of money withdrawn.
Profit Sharing Plans. These are defined contribution plans where employer contributions vary year-to-year depending on firm profitability (it may be zero if the firm is not profitable in that year).
Required minimum distributions. For tax deferred retirement plans, the government requires that a certain percentage of assets must begin by April 1st of the year following age 70½. The distribution is the account balance on Dec. 31 of the previous year (age 69) divided by the life expectancy from the table below. There is a 50% penalty on minimum distributions not taken.
Roth. These are defined contribution plans where distributions of contributions can be made without penalty and without tax after 5 years. Roth plans do not have mandatory distributions (if they are rolled over into Roth IRAs at retirement), and matching employer contributions with Roth plans go into traditional plans (not Roth plans). Roth plans allow you to save more money (as taxes are paid outside the retirement vehicle).
Stock Bonus Plan. These are defined contribution plans where employer contributions are made with employer shares of stock. Employee stock ownership plans (ESOPs) and leveraged ESOPs (LESOPs) are the most common.
Target Benefit Plan. These are defined contribution plans that establish a required contribution level to meet a specific target level of benefits at retirement.
Thrift /Savings Plans (TSP). These are defined contribution plans where the employer matches a percentage of employee contributions to a specific amount (i.e., free money). This program is for employees of federal civil service.
Vesting period. This is the period required before the promised benefits are considered yours.

Review Questions

1. What is a qualified retirement plan?
2. What are the three major types of employer-qualified retirement plans?
3. What is the general trend in regard to qualified retirement plans, or what types of plans are most companies shifting away from, and what types of plans are most companies shifting toward?
4. What are the three types of defined-contribution plans?
5. In relation to an employer's contributions to your retirement fund, what does "vesting" mean? Why is it important to know the vesting requirements of your employer?

Case Studies

Case Study 1

Data

Bill, married with two kids, will be graduating in April with his bachelor's degree and has two similar offers from companies located in San Francisco, California. Both are companies he would be content to stay with for 30 years. Company A has a 401(k) with a 100 percent match up to 4 percent of his salary. Company B has a 401(k) with no match but has a defined-benefit plan with the formula based on average salary, a factor of 1.5 percent, and years of service up to 30 years.

Calculations/Application

A. Assuming the salary is $50,000 for each firm, which has the more attractive retirement package for Bill?

B. Can Bill participate in other retirement plans?

Case Study 1 Answers

A. This is a difficult question to answer and depends on (1) Bill's plans, (2) Bill's forecast for the company, and (3) Bill's view of company policy.

(1) Bill's Plans. How long is he planning to be with either company? Is he going back to graduate school soon? How portable is the defined-benefit plan? The answer to this question is really based on the assumptions Bill has regarding how long he plans to stay with either company. Since a defined-benefit plan generally requires you to stay for an extended period, that benefit will only be valuable if Bill is committed for a long period of time.

(2) Bill's Forecast for the Company. Is the company viable, particularly company B? Will Company B be around for as long as Bill wants it to? Are the products of both companies viable?

(3) Bill's View of Company Policy. Will either company change its retirement policies after Bill retires? Have the companies historically taken good care of their employees? Are the plans consistent with similar companies? What is Company B's defined-benefit formula? If Bill stays until retirement at B, what is the annual benefit? Assuming a reasonable interest rate, what is the present value of the annual benefit to

Bill? What is the value of the company match over the same period?

B. Bill can have other plans, as long as his salary is below specific IRS-determined limits. Based on the information provided, he could also invest in either a Roth or traditional IRA, or if he had a small business, he may be able to invest in a small business plan, such as a SEP IRA.

Case Study 2

Data

Greg is 50 years old and has been working for 10 years with a company that has a defined-benefit plan. The formula is the average of the five highest annual salaries within the last 10 years multiplied by a company-determined factor of 1.5 percent multiplied by years in service (to a maximum of 33). Assume Greg stays with the company until his retirement at age 65 and his highest annual salaries for five years average $60,000.

Calculations

A. How much can Greg expect to receive annually at retirement?

B. What is the percent of his final five-year average salary?

Case Study 2 Answers

A. Greg can expect to receive the following:

$60,000 * .015 * 25 years = $22,500 per year until he dies.

B. This is $22,500 / $60,000, or 37.5 percent, of his final salary.

Case Study 3

Data

Adam is 55 and plans to retire in 10 years. He is working for a company with a tax-sheltered annuity (TSA, or 403(b) Plan).

Calculations

A. How much can he contribute, assuming his salary is below the IRS-determined limits, into his company's Roth 403(b) plan in 2019?

B. If his company has a matching program, what impact will that have on Adam's contribution?

Case Study 3 Answers

A. Contribution limits for the 401(k), Roth 401(k), 403(b), Roth 403(b), and 457 Plan annual contribution limits are:

Year	Contribution Limit	Catch-Up Contr.
2017	18,000	6,000
2018	18,500	6,000
2019	19,000	6,000

Since Adam is over 50 years old, he could contribute $19,000 plus a $6,000 catch-up contribution in 2019, for a total of $25,000.

B. The company match will have no impact on the amount Adam can contribute.

Case Study 4

Data

Adam retired on his 60th birthday and did not use any of his traditional IRA balances. On December 31 of his 69th year, he had $450,000 in his 401(k) plan.

Calculations

A. How much would he be required to take out of his account the next year, the year he turns 70.5?

B. How much would he be required to take out if this was a Roth 401(k)?

Life Expectancy Table

Age	Life Expectancy (LE)
70	27.4
71	26.5
72	25.6

Case Study 4 Answers

A. From the table, his life expectancy at age 70 is 27.4 years. Adam will be required to take a distribution of his 401(k) plan of $450,000 / 27.4, or $16,423, the next year.

B. If this was a Roth 401(k), he would still have to take the required distributions. However, if, once he retired, he rolled his Roth 401(k) over to a Roth IRA, there would be no required distributions.

Case Study 5

Data

Sam graduated last year and has already begun his retirement program. He has invested enough in his company 401(k) plan to get the company match this year and has found out that his company has a Roth 401(k) plan as an option. He is discussing with a friend the benefits of the Roth 401(k) versus the traditional 401(k).

Application

A. Which vehicle, the Roth or traditional 401(k), should Sam select and why?

B. What are the assumptions that would impact Sam's choice of retirement vehicle?

Case Study 5 Answers

A. Which vehicle Sam chooses should be based on his vision, goals, objectives, and assumptions for the future.

B. His assumptions should relate to seven key areas (see Roth versus Traditional: Which Is Better for You (LT28):

1. Sam's projected tax rate in retirement. If Sam expects his tax rate to be higher (or lower) in retirement, the Roth (or traditional) is preferred. Make sure Sam takes into account child tax and other credits when determining his current tax rate.

2. Sam's need for the tax break now. If the reduction in AGI is important for Sam to reduce his current tax bill, he would likely choose the traditional.

3. His cash flow situation. If he has additional money to invest for retirement, he can invest more in the Roth than the traditional, due to taxes.
4. His possible need for principal. If Sam might need some of the money in the account (just in case), with the Roth he can take out principal after five years without penalty or taxes, as principal has already been taxed. He cannot, however, take out earnings and interest without penalty.
5. His desire to have more money saved for retirement. If Sam wants to put more money in for retirement, since he pays taxes outside the retirement vehicle with a Roth vehicle, he is actually saving more for retirement. For example, if he puts both $5,000 into both a Roth and traditional IRA, the Roth will be worth more at retirement after taxes as Sam must pay taxes on the traditional IRA when he takes out the money.
6. Does he want to avoid RMDs or required minimum distributions. If he puts money into a tax-deferred account, he is required by law to take out a required minimum distribution each year after age 69. If he does not take out these RMDs, his penalty is 50% of those RMDs, which is steep.
7. *Does he want to leave money to your heirs without major tax or other problems*. Tax deferred money has yet to be taxed. When these assets are left to heirs, the heir still must pay taxes on these assets. With Roth vehicles, because the taxes are already paid, it is much easier from a tax basis to give them to heirs.
8. *Does he want to be able to target his tax rate in retirement.* If he wants to target his tax rate in retirement, he should have a balance of his assets in tax-now accounts (brokerage, banks, and mutual fund companies), tax-deferred accounts (traditional 401k, 403b and IRA accounts), and tax-never accounts (Roth IRA and Roth 401k accounts). This way he can pull out assets from his tax-now and tax-deferred accounts up to his targeted tax rate, and anything beyond, he takes from his Tax-never accounts.

30. Retirement 4: Understanding Individual and Small-Business Plans

Introduction

Whether you work for a large or a small company or are self-employed, you need to plan for retirement. This chapter will discuss your third priority regarding money when saving for retirement: individual retirement accounts. I will explain how you can plan for retirement if you work for a small company or are self-employed. Even if you already have a qualified retirement plan with your company, you may still be eligible to contribute to an individual retirement plan and save even more for your retirement goals. The key is to understand the retirement vehicles available to you and how you can utilize these vehicles to help you achieve your goals.

Objectives

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

A. Understand individual retirement accounts
B. Explain when it is beneficial to convert a traditional IRA to a Roth IRA
C. Describe retirement plans designed for small businesses and individuals who are self-employed
D. Understand plans and strategies for individual and small business plans.

Understanding individual and small-business retirement plans is an important part of retirement planning.

Describe Individual Retirement Accounts

Because of the Taxpayer Relief Act of 1997, there are now three main types of individual retirement accounts (IRAs): the traditional IRA, the Roth IRA, and the education IRA. In addition to these three main types of IRAs, there are many other types of IRAs you should learn about as you prepare for retirement.

Traditional IRAs

A traditional IRA is a retirement account in which you can contribute up to $6,000 in 2019 if you are under age 50; if you are over age 50, you can contribute $7,000 (see Table 1). This account may or may not be tax-deferred, depending on your income level and whether or not you are a participant in another employer-sponsored retirement plan (ESRP). To contribute to a

traditional IRA, you must be younger than 70½ years, and you or your spouse must have earned income the year you contribute.

Contributions to a traditional IRA are tax-deductible if you meet certain conditions. If you are single and are not an active participant in an ESRP, or if you are married and neither spouse is an active participant in an ESRP, your traditional IRA contributions are tax-deductible regardless of your income level. If you or your spouse is an active participant in an ESRP, you can deduct contributions only if your income is below a certain level (see Table 3). For example, in 2018, if you are below age 50, you can deduct the full $6,000 contribution on your income tax return if you do not have an ESRP. You can also deduct the full $6,000 if you have an ESRP but your modified adjusted gross income (AGI) is $101,000 or less for a joint return or $63,000 or less for a single return (see Table 3).

Table 1. Traditional and Roth IRA Annual Contribution Limits

Year	Contribution Limit	Catch-Up Contributions*
2015	$5,500	$1,000
2016	$5,500	$1,000
2017	$5,500	$1,000
2018	$5,500	$1,000
2019	$6,000	$1,000

* The catch-up contribution is for individuals over age 50.

You can take withdrawals from a traditional IRA after you reach age 59½ and you can use the money for any purpose. Before you reach this age, your withdrawals are subject to federal penalties of 10 percent unless you use the withdrawals to pay for your first home (limit $10,000), death or disability expenses, annuity payments, or medical expenses greater than 7.5 percent of your AGI.

Traditional IRA plans that defer taxes require that you begin taking minimum distributions by April 1 of the year after you turn age 70½. You can always take out more. This required minimum distribution amount is calculated by dividing the total account balances of all tax-deferred IRA retirement plans on December 31 of the previous year by the individual's current life expectancy (see Table 2). Note that there is a 50 percent penalty on minimum distributions that are not taken.

Table 2. Life Expectancy and Age

Age	Life Expectancy (LE)	Age	LE
70	27.4	75	22.9
71	26.5	76	22.0
72	25.6	77	21.2
73	24.7	78	20.3
74	23.8	79	19.5

Roth IRAs

A Roth IRA : is a type of individual retirement plan in which contributions are made with after-tax dollars. Because you make contributions with after-tax dollars, your contributions are not tax-deductible. However, this plan provides a unique benefit that is not available with any other retirement plan: all earnings and capital gains are tax-free when you or your beneficiaries make withdrawals at retirement.

You can contribute to a Roth IRA even if you have an ESRP and even if you are over age 70½. In 2019, each individual can contribute up to $6,000 (see Table 1).

A big advantage of a Roth IRA is that you can withdraw your initial contributions at any time without incurring taxes or penalties (check your state's tax rules for more information); however, this benefit does not apply to earnings. Earnings are tax-free if your Roth IRA has been in place for at least five years and if you are at least 59½ when you make withdrawals. You can contribute to both a traditional IRA and a Roth IRA in a single year, but you cannot exceed the yearly contribution limits for the combined contributions to your traditional and Roth IRAs. With Roth IRAs, you are not required to receive distributions by age 70½.

The disadvantages of a Roth IRA include that there are income limits above which you cannot invest in a Roth IRA (see Table 3), and you must hold your account for at least five years before you can make earnings withdrawals without penalty.

If you make withdrawals before age 59½ and you have had the account for fewer than five years, earnings are subject to ordinary income taxes. Earnings are also subject to an early withdrawal penalty of 10 percent unless you use the money to purchase your first home or to pay for death or disability costs.

If you make withdrawals after age 59½ but you have had the account for fewer than five years, earnings are subject to ordinary income taxes but not to early withdrawal penalties.

If you make withdrawals after age 59½ and you have had the account for five years or more, all contributions and earnings can be withdrawn tax-free. There are no minimum withdrawal requirements.

Education IRAs or Coverdell Education Savings (ESA) Accounts

An education IRA : is an investment tool you can use to prepare for the cost of your children's education. You can set up a separate IRA for each child and make contributions to these accounts until the child reaches age 18. The annual contribution limit for education IRAs in 2018 is $2,000 per child; your total contributions into different ESA accounts can equal no more than $2,000 per child. These contributions and their earnings can be withdrawn tax-free if they are used to pay for qualified educational expenses related to enrollment at eligible elementary, secondary, post-secondary, and higher-education facilities. All savings must be withdrawn by the time the child reaches age 30, but any amount left over after you pay for one child's education can be rolled into another child's account. You also cannot take a Hope education credit on your

tax return the same year in which you withdraw money from your education IRA. One disadvantage of an Education IRA is that there are income limits above which you cannot invest in an education IRA (see Table 3).

Other IRAs

The spousal IRA is funded by a married taxpayer in the name of his or her spouse. Normally, participants in IRAs must have earned income. However, it is not necessary for the spouse to have earned income with the spousal IRA.

In a nondeductible IRA, contributions are made with after-tax dollars, and earnings grow tax-deferred; taxes are paid on the earnings when they are withdrawn at retirement. Even if your modified adjusted gross income (MAGI) is greater than allowable limits, you may still find it useful to look into this type of IRA.

An individual retirement annuity is set up with a life insurance company through the purchase of an annuity contract. This annuity ensures a certain dollar amount of funds will be paid to the owner each period of the contract after retirement.

The employer and employee association trust account IRA is set up by employers, unions, and associations.

The rollover IRA is a traditional IRA that is set up specifically to receive distributions from a qualified retirement plan, such as another 401(k), IRA, or other plan.

An inherited IRA is acquired by the non-spousal beneficiary of a deceased IRA owner.

The simplified employee pension IRA (SEP IRA) is a traditional IRA set up by a small-business owner for the company's employees. This type of IRA will be discussed later in this chapter.

The savings incentive match plan for employees IRA (SIMPLE-IRA) is a traditional IRA set up by a small-business employer for the company's employees. This type of IRA will be discussed later in this chapter.

Deductibility and Contribution Limits

Individuals whose modified adjusted gross income (MAGI) is below the ranges listed in Table 3 can take the full deduction for contributing to a traditional IRAs or make a full contribution to a Roth IRA or education IRA. Your MAGI is calculated by taking your adjusted gross income and adding certain items such as deductions for foreign income, foreign-housing, student-loans, IRA-contributions, and for higher-education costs. If your MAGI is between the ranges indicated, you can take only a partial tax deduction on your contribution or make only a partial contribution to the indicated IRA account.

Which Is Better: The Traditional IRA or the Roth IRA?

The decision of whether you should invest in the traditional IRA or the Roth IRA should be based mainly on these five factors: (1) your need to reduce current taxes through tax deductions, (2) your anticipation of tax rates when you retire, (3) your availability of money to pay the necessary taxes on the money contributed to a Roth IRA, (4) your need for investment flexibility, and (5) your need for estate planning to transfer assets to your heirs.

If you need tax deductions now, the traditional IRA is the best choice. Note, however, that since you are taking a deduction now, you will have to pay taxes on your entire traditional IRA balance (principal and earnings) when you retire. Remember that tax-deferred vehicles have the disadvantage of converting capital gains income (which is taxed at a lower rate, generally 15 percent) into ordinary income (which is taxed at your higher marginal tax rate).

Table 3. IRA Deductibility and Contribution Limits

	Modified Adjusted Gross Income (MAGI) Range	
Traditional IRA- Deductibility Limits		
Year	Single Range	Married Range
2015	$61,000–$71,000	$98,000–$118,000
2016	$61,000–$71,000	$98,000–$118,000
2017	$62,000–$72,000	$99,000–$119,000
2018	$63,000–$73,000	$101,000–$121,000
2019	$64,000–$74,000	$103,000–$123,000
Roth IRA- Contribution Limits		
2015	$116,000–$131,000	$183,000–$193,000
2016	$117,000–$132,000	$184,000–$194,000
2017	$118,000–$133,000	$186,000–$196,000
2018	$120,000–$135,000	$189,000–$199,000
2019	$122,000–$137,000	$193,000–$203,000
Coverdell (Education IRA)- Contribution Limits		
2015	$95,000–$110,000	$190,000–$220,000
2016	$95,000–$110,000	$190,000–$220,000
2017	$95,000–$110,000	$190,000–$220,000
2018	$95,000–$110,000	$190,000–$220,000
2019	$95,000–$110,000	$190,000–$220,000

If you expect your tax rates to be lower in the future, the traditional IRA is usually the best choice. If you expect tax rates to be higher in the future, the Roth IRA is usually the better choice. To see the impact of tax rates on retirement savings, see Roth versus Traditional: Which Is Better for You (LT28).

If you currently have the money available to pay taxes on your retirement plan contributions, your best choice is likely the Roth IRA. If you pay taxes now on the principal, you will never have to pay taxes on any of the earnings again if you withdraw funds after age 59½ and have

held the fund for at least five years. In addition, you can theoretically contribute more to the Roth IRA than to the traditional IRA. Remember that the Roth is an after-tax contribution fund—this means that to make the $6,000 contribution in 2019, you must earn $6,000 plus any taxes you must pay on your income. If your average tax rate is 15 percent, you would, in essence, be contributing $6,471 in earnings ($6,000 / (1 – .15)) before taxes.

If you need investment flexibility, which in this case means that you think you may need to withdraw some of your retirement funds before retirement (and you would like to withdraw funds without a penalty), the Roth IRA is the better choice. Since you have already paid taxes on the principal you contribute to the Roth IRA, you are allowed to withdraw the principal at any time without having to pay any penalties or taxes.

Finally, if you want to leave your retirement money to your heirs, the Roth IRA is usually the better choice. Since taxes are paid up front on the Roth IRA, the money can be left to heirs without the imposition of additional estate or inheritance taxes on distribution. Assets from a traditional IRA require the payment of taxes before distribution to your heirs.

Explain When It Is Beneficial to Convert a Traditional IRA to a Roth IRA

Converting : your traditional IRA into a Roth IRA may be a smart choice under the following circumstances: (1) you think your tax bracket will stay the same or go up after you retire, (2) you plan to wait at least five years before withdrawing money, (3) you have sufficient funds from other savings or investments to pay the taxes on the conversion; (4) you won't move into a higher tax bracket during the year by converting, or (5) you want to avoid a minimum-distribution requirement from your retirement savings at age 70½.

To convert to a Roth IRA, you take the money from your traditional IRA, 401(k), 403(b), or 457 plan and pay the taxes on these accounts before moving the funds to a Roth IRA. For the money to accumulate tax-free in the Roth account, both the 5-year rule and the 59½-year rule still apply.

Transfers are allowed in three ways: (1) by accepting a payment from your traditional IRA and re-depositing it within 60 days, (2) by requesting a trustee-to-trustee direct transfer, or (3) by changing the account designation to a Roth with the account's trustee. The direct transfer is the simplest and safest way to convert. If you use the 60-day rollover option, remember that a 10 percent penalty tax will be withheld at distribution, and you will have to replace the withheld taxes with other funds when the money is deposited into the Roth account. Moreover, the 10 percent early withdrawal penalty applies if you use IRA funds to pay income taxes at conversion. Direct transfer is the simplest and safest way to convert funds from one type of account to another.

Describe Retirement Plans Designed for Small Businesses and Self-Employed

Just as there are: retirement plans available to employees of large businesses, there are also retirement plans available to employees of small businesses and to individuals who are self-

employed. These plans have some of the same tax advantages as the plans available to larger businesses, and some are even more generous. Some of these plans allow you to invest even if you already have another retirement plan through another employer. If you are self-employed (either full- or part-time), or if you work for a small business, you can invest money in a simplified employee pension plan (SEP IRA), a Keogh plan, or a new savings incentive match plan for employees (SIMPLE IRA).

There are two categories of small-business retirement plans. The first category includes plans funded by the small-business employer, for example, SEP IRAs and Keogh plans. The second category includes plans funded by both the small-business employer and the employee: mainly the SIMPLE IRA and SIMPLE 401(k) plans.

Plans Funded by Your Employer

The **SEP IRA** (simplified employee pension individual retirement account) allows a small-business employer to contribute to employees' retirement funds. The employer usually contributes the same percentage of income for each eligible employee. In 2018, employers could contribute a maximum of either 25 percent of an employee's salary or $56,000, whichever was less. The limits on the amount of money that can be contributed to this defined-contribution account are set in Code 415 of the Internal Revenue Code (see Table 4). There are no minimum contribution requirements on the amount the employer can contribute to these plans, and they are generally best for companies with few employees. If you have one of these accounts, you can still have other qualified individual retirement accounts. Contributions are tax-deductible for the employer, earnings grow tax-deferred for the employee, and the individual employees own the plans.

Table 4. Section 415 Funding Limits

Year	$ Amount
2015	53,000
2016	53,000
2017	54,000
2018	55,000
2019	56,000

SEP IRAs are easiest to set up and maintain, and they do not require annual filings. They allow larger contributions than traditional IRAs ($56,000 versus $6,000 in 2019). This is the best type of retirement plan for businesses with no or only a few employees.

The major disadvantages of a SEP IRA include that you cannot borrow against the retirement plan and that early withdrawals (withdrawals made before age 59½) incur a 10 percent penalty in addition to ordinary income taxes.

Keogh Plans (also called HR 10 plans) are set up by a sole proprietor or partnership. These plans allow small businesses to make tax-deductible contributions to employees' retirement plans.

Plans can either be defined-benefit plans or defined-contribution plans, but most Keogh plans are defined-contribution profit-sharing plans or defined-contribution money-purchase plans.

Employers usually contribute the same percentage of income for each eligible employee. As an employee, you can also contribute up to 20 percent of your income (to a maximum of $56,000 in 2019) into your Keogh plan. As with many other retirement plans, Keogh investments grow tax-deferred.

There are three unique options that make Keogh plans flexible: two are defined-contribution plans and one is a defined-benefit plan. These options make Keogh plans somewhat similar to the defined-benefit plans and defined-contribution plans offered by larger companies. (For more complete details on these plans, see Internal Revenue Service, Publication 560: Retirement Plans for Small Businesses: SEP, SIMPLE, and Qualified Plans at http://www.irs.gov/pub/irs-pdf/p560.pdf.)

There are two types of Keogh defined-contribution plans: profit-sharing plans and money-purchase plans. Profit-sharing plans allow employers to share company profits with employees by contributing to employee retirement plans. Contribution limits for profit-sharing plans are more flexible than limits on other plans. Money-purchase plans have a fixed contribution limit that is not based on company profitability. A Keogh defined-benefit plan is any plan that is not a defined-contribution plan.

In a defined-contribution plan, the maximum amount an employer can contribute in 2018 is either 100 percent of an employee's average salary for the past three years or $56,000, whichever is less. In a defined-benefit plan, the maximum amount an employer can contribute in 2018 is either the employee's average salary for the past three years or $225,000, whichever is less. Because of these higher contribution maximums, Keogh plans are especially helpful for those trying to catch up on retirement savings.

Possible disadvantages of Keogh plans include that they require more administrative work than SEP IRAs, they cannot be borrowed against, and they must be established by December 31 of each year.

Plans Funded by Both You and Your Employer

The most popular plans that are funded by both the employer and employee are the SIMPLE plans. SIMPLE plans, or savings incentive match plans for employees, are tax-sheltered retirement plans for small businesses (businesses with fewer than 100 employees) or for individuals that are self-employed. In SIMPLE plans, an employer matches some employee contributions; SIMPLE plans are similar to company-matching 401(k) plans. There are two different types of SIMPLE plans: SIMPLE IRAs and SIMPLE 401(k) plans.

In a SIMPLE IRA, both you and your employer take part in funding your retirement. To be eligible for a SIMPLE IRA, you cannot have another qualified plan at the same time. In 2019,

you can contribute up to 100 percent of your annual income, up to a maximum of $13,000, in tax-deferred funds (see Table 5). Since contributions are tax-deferred, there is a penalty for early withdrawals. Money withdrawn within two years of establishing the account incurs a 25 percent penalty, and money withdrawn before you reach age 59½ incurs a 10 percent penalty and is taxed as ordinary income.

With a SIMPLE IRA, your employer must match your contributions (usually up to two to three percent of your annual income) unless you make non-elective or optional contributions. The employer is required to make a minimum contribution of two percent of your annual income to your SIMPLE IRA each year. Any contributions you or your employer makes to your SIMPLE IRA are tax-deductible. Compared with other small-business plans, SIMPLE IRA plans are easy to set up and administer.

Table 5. SIMPLE IRA/401(k) Plan Contribution Limits

Year	Contribution Limit	Catch-up*
2015	$12,500	$3,000
2016	$12,500	$3,000
2017	$12,500	$3,000
2018	$12,500	$3,000
2019	$13,000	$3,000

* Catch-up contributions are available for those over age 50.

A SIMPLE 401(k) plan is very similar to a SIMPLE IRA and has the same contribution limits and matching requirements. However, a SIMPLE 401(k) plan requires more time and resources to establish. If you are making contributions to a SIMPLE 401(k) plan, your employer must match one to three percent of your elective annual contributions or contribute at least two percent of your annual income as a non-elective contribution.

Understand Plans and Strategies for Small Business and Individual Plans

As you put your Retirement Plan together, it is important to think through some plans and strategies. Examples include:

Plans and Strategies

Accumulation

- Live on a budget, save 20%, always get the company match
- Save 20% of every dollar, 15% into your Roth 401k or Roth IRA for both you and your spouse (if you don't have a Roth 401k), 3% for other goals, and 2% for children's mission and education
- Invest in Roth accounts while young and when rates are low. Use these to target your tax rate in retirement (to a low level)
- Even though you don't know future tax rates, maximize investments in Roth accounts as you are saving more for retirement.

Retirement

- Calculate a minimum level of retirement income, and annuitize that amount (if you have sufficient assets). The process is:
    - a. Calculate Social Security and defined benefit plan(s)
    - b. Determine your minimum amount needed to live on
    - c. Take a percentage of retirement assets (including 401k/403b/Roth and traditional IRAs/SEP/Simple Plans) at retirement to purchase an immediate annuity to give you the minimum amount needed for an acceptable level of income
- Have both Roth and traditional retirement assets so you can target your tax rates in retirement
- Donate assets from your traditional IRA/SEP/Simple plans to pay tithes and offerings to eliminate your capital gains.

Distribution

- Have taxable (tax now), Roth (rarely taxed) and traditional (taxes later) vehicles to target your tax rate in retirement
- Set a target tax rate, then pull traditional assets up to that specific amount, then Roth assets afterwards to reduce taxes
- Make sure to pay your Required Minimum Distributions if over 69.5
- During your later years which your income is less, i.e., during missions, transfer money from your tax-deferred to tax-eliminated accounts. Use this time to move assets into Roth accounts with as little tax consequences as possible
- After age 69.5, donate assets from your traditional IRA/SEP/Simple/401k/403b plans to pay tithes and offerings, to eliminate your capital gains, and to fulfill your required Minimum Distribution amounts.

Summary

It is important to plan for retirement. Because of the Taxpayer Relief Act of 1997, there are now three main types of individual retirement accounts (IRAs): the traditional, the Roth, and the education. There are also many other types of IRAs that you should learn about as you plan for retirement. Individuals who are self-employed or employed by small businesses have access to unique retirement plans that can help them reach their retirement goals. It is important for you to understand and use the investment vehicles available to you.

A traditional IRA is a retirement account in which you can contribute up to $6,000 each year (in 2019) if you are under age 50 or up to $7,000 if you are over age 50 (see Table 1). This account may or may not be tax-deferred, depending on your income level and whether you or your spouse are participating in an employer-sponsored retirement plan (ESRP). To contribute to a traditional IRA, you must be younger than 70½ and you or your spouse must have earned income. Contributions to a traditional IRA are tax-deductible if you meet certain conditions.

A Roth IRA is a type of individual retirement plan in which your contributions are made with after-tax dollars. Your contributions are not tax-deductible, but all earnings and capital gains are tax-free when you or your beneficiaries make withdrawals at retirement.

A Coverdell Education Savings Account, or education IRA, is an investment tool you can use to prepare for the cost of your children's education. You can set up a separate IRA for each child and make contributions into these accounts until the children reach age 18. The annual contribution limit for Education IRAs in 2019 is $2,000 per child. These contributions and their earnings can be withdrawn tax-free if they are used to pay for qualified educational expenses related to enrollment at eligible elementary, secondary, post-secondary, and higher-education facilities.

In addition to the traditional IRA, Roth IRA, and education IRA, there are a number of other IRAs you should learn about. These IRAS include the spousal, nondeductible, individual retirement annuity, employer and employee association trust account, rollover, inherited, simplified employee pension (SEP IRA), and savings incentive match plan for employees IRAs (SIMPLE IRA).

The decision of whether to invest in the traditional IRA or the Roth IRA should be based mainly on five factors: (1) your need to reduce current taxes with tax deductions, (2) your anticipation of tax rates when you retire, (3) your availability of money to pay the necessary taxes on the Roth IRA, (4) your need for investment flexibility, and (5) your need for estate planning to transfer assets to your heirs.

There are special retirement plans available to employees of small businesses and individuals who are self-employed. These plans have some of the same tax advantages as the plans available to larger businesses and may be even more generous. Some of these plans allow you to invest even if you already have another retirement plan through another employer. For example, if you are self-employed, either full- or part-time, or if you work for a small business, you can invest money in a simplified employee pension plan (SEP IRA), a Keogh plan, or a new savings incentive match plan for employees (SIMPLE IRA).

There are two categories of small-business retirement plans. The first category includes plans funded by the small-business employer, such as SEP IRAs and Keogh plans. The second category includes plans funded by both the small-business employer and the employee, mainly the SIMPLE IRA and SIMPLE 401(k) plans.

Assignments

Financial Plan Assignments

Your Retirement Plan has many different sections, including individual and small business plans. How will you utilize individual IRAs in your retirement Plan? Do you have a small-business retirement account or an individual retirement account? If so, who do you have the plan with?

What are your annual fees for the account? Is there a way to minimize those fees?

Where are your assets invested? Are they invested in a manner that is consistent with the asset-allocation targets detailed in your financial plan and the fact that they are longer-term assets? What are your plans and strategies for these accounts?

Learning Tools

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

Retirement Planning Needs Spreadsheet (LT06)
This Excel spreadsheet helps you determine how much you must save each month to achieve a specific lifestyle at retirement based on the following estimates: years until retirement, expected return, inflation, and tax rates.

Retirement Planning Ratio Forecasts (LT25)
This spreadsheet is an Excel template that will help you determine where you are in your progress toward achieving your retirement goals. By inputting the relevant information, you can estimate whether you are on track for reaching your retirement goals, based on your age and income.

Roth versus Traditional: Which Is Better for You (LT28)
This spreadsheet includes an Excel template to help you determine whether the traditional or the Roth IRA is a better investment vehicle to help you save for retirement. Note that this spreadsheet considers only the factor of future taxes when making this decision.

Review Materials

Terminology Review

Education IRA. An Education IRA, also called a Coverdell ESA, is an investment vehicle for planning for the future cost of a child's education. The plan allows after-tax contributions each year for each child until age 18. Contributions and their subsequent earnings are tax-free when withdrawn to pay for qualified secondary and post-secondary education expenses.
Individual Retirement Accounts. These are retirement account created with the Taxpayer Relief act of 1997. While there are over a dozen different individual retirement accounts, the three major types of Individual Retirement Accounts are Traditional IRA, Roth IRA, and Education IRA, which is also called a Coverdell Education Savings Account (ESA).
Individual Retirement Annuity: An IRA set up with a life insurance company through purchase of annuity contract.
Inherited IRA: An IRA acquired by the non-spousal beneficiary of a deceased IRA owner.
Keogh Plan. This is a small business retirement plan set up by a sole proprietor or partnership (not incorporated) which allows employers to make tax-deductible payments to retirement plans, similar to pension or profit-sharing plans. Plans can be either a defined benefit or defined contribution, but most commonly are DC profit sharing or money purchase plans. Contributions

are tax deductible, earnings grow tax-deferred, and employers may borrow from the Plan
Non-deductible IRA. Individuals may contribute to a non-deductible IRA. The benefits are that money is contributed after-tax, and investment earnings grow tax-deferred. No taxes are paid on the investment earnings until the earning are withdrawn at retirement. Accurate record keeping is required to pro-rate the nondeductible portion of any subsequent distribution.
Non-deductible IRA: An IRA with contributions made after-tax, and earnings grow tax-deferred, with taxes paid when withdrawn at retirement.
Required Minimum Distributions. This is a legal requirement of many tax-deferred retirement vehicles which require savers to distribute a specific amount each year after age 69 of total plan assets. It is calculated by dividing the total amount in accounts by a specified number given.
Rollover IRA: A traditional IRA set up to receive a distribution from a qualified retirement plan.
Roth Conversion. This is the process of converting a traditional individual retirement account to a Roth account.
Roth IRA. This is an individual retirement account which provides no deduction for contributions but provides that all earnings and capital gains are tax free upon withdrawal after retirement. You are actually investing more with a Roth, since your investments are after-tax, and contributions can be withdrawn tax/penalty free. Earnings grow tax-free if the Roth IRA is in place for at least 5 years, and you are 59½ years old.
SEP-IRA. The Simplified Employee Pension (SEP-IRA) is an Individual Retirement Account which allows a small business employer to contribute to the retirement of the employees. Employer contributes the same percentage to all employees, and no required annual contribution. Contributions are tax deductible, earnings grow tax-deferred, and employees own the plans.
SIMPLE 401k. This is a small business qualified retirement plan that provides some matching funds by the employer. Employees can have no other qualified plan, and may contribute up to the specific amount each year. Contributions are tax deferred and grow tax-free, and there is a penalty for early withdrawal. The employer is "required" to either contribute at least 2% or to match employee contributions, usually 1-3%
SIMPLE IRA. This is one of the SIMPLE retirement plans where Employees can participate. Contributions are tax deductible, it is easy to set up and administer (compared with a traditional 401(k)). A small business qualified retirement plan that provides some matching funds by the employer.
SIMPLE Plans. These are Savings Incentive Match Plans (SIMPLE) that provides matching funds by the employer. It can be established as an IRA or as part of a 401k plan. Employees can have no other qualified plan, and can contribute up to 100% of compensation to a maximum limit each year. The employer is "required" to either contribute at least 2% or to match employee contributions, usually 1-3%.
Spousal IRA. A Spousal IRA is an IRA contribution for a non-earning spouse. If one spouse is an active participant, the non-earning spouse can contribute to a Spousal IRA. Limits are the same as the traditional and Roth IRA.
Traditional IRA. An individual retirement account in which an individual can contribute up to a specific amount annually which is tax-deferred. Eligibility and amounts depend on the contributor's income level and whether they have other retirement plans. The contribution is tax deductible and earnings grow tax-deferred.

Review Questions

1. What are the three main types of individual retirement accounts?

2. If your marginal tax rate is low now and you believe it will continue get larger as you grow older, which type of IRA should you most likely make contributions into?
3. What is the 2019 annual contribution limit per individual for a traditional IRA? Roth IRA? Education IRA?
4. If you currently need a tax deduction, which type of IRA is preferable to contribute to?
5. What are two types of small business/self-employment retirement plans that are funded by the employer?

Case Studies

Case Study 1

Data:

Steve is considering a traditional IRA. He is married and he and his wife both have an Employer Sponsored 401k retirement plan at work. His modified adjusted gross income is $115,000 this year.

Application:

a. Can Steve fully contribute to a traditional IRA and get the tax deduction? Why or why not?

b. Can he contribute to any other IRAs?

c. If neither Steve nor his wife have an employer sponsored retirement plan at work, could he still contribute to a traditional IRA and get the tax deduction?

Case Study 1 Answers

a. Can Steve contribute to a traditional IRA?

- Steve cannot contribute to a traditional IRA and get the full tax deduction as his income is beyond the MAGI phase-out limits of $103-123,000 in 2019

b. Can he contribute to other IRAs?

- He could contribute to a Roth or a non-contributory IRA which is a traditional IRA with no initial tax benefits

c. Neither have an employer plan, so what can they do?

- If neither Steve nor his wife are covered by an employer sponsored retirement plan at work, they can both contribute to a traditional IRA regardless of MAGI limits. If only one spouse is covered by a retirement plan at work, the traditional IRA limits are expanded to the limits of the Roth IRA

Case Study 2

Data

Bill has money in a traditional and a rollover IRA. He retired on his 60th birthday and did not use any of his traditional IRA balances. On December 31 of his 69th year, he had $150,000 in his traditional IRA.

Calculations:

How much is he required to take out of his account the next year?

Age	Life Expectancy
70	27.4
71	26.5

Case Study 2 Answer

Bill will be required to take a distribution of $150,000 / 27.4 (from the life expectancy table), or $5,474.45, the next year.

Case Study 3

Data

Steve is considering a traditional IRA. He is married, and his modified adjusted gross income is $121,000 per year.

Application

Can Steve contribute to a traditional IRA? Why or why not?

Can he contribute to any other IRAs?

If neither Steve nor his wife have an employer sponsored retirement plan at work, could he still contribute to a traditional IRA and get the tax deduction?

Case Study 3 Answers

a. Steve will not be able to contribute to a traditional IRA because his income is beyond the MAGI phase-out limits of $101-121,000 in 2019.

b. He could, however, contribute to a Roth IRA as he is below the phase out limits, or a non-contributory IRA which is a traditional IRA with no initial tax benefits.

c. If neither Steve nor his wife are covered by an employer sponsored retirement plan at work, they can both contribute to a traditional IRA regardless of MAGI limits. If only one spouse is covered by a retirement plan at work, the traditional IRA limits are expanded to the limits of the Roth IRA.

Case Study 4

Data

Sam and his wife just turned 60, and they are very concerned about retirement. All their kids are grown, and they have additional money they want to contribute toward retirement in 2018. Their modified adjusted gross income is $120,000 this year, and they feel they can save 30 percent for retirement this year. Their company has a 401(k) plan without a match.

Application

Which vehicles can they use, and how much can they save for retirement?

Case Study 4 Answers

Sam is eligible for not only the 401(k) (limit of $19,000 in 2019), but also the $6,000 catch up contribution.

Both he and his wife are also eligible for the $6,000 Roth IRA contribution, as well as the

$1,000 catch up limit, as they are not beyond the phase-out limits for the Roth IRAs ($14,000 total). They are, however, beyond the limits for the traditional IRA to get the deduction.

Overall, they could invest $25,000 in their 401(k) and $14,000 in their IRAs for a total of $39,000 saved in 2019.

31. Estate Planning: Taking Care of Those You Love

Introduction

Estate planning is the process of planning for the accumulation, conservation, and distribution of estate assets. This process should be used to help you accomplish your personal and family goals. Every estate is eventually planned, either through planning done by an individual for his or her estate or by default through rules established by the state and local governments. The purpose of estate planning is to ensure that you—and not others, such as the government or lawyers—choose who will inherit your wealth. Through proper estate planning, you can take care of those you love even after you die. The Church of Jesus Christ of Latter-day Saint's family guidebook states the following:

> Brigham Young once said, "A fool can earn money; but it takes a wise man to save and dispose of it to his own advantage." . . . Estate planning is the way we manage our major financial resources and properties to "dispose of it to [our] own advantage." . . . This kind of planning, begun early in life, can help provide financial security for a family throughout several generations.[1]

Objectives

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

A. Understand the principles, importance and the process of estate planning
B. Know how trusts can be used to your advantage in estate planning
C. Understand the importance of wills and probate planning
D. Understand how to create your advance plan.

Understand the Importance, Process and Principles of Estate Planning

The purpose of estate planning is to help us achieve our personal and family goals even after we die. Estate planning ensures that your wealth will go to those you want it to go to, so you can achieve your personal goals even after you are gone. Proper estate planning can even significantly reduce the taxes paid to Uncle Sam, thus ensuring that your heirs get a larger inheritance.

There are five main goals of estate planning:

1. Live Life Fully

To live life fully, you must provide for yourself as well as for others for whom you are

responsible. You must account for the possibility that you may die prematurely. One of the main ways of managing the risk of premature death is to buy life insurance, which we discussed earlier. There are two main types of life insurance. Term life insurance provides a simple death benefit with no accumulation of cash value but significantly lower premiums. Cash-value policies offer a death benefit plus a cash-value component that grows, tax-deferred, over time and cannot be canceled.

In order to live life fully, you also need to plan for the possibility that you may become unable to provide for yourself. Medical-advance directives cover this possibility by allowing you to establish a living will and/or designate the special power of attorney for health-care, which gives someone else the power to make medical decisions for you should you become unable to make them for yourself. Exercise caution when establishing powers of attorney, such as durable power of attorney, special power of attorney, or general power of attorney. Someone who has your power of attorney can do anything you can do, including sell your house and your car and enter into agreements. An example of a medical-advance directive is Utah Advance Health Care Directive (LT14).

2. Pass Property at Death According to Your Desires

There are four ways to designate how property should be divided after you die: by will, by law, by contract, or by trust.

Pass on property at death by will: A will is a legal document that specifies your desires at the time of your death and allows your desires to be enforced. Wills permit you to appoint a personal representative to act on your behalf, appoint guardians for your minor children, appoint conservators for the assets of your minor children, and provide for disposition of your property at death. In some states, wills allow you to keep a separate updated list of tangible personal property dispositions, so you do not have to write a new will each time you decide to give something to someone else.

Current wills can revoke or change earlier wills. A will is necessary to disinherit a presumed heir, and a will can create a testamentary trust, a trust that is to be set up when you die. Unfortunately, creating a will does not avoid probate, even if the will creates a testamentary trust.

Some states, including Utah, consider holographic wills to be valid. A holographic will must be made completely in your own handwriting. It must include the date at the top and your signature at the bottom. Within the holographic will, you must name a guardian, alternate guardians, and how you would like your assets divided among your heirs. It is not necessary to have either a notary or witnesses. Be careful if you decide to create a holographic will, however. You should consider consulting an attorney about the language, and you should use a holographic will only if you do not have significant assets or a complicated family situation. Remember that a will does not avoid probate.

Pass on property at death by law: If you fail to write a will, the state will write your will for you upon your death. Through this process, known as intestacy, the state tries to determine what your will would have been had you written a will for yourself.

For example, in Utah, if a deceased person with no will has no children, the surviving spouse is given 100 percent of the deceased's assets. If the deceased has children by a prior relationship, the surviving spouse gets the first $50,000 and half of the remaining assets. If there is no surviving spouse, the assets go to each of the children on a per capita basis at each generation. If there are no children, the assets go to parents, then to the parents' descendants, and so on.

Pass property at death by contract: Third-party contracts and deeds are two examples of contracts to disperse property upon death. Examples of third-party contracts include insurance, pay-on-death accounts, IRAs, and pension plans. Contractual deeds can either be in the form of joint tenancy, which grants rights of survivorship (i.e., the property goes to the surviving tenant), or tenancy-in-common, which grants no such rights of survivorship (i.e., the property goes to whoever is stated in the contract). Although contracts do avoid probate, they do not avoid tax consequences.

Having a contractual deed for joint-tenancy with a non-spouse may not be a good idea because it circumvents will and trust provisions. This contract creates a gift for tax purposes when a non-spouse's name is added. A joint-tenancy contract postpones probate only until the second joint-tenant dies. It also may create problems for the new tenant because of taxes on capital gains income. Additional problems may occur if one joint-tenant becomes incompetent because the asset cannot be sold or disposed of under this contract. Creating a joint-tenancy with a person who is not your spouse causes loss of control.

Pass on property at death by trust: There are many advantages to passing on property by way of trusts. Trusts are legal entities that are allowed, by law, to hold assets. Specific types of trusts may reduce or eliminate estate taxes, allow for privacy, and facilitate advanced planning. Trusts may be used as a means of handling complex family situations.

3. Provide for Guardianship of Minor Children

For most parents, the most important part of estate planning is providing for guardianship of children who are still minors. You must answer the question, if your spouse and you were to die, who would take care of your children and raise them the way you would want them to be raised? In addition, you must ask yourself, who would take care of your children's assets until the children are old enough and wise enough to manage these assets themselves?

4. Avoid Probate If Desired, or Use Probate Strategically

Probate is the legal process by which an asset's title is transferred after an individual's death. One concern many individuals have regarding probate is that the records of the assets, including information about who owns the assets, are open to public view. Anyone who reviews the public

records gains access to the information.

Probate is not necessarily bad, and it is often necessary to pass on an asset's title. However, if it is important that information about ownership not be available to the public, advance planning and the use of various estate-planning tools can be helpful in avoiding probate.

5. Avoid Taxes

The final reason for estate planning is to avoid taxes. There are many legal ways to save substantially on estate and gift taxes. A few ideas will be discussed later.

The Estate-Planning Process

There are four steps in the estate-planning process:

1. Determine how much your estate is worth.
2. Choose your heirs and decide which assets they will receive.
3. Determine the cash needs of the estate and calculate your estate taxes.
4. Select and implement estate-planning techniques to maximize the money going toward your personal and family goals and to minimize taxes.

Estate planning helps you use your assets wisely in order to achieve your personal goals even after your death. If you prepare well before you die, there is a greater chance you will be able to achieve your personal and family goals even after your death. For help in this process, see Estate Planning Tax Spreadsheet (LT40), which helps you understand and calculate estate taxes.

Step 1: Determine What Your Estate Is Worth

The worth of an estate is basically the difference between the value of the estate's assets and the value of the estate's liabilities. However, there are a number of steps for calculating the value of your estate.

First, calculate the gross value of the estate. This is the combined value of all estate assets, including pensions, investments, and any real or personal property. The gross value also includes life insurance proceeds payable to your estate or, if you own the policy, to your heirs; the value of certain annuities payable to your estate or heirs; and the value of certain properties you have transferred within three years of your death. The government counts assets gifted to others in the last three years of your life as part of your estate.

Second, calculate the taxable estate. This is equal to the gross value of the estate minus estimated funeral and administrative expenses, debts, liabilities, taxes, and any marital or charitable deductions.

Third, calculate the gift-adjusted taxable estate. This is equal to your taxable estate plus any taxable lifetime gifts (the cumulative total of all gifts over the annual limit). This will be

discussed later. The adjusted taxable gifts are the total amount of the taxable gifts you made after 1976 that are not included in the gross value of your estate.

Step 2: Choose Your Heirs and Decide What They Will Receive

In making these decisions, remember the long-term goals for you and your family and use your financial resources to help you achieve these personal goals. Make these decisions with much thought and prayer.

Step 3: Determine the Cash Needs of Your Estate and Calculate Your Estate Taxes

Determining the cash needs of the estate is the process of making sure there will be sufficient cash available to pay the necessary debts, bills, and taxes. If the estate is large, there must be sufficient liquid assets available to pay the required estate taxes, which may be high.

Estate taxes are equal to the gift-adjusted taxable estate multiplied by the appropriate tax rate. To determine the net tax owed, calculate the total tax owed and subtract the unified gift-tax and estate-tax credit (this is discussed in more detail later in the chapter). Ensure that you have adequate liquidity available to your heirs. Term or cash-value life insurance may be used as a tool to ensure sufficient liquidity for paying estate taxes.

Step 4: Select and Implement Your Estate-Planning Techniques

If you prepare well before your death, your estate will do well after you have died. Generally, qualified legal help is critical to help you determine and implement the best estate-planning vehicles. Remember that these vehicles are not useful until they are funded.

Table 1. Estate Tax Limits

Year	Exclusion Amounts	Top Tax Rate
2015	$5,430,000	40%
2016	$5,450,000	40%
2017	$5,490,000	40%
2018	$11,180,000	40%
2019	$11,400,000	40%

Table 2. Unified Estate Tax and Gift Tax Rates

If Amount Is Over	But Not Over	Tax on Column A	Rate on Excess Over A
$0	$10,000	$0	18%
$10,000	$20,000	$1,800	20%
$20,000	$40,000	$3,800	22%
$40,000	$60,000	$8,200	24%
$60,000	$80,000	$13,000	26%
$80,000	$100,000	$18,200	28%
$100,000	$150,000	$23,800	30%

$150,000	$250,000	$38,800	32%
$250,000	$500,000	$70,800	34%
$500,000	$750,000	$155,800	37%
$750,000	$1,000,000	$248,300	39%
$1,000,000	$1,250,000	$345,800	41%
$1,250,000	$1,500,000	$448,300	43%
$1,500,000	$2,000,000	$555,800	45%

Table 3. Unified Estate Tax Exclusion Amounts

Amounts Above	Year	Tax on Column A	Rate on Excess
$5,430,000	2015	$2,172,000	40%
$5,450,000	2016	$2,180,000	40%
$5,490,000	2017	$2,196,000	40%
$11,180,000	2018	$4,472,000	40%
$11,400,000	2019	$4,505,000	40%

Table 4. Gift Tax Exclusion Amounts

Year	Maximum Amount
1982–2002	$10,000
2003–2005	$11,000
2006–2008	$12,000
2009–2012	$13,000
2013-2017	$14,000
2019	$15,000

Four Key Taxes on Estates

There are four key taxes on estates:

1. Estate taxes, or inheritance taxes, are taxes that must be paid on an estate that has a value greater than a government-determined exclusion amount. An estate tax return for a U.S. citizen or resident needs to be filed only if the gross estate value exceeds the exclusion amount that has been determined by the government in the year of the citizen or resident's death (see Table 1). For example, if John Smith died in 201 and his estate was valued at less than $11.4 million, John's estate would not be required to pay estate taxes because its value is less than the estate tax exclusion amount for 2019.

2. Gift taxes: Gift taxes apply to the transfer of any property, including money, in the form of a gift. If you sell something at less than its full value, if you make an interest-free or reduced-interest loan, or if you allow the free use of your property or income from your property, you may be giving a gift. Gift taxes are taxes paid on gifts of property or money that exceed the annual exclusion, which is $15,000 per individual (or $30,000 per couple) in 2019. This amount can be divided and given to an unlimited number of people without incurring federal gift taxes. In the future, the $15,000 exclusion amount will be indexed to account for inflation; the

exclusion amount will increase in $1,000 increments. A gift tax must be paid on all transfers to others (other than a spouse) that are in excess of the maximums listed in Table 4.

Tax Implications of Defined-Contribution Plans

If your company offers a defined-contribution plan, there are several tax implications you should be aware of:

Gifts in excess of the annual exclusion limit are subject to taxes and are subtracted from your lifetime gift limit of $11.4 million in 2019. The following are exempt from this limit: gifts less than the exclusion amount in any of the previous years; tuition payments made directly to the school or medical expenses paid directly to the hospital for others; and gifts to spouses, political organizations, or charities. While a gift for one year may be greater than the annual exclusion and requires you to file a gift tax return (Form 409), you may not have to pay a gift tax if you apply the unified credit to your gift tax.

3. Unlimited marital deductions: There is no limit on the value of an estate that can be passed tax-free to a spouse who is a U.S. citizen. However, the unlimited marital deduction does not apply to spouses who are not U.S. citizens. The limit on tax-free gifts that can be made beyond the tax-free transfer threshold per year to non-citizen spouses is $155,000 in 2019 (see Table 6).

Table 6. Tax-Free Gifts to Non-Citizen Spouses

Year	Maximum Amount
2015	$147,000
2016	$148,000
2017	$149,000
2018	$150,000
2019	$155,000

4. Generation-skipping taxes (GSTT): In addition to the regular estate tax, a tax is imposed on any wealth or property transfers made to a person two or more generations younger than the donor. The GSTT is designed to allow tax-free transfers to spouses and children but imposes taxes on transfers going to grandchildren and others who are two or more generations away from the person making the transfer. The tax is 40 percent of the value of the property transferred in 2018 (see Table 7). There are exceptions to this tax. The $15,000 gift-tax exclusion applies, as do the education-tax exclusion and medical-expense gift-tax exclusion. In addition, up to $11.4 million per individual ($22.8 million per couple) may be passed on to grandchildren in 2019 without incurring taxes.

Principles of Estate Planning

The following are a few important principles of estate planning:

1. Understand Yourself, Your Vision, Goals and Plans. What is your vision for estate planning? What would you like to accomplish? What are your personal and family goals? Make sure what you are planning to do is in the best long-term interest of those you love.

What is your budget and balance sheet? Is what you are planning to do reasonable in light of your available resources? Will it still allow you to live in an acceptable manner for the rest of your life?

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received. Realize that inheritance gifts are not always blessings. There may be others ways to accomplish your vision and goals than just giving money.

3. Understand the key areas of Estate-Planning and All Applicable Laws. Once you understand what you want to accomplish, you must next understand the estate-planning process and applicable laws. Make sure what you are doing is legal. Recognize the tax consequences of your actions and plan for adequate liquidity to meet your tax needs.

4. Start Early and Seek Qualified Legal Help. Start estate planning early. Once you are married, write a will to make sure your assets will go to who you want. Once you have children, make sure you articulate who you want to be the guardian of your children and executor of your will. As your assets reach a critical mass, determine how you want to dispose of those assets, and do so in a way that is consistent with your goals and objectives.

Seek qualified legal help in this process. Make sure the legal documents are well written and will accomplish the goals you want to accomplish. Realize that if you have assets in multiple states, you may need legal help in each state.

5. Remember the Key Principles of Finance. Remember the key principles of finance: Ownership: none of what we have is ours. Stewardship: we are stewards over all God has and will bless us with. Agency: the gift of choice is one of God's greatest gifts. And accountability: we will be held accountable for all of our choices, including our financial ones.

Finding Balance

As you work on your Advance Plan, finding balance among doctrines, principles and application is important in helping you prepare for what happens after we pass away. We have shared some ideas for principles. Below are a few ideas for doctrines on which the principles are based.

Principles	Doctrines
Understand yourself and your vision	Identity
Seek, receive and act on the Spirit's guidance	Obedience

Understand needs after retirement	Stewardship
Understand your posterity's needs	Agency
Understand the key areas of estate planning	Stewardship
Get very qualified legal help	Agency

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on preparing for life after death; rather, from a higher perspective, or with increased vision,

> We are children of the living God (identity), living worthy of the Spirit's guidance (obedience), using our agency wisely (agency) so we can carefully and with wisdom make long-term decisions (agency) for the disposition of our current and future assets (accountability). As we think through our vision and goals for life, we will develop Plans and Strategies that will help our family (stewardship), with our help, to accomplish our individual and family vision and goals even after we pass away.

Know How Trusts Can Be Used to Your Advantage in the Estate-Planning Process

Trusts give you professional management of your assets and provide for confidentiality. They may allow you to reduce your personal assets by transferring ownership to the trust, thus helping you avoid estate taxes. They may also allow you to avoid probate.

Table 7. Generation Skipping

Year	Generation-Skipping Transfer Tax Exemption	Tax Rate of Amount Over Exemption
2015	$5,430,000	40%
2016	$5,450,000	40%
2017	$5,490,000	40%
2018	$11,180,000	40%
2019	$11,400,000	40%

Other benefits of trusts include that they may allow you to more clearly specify your desires regarding your assets, since they are much more difficult to challenge than wills. They may allow you to specify which assets should go to which children (particularly children from a previous marriage). Finally, trusts can be used to provide for children with special needs or to hold money until a child reaches maturity.

If any of the following conditions apply to you, you should seek professional advice regarding the ways a trust could benefit you:

1. Your total estate is larger than the estate tax-exemption amount, which was $11.4 million in 2019.
2. You want to avoid probate.

3. You have specific desires or goals for the management and disbursement of your assets.
4. You want to leave an inheritance to children from a prior marriage.
5. You have a child with a handicap or a relative who requires specialized care because of a disability.

Trust Assets

Once a trust is established, it is critical to transfer the assets to the trust; a trust is worthless until assets have been transferred into it. Trusts can hold all types of assets, including real property assets, such as a home; real estate assets; land tracts and out-of-state properties; liability and title insurance assets; property taxes; transfer taxes; and rental real estate.

Trusts can also hold credit cards, notes you owe, mortgages, loans, checking accounts, savings accounts, pay-on-death accounts, certificates of deposit, credit union accounts, safe deposit boxes, stocks, bonds, mutual funds, and savings bonds.

Trusts can hold real assets such as boats, automobiles, motorcycles, recreational vehicles, and other vehicles. In addition, they can hold life insurance and other self-provided insurance.

Businesses may be included in trusts if they are sole proprietorships, limited partnerships, closely held corporations, S corporations, limited liability companies, or general partnership interests.

Other assets that may be included in trusts include personal untitled property, copyrights, patents, royalties, oil and gas interests, club memberships, and foreign assets.

Types of Trusts

There are two different types of trusts: living trusts and testamentary trusts. A living trust is a trust in which assets are placed while you are still living. With a testamentary trust, assets are placed in the trust after you die. This trust is created after probate, according to your instructions.

1. Living trusts: There are two different types of living trusts: revocable living trusts and irrevocable living trusts.

A revocable living trust allows for unlimited control by the trust owner because the owner retains the title to all the assets in the trust. The advantage of a living trust is that the assets in the trust do not pass through probate when the owner dies. In addition, a living trust provides greater ease of distribution and greater privacy upon death. The disadvantage to a living trust is that it does not provide any tax advantages. The entire amount of the living trust is considered an asset for estate tax purposes.

An irrevocable living trust cannot be changed by the owner once established because the trust becomes a separate legal entity that owns all the assets it contains and pays taxes on the assets and the gains they produce. The advantage of an irrevocable living trust is that the assets are not subject to estate taxes, since they are not part of the owner’s estate. Additionally, assets in the

trust do not pass through probate. The disadvantage to an irrevocable living trust is that the owner no longer has the title to or use of any of the assets.

2. Testamentary trusts: A testamentary trust is a trust in which assets are placed only after the owner dies. The trust is created after probate, according to the desires of the owner, and the assets are transferred into the trust. There are different types of testamentary trusts, including standard family trusts, qualified terminable interest property trusts (Q-TIP trusts), and sprinkling trusts.

Standard family trusts hold the assets of the first spouse who dies until the second spouse dies. The surviving spouse has access to income from the trust, or the trust principal, if necessary. Standard family trusts reduce the size of the estate for the second spouse, which reduces estate tax liability.

A Q-TIP trust provides a means of passing on income to a surviving spouse without turning over control of the assets. These trusts ensure that assets will be passed on to your children upon the death of your surviving spouse.

A sprinkling trust distributes assets to a designated group of beneficiaries on an as-needed basis rather than in accordance with a preset plan.

Setting Up a Trust

In order to establish a trust, you must understand the following terminology:

Grantor: The person who creates the trust.
Trustee: The person who will manage the trust.
Successor trustee: The person who will succeed the trustee should the trustee be unable to manage the trust.
Beneficiaries: The recipients of the trust's earnings or assets.
Children's trusts: Trusts created for underage children.
Guardian: The person who raises children in lieu of their parents.
Children's trustee: The person who manages children's assets in lieu of their parents.

A qualified estate-planning lawyer or financial planner can help you establish a trust. Be sure to consult with a lawyer or financial planner who is not trying to sell you any products. Insist on seeing identification and a description of your consultant's qualifications, education, and expertise in estate planning. Seeking advice from a good, qualified consultant is important, especially if the size of the trust is significant and if there may be questions as to how assets should be distributed.

Do not allow yourself to be rushed. Ask for time to consider your decision, and report high-pressure tactics, misrepresentations, or fraud immediately to the Better Business Bureau. Always ask for a copy of any documents you sign, and know your cancellation rights. Finally, be wary of

home solicitors who insist on receiving confidential and detailed information. If any concerns arise, call the Better Business Bureau and report the solicitors.

Be aware of the costs of establishing and managing a trust. The costs will vary from lawyer to lawyer, but they should include the costs of reviewing your assets and their present titles, discussing your estate plan, preparing your trust, and supervising the execution of the trust and the transfer of assets.

Understand the Importance of Wills and Probate Planning

A will is a legal document that indicates how the state should distribute your assets upon your death. The legal term for someone who dies without a will is "intestate." When someone dies intestate, or without a will, the state determines, based on specific state laws, which assets will go to which individuals, regardless of the intentions of the deceased. That is why it is so critical to have a will.

Having a will ensures that state law will not dictate the distribution of your assets, the custody of your children, or the care of those under your responsibility who have special needs. A will also allows you to avoid the costs associated with having a court-appointed administrator.

The following are key terms related to wills that you should be familiar with:

Will: A legal document that transfers an estate after death.
Beneficiaries: People who receive the deceased's property and assets.
Executor or personal representative: The person responsible for carrying out the provisions of the will.
Guardian: The person who cares for minor children of the deceased and manages the children's property.

Wills

Wills can be handwritten, computer-generated, or oral. It is safest to have a will drawn up by a lawyer. Most wills (holographic wills being the exception) must be signed, witnessed by two or more people, and notarized.

Wills should be stored in a safe place; however, a safe-deposit box is not always a good place to store a will because it may be sealed upon your death. Always tell someone you trust where your will is so it can be found upon your death.

In order to have a valid will, a person must have mental competence and must not be under undue influence from another person. For a will to be valid, it must also conform to the laws of the state in which it is written.

An amendment to a will (a codicil) institutes minor changes to the original will. To be effective, a codicil must be signed, witnessed, and attached to the original will. However, if the changes are

major, a new will should be drafted.

Probate

Probate is the process of distributing an estate's assets. The probate process includes appointing an executor if one is not named, validating the will, allowing for challenges to the will, overseeing the distribution of assets, filing a report with the court, and closing the estate.

There are numerous costs and fees involved in the probate process, including legal fees, executor fees, and court fees; these fees can be from one percent to eight percent of the estate's value. Additionally, the probate process can be quite slow, especially if there are challenges to the will or tax problems.

Ways to Avoid Probate

You can avoid probate in the following ways:

Have joint ownership: There are several different options for joint ownership of property that help you avoid probate. You can have tenancy by the entirety, joint tenancy with the right of survivorship, tenancy in common (where the will controls distribution of the deceased's share of the property), or community property (where state law and a will control distribution of the property). Each of these methods does not require probate for the transfer of titled property.

Make gifts (with the exception of life insurance policies): You can take advantage of unlimited gift-tax exclusions on payments made for medical and educational expenses. However, you must make the payments directly to the hospital or college. Money donated to charities is also eligible for gift-tax exclusions.

Name beneficiaries in contracts such as life insurance: In most cases, ownership of contracts such as life insurance passes to the beneficiaries upon death of the owner without the contract having to be probated.

Use trusts: Two types of trusts allow you to avoid probate: a living trust, which takes effect before death, and a testamentary trust, which takes effect upon death.

Other Estate-Planning Documents

There are a number of estate-planning documents you should be aware of:

Durable power of attorney: This document allows someone to act on your behalf if you should become mentally or physically incapacitated. This document is separate from the will and goes into effect before your death. A durable power of attorney should be very specific as to which legal powers it transfers.

Living will: A living will is a document that states your wishes regarding medical treatment in the event of a terminal illness or injury.

Health-care proxy: A health-care proxy designates someone to make health-care decisions for you if you should become unable to make them yourself.

Understand and Create Your Advance Plan

In putting together your Advance Plan, which includes your will, Advance Health Care Directive, and your Estate plan, it is similar to your other Plans. Following are a few ideas for helping you put together your Estate Plan.

Vision

- From your plan for Life. It may also include:
  - My first priority is to live life fully and take care of my spouse. They will be able to enjoy their remaining years of life in dignity and with family.
  - If there are sufficient resources remaining, we will use them for our individual and family vision and goals.

Goals

- We will live life to the fullest, and will use probate strategically and will have a plan for the disposition of our assets according to our vision and goals
- I will plan for future medical care and accidents by signing a Utah Advanced Health Care Directive (LT14)
- We will have sufficient assets saved to be able to take care of my spouse and I throughout our lives.
- We will help our children and grandchildren with worthy goals including missions and education

Plans and Strategies

Single and Young Marrieds

- We will start with a holographic will while in school (we will do one in this class).
- We will complete our Utah Advanced Health Care Directive (LT14)
- As we graduate, begin work and have children, I will get a will from a qualified lawyer

Married with children

- We will prepare a holographic will while in college, and then get a will from a qualified lawyer
- We will agree to the same guardian of the minor children and the same personal representative to ensure two different people looking after our children should we pass
- As our assets increase, we will set aside money to help with missions and education

- As our asset size increases above $100,000 or we purchase a home, we will create a living trust, that will allow the assets to pass to heirs without probate and reduce probate costs (which is roughly 5% of the estate value)

Empty Nesters

- We will determine our needs for the remainder of our lives. If they are sufficient, we will:
    - Create a living trust to help our grandchildren and great grandchildren pay for missions and college
    - We will create a Family Foundation to teach children financial skills and the importance of giving to others. It will also pay for expenses to bring the family together once a year to talk about foundation issues (and to be a great family vacation)
- We will review our Advance Plan every 3-5 years.

Constraints

- Inability to live on a budget and save will directly reduce amounts available
- Excessing spending will limit amounts for children and grandchildren
- Sin will eliminate the desire to save, will cause us to seek the things of the world, and will definitely increase spending
- Health care costs may eat into the amounts available to put into trusts for children and grandchildren

Accountability

- We will work on these plans together with my spouse
- We will share them with our children and grandchildren as appropriate times
- We will not use inheritance as part of a negotiation strategy with our children.

Summary

Estate planning is the process of planning for the accumulation, conservation, and distribution of estate assets; this process can help you accomplish your personal and family goals. Every estate is planned, either by the individual or by default through rules established by the state and local governments. The purpose of estate planning is to ensure that you—and not others, such as the government or lawyers—choose who will inherit your wealth.

There are four steps in the estate-planning process: (1) determine how much your estate is worth, (2) choose your heirs and decide on the assets they will receive, (3) determine the cash needs of the estate and calculate your estate taxes, and (4) select and implement estate-planning techniques to maximize goals and minimize taxes. Estate planning can help you use your assets wisely in order to achieve your personal goals even after you die. The four key taxes on estates are estate taxes, gift taxes, unlimited marital deductions, and generation-skipping taxes.

When you create a trust, you enter into a legal contract that gives you professional management

of your assets and provides for confidentiality. Trusts may allow you to reduce your personal assets by transferring ownership to the trust, thus helping you avoid estate taxes. They may also allow you to avoid probate. Other benefits include that they may allow you to more clearly specify your desires regarding your assets, since trusts are much more difficult to challenge than wills. They may allow you to specify which assets should go to specific children (particularly children from a previous marriage). Finally, trusts can be used to provide for children with special needs or to hold money until a child reaches maturity.

A will is a legal document that indicates the way the state should distribute your assets upon your death. Someone who dies without a will is "intestate." When someone dies intestate, the state determines, based on specific state laws, which assets will go to which individuals, regardless of the intentions of the deceased. Having a will ensures the state law will not dictate the distribution of your assets, the custody of your children, or the care for those under your responsibility with special needs. A will also allow you to avoid having a court-appointed administrator and the associated costs.

Finally, we discussed ideas for putting together your Estate Plan.

Assignments

Financial Plan Assignments

First, review the goals you made in Chapter 2. Do you have specific goals that may extend beyond your lifetime and would require a trust? If so, what would you like to do about these goals? Are they feasible given your current financial condition? Review your net worth (discussed in Chapter 3). Does your current net worth exceed the estate tax threshold established by the IRS? How close are you to the threshold? If you are close, you should get qualified help.

Second, do you have a will? If you have children, a will is critical because it states your wishes regarding who should take care of your children should you pass away. Your choice is either to write your own will or let the government determine how you would have wanted your assets distributed. If you have few assets and you reside in a state that allows holographic wills, write one immediately. At least write your wishes regarding who is to take care of your children. If you are beginning to acquire assets, it is recommended that you visit a legal attorney who can, for a fee, help you write up a will that is valid for your state. Wills should be reviewed every three to five years, or more often if your situation changes.

Finally, are you concerned that your wishes regarding health-care might not be made known to medical personnel should something happen to you and you are unable to communicate your wishes? Filling out Utah Advance Health Care Directive (LT14) will allow you to state your intentions for medical care in the event of an emergency in which you are unable to make your wishes known.

Once you answer these three questions, you can begin to put together your Advance Plan. Remember that giving things to others may not always be a blessing.

Learning Tools

Utah Advance Health Care Directive (LT14).
This is an example of a Advance Health Care directive. If you move to another state, you should likely fill one out in that state.

Estate Planning Spreadsheet (LT40)
This tool can help you as you determine your estate taxes for 2018. It separates out total, adjusted gross income, taxable income, and helps you calculate your refund or payment.

Review Materials

Terminology Review

Advanced Health Care Directive. This document, also known as a living will or personal or advance directive, is a legal document where a person specifies what actions should be taken for their heath care if they are no longer able to make decisions for themselves due to illness or other reasons.
Beneficiaries. The people who receive the property or assets.
Children's Trustee. The person who manages the assets for the children.
Children's Trusts. Trusts specifically for underage children.
Codicil. A document which institutes minor changes in the original will. Must be signed, witnessed, and attached to the original will.
Community Property. A form of ownership is equal and only between partners. Lifetime control is shared by both spouses, consent from both is required to sell, income is shared between owners, and testamentary control in the one-half interest is unlimited unless property has right of survivorship feature (applicable in some states).
Durable power of attorney. This provides for someone to act on your behalf in the event you should become mentally or physically incapacitated. This document is separate from the will and goes into effect before death. This document should be very specific as to which legal powers it transfers.
Estate planning. The process of anticipating and arranging for the disposal of your resources to accomplish your personal and family goals after you pass away.
Estate Taxes. These are taxes, paid to the government, due on passing of an individual. Estate taxes are equal to the gift-adjusted taxable estate multiplied by the appropriate tax rate. To determine the net tax owed, calculate the total tax owed and subtract the unified gift and estate tax credit.
Estate transfer. This is the process that property interests are legally transferred from one to another, either during the person's lifetime or at death
Exclusion Amount. This is the amount of estate value that is excluded from the estate tax.
Executor or personal representative. This is the person who is responsible for carrying out the provisions of the will.
Generation-Skipping Tax. This is a tax on revenue lost when wealth is not transferred to the

next generation, but to a succeeding generation. It is a flat tax, in addition to the regular estate tax, imposed on any wealth or property transfers to a person two or more generations younger than the donor.

Gift Tax Exclusions. A gift tax must be paid on all transfers to others (other than a spouse) that are in excess of the maximums specified. The maximum specified is your exclusion.

Gift-Adjusted Taxable Estate. This is equal to your taxable estate plus any taxable lifetime gifts, which is the cumulative total of all gifts over the annual limit.

Gross Estate. This is the value of all your assets, including life insurance, pensions, investments, and any real or personal property.

Guardian. The person who cares for minor children and manages their property.

Health care proxy. A health care proxy designates someone to make health care decisions should you be unable to do so for yourself.

Holographic Will. A will and testament that is entirely handwritten and signed by the testator. Traditional wills require signatures of witnesses as well as the testator's signature and intent. Holographic wills are treated equally with witnessed will and need only to meet minimal requirements in order to be probated

Intestate. The process whereby the state essentially writes the will for a person because they did not prepare a will during their lifetime.

Irrevocable Living Trust. A trust that cannot be changed by the owner once established, because the trust becomes another legal entity which owns all the assets contained in the trust and pays taxes on the assets and gains they produce. The assets are not subject to estate taxes since they are not part of your estate and assets in the trust do not pass through probate.

Issue. These are children.

Joint Tenancy with Right of Survivorship (JTWROS). Ownership is shared equally and lifetime control is shared, income is shared between owners, testamentary control is absent, and then right of survivorship is key.

Lifetime transfers. Methods of transferring property including the sale or gifting of one asset to another.

Living Trust. A trust where assets are placed in the trust while you are still living. You can take them out and move them according to what you want to do before you die.

Living will. It is a legal document that details your end-of-life wishes for health care. It is used when you are still alive but unable to make health care decisions for yourself. A living will states your wishes regarding medical treatment in the event of a terminal illness or injury

Non-probate transfers. These are "will substitutes," and include state law, right of survivorship, beneficiary designations, and gifts causa mortis.

Personal Representative (Executor). This is the person who fulfills the requirements of the trust or will.

Probate. Probate is the process of distributing an estate's assets after death. Probate is a matter of state law. It is the matter of administering the portion of the person's estate that is disposed of in either by will provisions, for those with a valid will, or by intestate succession, for those who die without a will.

Q-TIP (Qualified Terminable Interest Property) Trust. A Q-TIP Trust is a testamentary trust which provides a means of passing income to the surviving spouse without turning over control of the assets. These trusts ensure that assets will be passed to your children upon the death of the surviving spouse.

Revocable Living Trust. It is the most common type of living trust. It is a trust which allows for unlimited control by the trust's owner, because the owner retains title to all the assets in the trust.

They do not pass through probate. They provide greater ease and privacy of distribution upon death.
Sole ownership. Ownership where ownership and control is absolute in one individual. Income belongs to sole owner and testamentary control is absolute.
Sprinkling Trust. A Sprinkling Trust is a testamentary trust that distributes assets on a needs basis rather than according to some preset plan to a designated group of beneficiaries.
Standard Family trust. This is a testamentary trusts which hold the assets of the first spouse to die until the second spouse dies. The spouse has access to income from the trust, or the trust principal, if necessary. They reduce the estate of the second spouse so that the estate taxes can be reduced.
Stepped Up Basis. This is the process of the value of an asset being stepped up, or changed from the original value when purchased, to the current value when the person dies and it is transferred to heirs.
Successor Trustee. This is the person to succeed the trustee should the trustee not be able to manage the trust.
Taxable Estate. This is equal to the gross value of your estate, less estimated funeral and administrative expenses, debts, liabilities, taxes and any marital or charitable deductions.
Tenancy by the entirety. Ownership is shared equally and limited to spouses, lifetime control is shared by both spouses, consent from both is required to sell, income is shared between owners, testamentary control is absent, and the right of survivorship is key.
Tenancy in Common. Ownership is shared, with each owning an undivided fractional interest that may be unequal, lifetime control is unlimited, income is shared between owners in relation to fractional interest, and testamentary control is unlimited.
Testamentary transfers. Methods by which property is transferred at death.
Testamentary Trust. The process where assets are placed in trust after you die. The trust is created after probate according to your will.
Trust Grantor. The person who created the trust.
Trustee. The person who will manage the trust.
Trusts. A trust is a legal contract. When you create a trust you are simply creating another legal entity. Trusts avoid probate and are more difficult to challenge than wills. They may reduce estate taxes, allow for professional management, provide for confidentiality, can be used to provide for children with special needs, can be used to hold money until a child reaches maturity, and can assure that children from a previous marriage will receive some inheritance in the future.
Unlimited Marital Deduction. There is no limit on the value of an estate that can be passed tax-free to a U.S. citizen spouse. This does not apply to non-U.S. citizen spouses. The tax-free maximum gift per year to non-citizen spouses is specified.
Will. A legal declaration by which a person provides for the disposition for their property and other assets at death.

Review Questions

1. What is estate planning?
2. What are the five main goals of estate planning?
3. What are four ways to designate where property should go after you die?
4. What are the four steps of the estate-planning process?
5. What are the four taxes that may be imposed on an estate?

Case Studies

Case Study 1

Data

Jonathan, a single man, passed away in December 2019. The value of his assets at the time of his death was $16,155,000. He also owned an insurance policy with a face value of $315,000 (which was not in an irrevocable trust). The cost of his funeral was $19,750, and estate administrative costs totaled $67,000. As stipulated in his will, he left $154,000 to charities. Also, for each of the years 2014 to 2017, Jonathan provided his niece Suzy with $20,000 per year for college tuition. Of this $20,000, $5,000 was paid directly to the college for tuition and fees, and the remaining $13,000 was paid to his niece to cover her living expenses while she was going to school, and $2,000 was for clothes. In addition to paying for his niece's schooling, he also gave her $25,000 as a late graduation present in 2018 for a down payment on a new house.

Calculations

Determine the value of Jonathan's gross estate, his taxable estate, his gift-adjusted taxable estate, and his year 2018 estate tax. The annual tax-free gift limits are as follows: 2018-19, $15,000; 2013-2017: $14,000; 2012–2009: $13,000; 2008–2006: $12,000.

Case Study 1 Answers

What is the gross value of Jonathan's estate?

Gross Estate = assets + life insurance policies not in irrevocable trusts

Gross Estate = $16,155,000 + $315,000 = $16,470,000

Determine the value of his taxable estate?

Taxable Estate = Gross Estate – liabilities – funeral expenses – administrative expenses – charitable deductions

Taxable Estate = $16,470,000 – $19,750 – $67,000 – $154,000 = $16,229,250

Determine his gift-adjusted taxable estate

Gift-Adjusted Taxable Estate = Taxable estate + gifts in excess of the annual allowance

Gift-Adjusted Taxable Estate = $16,229,250 + $1,000 (2014) + $1,000 (2015) + $1,000 (2016) + $1,000 (2017) +$10,000 (2018) = $16,243,250. Of the $20,000 each year, $5,000 was paid directly to the school, so the $5,000 is not counted in the tax-free gift. Only the payments of $15,000 are counted. After the limits are reached, there is an excess of $1,000 each year. Of the $25,000 in 2018, $15,000 was the tax-free exclusion, resulting in $10,000 to be added in excess of the allowance. Total to add back is $14,000.

Determine his estate tax liability for 2019 on gift-adjusted tax of $6,243,250.

Amount Above	Year	Tax on Column A	Rate on Excess
$11,400,000	2019	$4,560,000	40%

Two ways to calculate the tax

a. ($16,243,250 – $11,400,000) * 40% = $1,937,300

The estate tax is the difference between tax owed and the unified credit

Year at Death	2019

Key Data:

Value of Assets at Death	16,155,000
Life Insurance Policies	315,000
Insurance Death Benefit	
Funeral costs	19,750
Estate Administrative Costs	67,000
Charities	154,000

Note: Irrevocable Trusts (ILITS) are not included

I. Detrmine your Gross Estate:

Assets	16,155,000
Life insurance (not in an ILIT	315,000
Insurance Death Benefits	-
Gross Estate	16,470,000

II. Calculate your Taxable Estate

Gross Estate	16,470,000
Funeral expenses	19,750
Administrative expenses	67,000
Charitable deductions	154,000
Taxable Estate	16,229,250

III. Determine your Gift-Adjusted Taxable Estate

Taxable Estate	16,229,250
Gifts in Excess	14,000
Gift-Adjusted Taxable Estate	16,243,250

Total Excess of Annual Limits	14,000

Year	Amount	Exclusion	Excess
2011		13,000	-
2012		13,000	-
2013		14,000	-
2014	15,000	14,000	1,000
2015	15,000	14,000	1,000
2016	15,000	14,000	1,000
2017	15,000	14,000	1,000
2018	25,000	15,000	10,000
2019		15,000	-

2019 Estate Tax Information

Annual Exclusion	15,000
Estate Tax Tax-Free Exclusion	11,400,000
Tax Rate on on Excess	40.0%

IV. Calculate your Estate Tax Liability

Gift-Adjusted Taxable Estate	16,243,250
2019 Unified Credit Amount	11,400,000
Excess (if <= 0, no tax liability)	4,843,250
Tax Rate on Excess	40.0%
Estate Tax Liability	$ 1,937,300

Case Study 2

Data

The value of Suzy's estate plus taxable gifts is $11.7 million at the time of her death in 2019.

Calculations:

A. What is her estate tax liability?

B. How would the estate tax liability change if $1.3 million of his estate was held in an irrevocable trust?

Case Study 2 Answers

IV. Calculate your Estate Tax Liability

Gift-Adjusted Taxable Estate	11,700,000
2019 Unified Credit Amount	11,400,000
Excess (if <= 0, no tax liability)	300,000
Tax Rate on Excess	40.0%
Estate Tax Liability	$ 120,000

A. Calculating federal estate tax requires calculating Suzy's estate tax and then subtracting his unified credit. On an estate of $11.7 million, the amount in 2018 would be:

Amount Above	Year	Rate on Excess
$11,400,000	2019	40%

($11,700,000 – $11,400,000) * 40% = $120,000

IV. Calculate your Estate Tax Liability

Gift-Adjusted Taxable Estate	10,400,000
2019 Unified Credit Amount	11,400,000
Excess (if <= 0, no tax liability)	(1,000,000)
Tax Rate on Excess	40.0%
Estate Tax Liability	$ -

C. Assuming that $1.3 million is held in an irrevocable trust, the taxable estate drops to $10.4 million, which is less than the exemption equivalent of $11.4 million in 2019, so estate taxes would be $0.

Case Study 3

Data

In 2019, Dave and Sally gave $32,000 to their son for a down payment on a house.

Calculations:

A. How much gift tax will Dave and Sally owe?
B. How much income tax will their son owe?
C. List three advantages of making this gift.
D. How could they have avoided the gift tax?

Case Study 3 Answers

A. There will be a gift tax in 2019 as the amount is $2,000 in excess of the $30,000 maximum transferable each year ($15,000 per individual in 2019). They will need to fill out a gift-tax form. The gift tax before exclusions will be $2,000 * .18 = $360.
B. Their son will not have to pay any income tax because recipients of a gift do not have to pay tax on the gift. Recipients do have to pay tax on future income generated by the gift but not directly on the gift.
C. Advantages include (1) providing needed income to a family member, (2) reducing the donor's estate taxes (the recipient is not taxed), and (3) helping avoid probate as gifted assets no longer belong to the donor.
D. They could have eliminated this need for a gift tax by splitting the gift over two years. One idea would be to give their son $30,000 in cash in 2019, and give him a loan for $2,000 for the remainder. Then in 2020, they gift him another $2,000 to repay the loan.

<u>Case Study 4</u>

Data

Anne Smith had a $5,500,000 net worth at the time of her death in 2019. In addition, she had a $250,000 whole life policy with $40,000 of accumulated cash value; her niece was the beneficiary. She also had a $150,000 pension plan benefit.

Calculations

A. What was the gross value of Anne's estate?
B. How much of her estate is taxable?
C. How much estate tax will need to be paid?
D. How much of her estate must pass through probate?

Case Study 4 Answers

A. Anne's estate is calculated by adding to her net worth (estate taxes minus debts) the value of her life insurance death benefit plus death benefits associated with her employer retirement plan. Note that cash value is not distributed (unless with an insurance rider).
$5,500,000 + 250,000 + 150,000 = $5,900,000
B. All of Anne's $5,900,000 estate is taxable.
C. Anne will pay no estate taxes as the value is less than $11.4mn
D. Any of the $5,500,000 that passes to the heirs must go through probate.

Case Study 5

Data

Suzanne and Steve Smith have $2.2 million of assets in 2019: $600,000 in Steve's name, $600,000 in Suzanne's, and $1,000,000 of jointly owned property. Their jointly owned property is titled using joint-tenancy with right of survivorship. Suzanne also co-owns a $400,000 beach house with her sister Emily as tenants-in-common.

Application

A. What is the maximum amount of estate value that can be transferred by the Smiths free of estate tax in 2019?
B. What do the Smiths need to do to reduce their expected tax liability?
C. Who would receive Suzanne's half-share in the beach house if she were to die?

Case Study 5 Answers

A. The Smiths could jointly transfer a total of $22.8mn before incurring federal estate tax in 2019.
B. The Smiths should re-title their ownership of the property and put it in a trust to take advantage of taxes. In this way they can take advantage of a standard family trust and gift-giving.
C. Suzanne's half-share of the beach house would go to whomever she names in her will. If she dies intestate, state law will determine how her share in the beach house is transferred.

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[1] "Preparing for Emergencies," *Ensign*, Dec. 1990, 59

32. Family 1: Understanding the Fundamentals of Money and Marriage

Introduction

This discussion on the family is the first of a three-part series. The first chapter, "Money and Marriage," discusses how money impacts the relationship between couples. The second chapter, "Teaching Children Financial Responsibility," discusses ideas on teaching children about personal finance. Finally, the third chapter, "Saving for Children's Education and Missions," discusses methods of saving for your children's missions and education. Each of these areas is critical if we are to be successful in our challenge to be good parents and spouses and wise financial stewards.

We know the family is the most important societal unit both now and in the hereafter. We also have also been counseled, "No success in life can compensate for failure in the home."[1] How does money relate to this important assignment to be successful in our homes?

When you are single, you are the decision maker. Your goal is to "be a wise steward over your financial resources." However, once you become married, the process changes. Instead of "I" and "me" it becomes "us" and "we." There are now two equal decision makers. As such, unity now becomes a critical component, as "If ye are not one, ye are not mine."[2] (D&C 38:27). The goal changes and becomes "a unified and consecrated stewardship of your financial resources."

Unity in a marriage is critical. 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. Disability, death, or other circumstances may necessitate individual adaptation.[3]

Contrary to scripture and Christ's teachings, some have interpreted "presiding" to mean that after equal counsel, equal consent is not necessary because the presider (or husband) has the right of final say. L. Tom Perry corrected this and said, "There is not a president or a vice president in a family. The couple works together eternally for the good of the family. . . They are on equal footing. They plan and organize the affairs of the family jointly and unanimously as they move forward."[4]

Some have misunderstood what it means to "rule over." Bruce and Marie Hafen remind us:

> Genesis 3:16 states that Adam is to 'rule over' Eve, but this doesn't make Adam a dictator. … Over in 'rule over' uses the Hebrew bet, which means ruling 'with,' not ruling 'over.' … The concept of interdependent, equal partners is well-grounded in the doctrine of the restored gospel.[5]

Our marriage standard is simple. It is equal partners with equal responsibility and unified in working toward common individual and family goals. It may not be attainable by everyone, but it is still the standard we seek to achieve. It is also important to remember that widowed, divorced, never married and single parents have all been promised that those who faithfully follow the commandments and keep their covenants will receive all blessings promised by our loving Heavenly Father. There are no second-class citizens in the gospel.

Please note that many of the ideas from this first chapter on family are from "The Family: A Proclamation to the World"[6] and Bernard E. Poduska's *For Love and Money: How to Share the Same Checkbook and Still Love Each Other.*[7]

Objectives

There are three objectives from this chapter that you should remember:

> A. Understand the key changes in decision making once you are married and the principles of money and marriage
> B. Understand why money may be an issue in relationships and share a few recommendations for money and marriage
> C. Understand and create your family financial plan.

Deciding now that your family is your most important priority and developing an understanding of the key principles of money and marriage and the reasons money may be an issue in marriage are the keys to working toward achieving shared personal and financial goals.

Understand the Key Changes in Decision Making and the Principles and Practices of Money and Marriage

The decision making process changes once you are married. When you are single, you are the decision maker. Your general goal is to "be a wise steward over your financial resources." Once you become married, the process changes. Instead of "I" and "me" it becomes "us" and "we." There are now two equal decision makers. Unity now becomes a critical component, as "If ye are not one, ye are not mine."[8] The goal now changes and becomes "a unified and consecrated stewardship of your financial resources."

What is our standard for families? 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*. Disability, death, or other circumstances may necessitate individual adaptation.[9]

Many have been concerned about what it means to preside. Contrary to scripture and Christ's teachings, some have interpreted "presiding" to mean that after equal counsel, equal consent is not necessary because the presider (or husband) has the right of final say. L. Tom Perry corrected this and said: "There is not a president or a vice president in a family. The couple works together eternally for the good of the family. . . They are on equal footing. *They plan and organize the affairs of the family jointly and unanimously as they move forward*."[10]

Others have wondered what it means to "rule over." Bruce and Marie Hafen remind us:

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Our marriage standard is simple. Marriage partners are equal partners with equal responsibility and unified in working toward common individual and family vision and goals. It may not be attainable by everyone, but it is still the standard we seek to achieve. Widowed, divorced, never married and single parents have all been promised that those who faithfully follow the commandments will receive all blessings promised by Heavenly Father. There are no second-class citizens in the gospel.

Principles of Money and Marriage

There are principles of money and marriage that can help us to be happier and to better take care of our blessings. While the following principles are not exclusive, they provide a great starting point as you ponder how to best manage money in your marriage.

> **1. Understand Yourself, Your Vision, Goals and Plans**. What is your vision for your spouse and family? What would you like to accomplish as a marriage partner and family? What are your personal and family goals? Make sure what you are planning to do is in the best long-term interest of those you love.
>
> What is your budget and balance sheet? Is what you are planning to do reasonable in light of your available resources?
>
> **2. Seek, receive and act on the Spirit's guidance.** This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand and live the 9 key principles of successful marriages and families. Following the commandment and incorporating these traits in our lives are more likely to support successful marriages. From the Proclamation on the Family it states:

> Happiness in family life is most likely to be achieved when founded upon the teachings of the Lord Jesus Christ. Successful marriages and families are established and maintained on principles of faith, prayer, repentance, forgiveness, respect, love, compassion, work, and wholesome recreational activities.[12]

4. No one is more important that your spouse. David O. McKay said:

> Let me assure you, Brethren, that some day you will have a personal priesthood interview with the Savior, Himself. . . . I will tell you the order in which He will ask you to account for your earthly responsibilities. First, He will request an accountability report about your relationship with your wife. Have you actively been engaged in making her happy and ensuring that her needs have been met as an individual?[13]

If the first question our Savior will ask us concerns our relationship with our spouse, does that not tell us something about the primary importance of that relationship? Our relationship with our spouse should be the most important thing for us to work on.

5. The Family Is Ordained of God. The Family: A Proclamation to the World states, "The family is ordained of God. Marriage between man and woman is essential to His eternal plan. Children are entitled to birth within the bonds of matrimony, and to be reared by a father and a mother who honor marital vows with complete fidelity."[1]

Gordon B. Hinckley also stated "We must work at our responsibility as parents as if everything in life counted on it, because in fact everything in life does. If we fail in our home, we fail in our lives. No man is truly successful who has failed in his home."[14]

Clearly the family deserves to be considered your highest priority. As such, it deserves to be given the time and attention necessary.

6. Marriage Partners Are Equal. The Family Proclamation 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."[1]

Equal partners means that both have equal responsibility and equal say in financial matters. There should be unity in family decisions. In addition, control of money by one spouse as a source of power, or failure to take part in family finances are both inappropriate. Marvin J. Ashton wrote:

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.[15]

7. Spouses Are to Leave Their Parents and Become One. We have been commanded, "Therefore shall a man leave his father and his mother, and shall cleave unto his wife: and they shall be one flesh."[16] After being married, the newlyweds are to leave their parents to work with their partner (not their parents, friends, or bank accounts) to become one: one in purpose and goals.

We should leave behind the things our parents have done incorrectly or things that could have been improved on. After being married, you have the opportunity, together with your spouse, to set new goals and ways of doing thing, to put your family financial houses in order, giving you two the freedom to set up a budgeting style and goals that work for your unique partnership. This means that the things that work (or didn't work) for your parents may or may not work for the two of you. The important thing is to be unified regarding your partnership's financial approach and goals.

8. The Best Things in Life are Free. The Lord counsels us to "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."[17]

The things that are truly the most important to us and that will make a difference in our lives are not those things that cost money but those that bring us closer together as families and communities, both temporally and spiritually.

9. Financial Problems Are Usually Behavioral Problems Not Money Problems. The Lord shared a parable in which He explained, "For the kingdom of heaven is as a man travelling into a far country, who called his own servants, and delivered unto them his goods. And unto one he gave five talents, to another two, and to another one . . . But he that had received one [talent] went and digged in the earth, and hid his lord's money."[18]

In this parable, it wasn't money but the servants' use of that money that affected their standing in the Lord's eyes. All three servants had the same opportunity to make the most of the talents they were given.

The Lord expects the same from us with our financial obligations in marriage—it isn't money but our use of that money that will make a difference in our marriages. Marvin J. Ashton commented:

> How important are money management and finances in marriage and family affairs? Tremendously. The American Bar Association recently indicated that 89

> percent of all divorces could be traced to quarrels and accusations over money. . . May I at this time hasten to emphasize the fact that these marriage tragedies are not caused simply by lack of money, but rather by the mismanagement of personal finances.[19]

10. We can and must change and become better. Change is critical if you are to improve. As the saying goes, "If you always do what you've always done, you will always get what you've always got!" The scriptures say, "For whatsoever a man soweth, that shall he also reap."[20]

These sayings are applicable in the world of marital finances:

- If you continue to spend instead of save, you will continue living from paycheck to paycheck.
- If you continue to borrow to support a lifestyle you cannot afford, you will continue to sink further into debt.
- If you continue to save and invest wisely, you will likely continue to achieve your personal and family goals.

Despite challenges and setbacks that will inevitably occur, there is peace in knowing we are doing the best we can—which should be a key personal and family goal. Some personal and family goals are best measured by our efforts, which we can control, rather than the outcome, which we often cannot control. We must be willing to change if we are to make progress in becoming better financial stewards.

Finding Balance

Marriage is an equal partnership, and a critical part of the Lord's Plan of Salvation. As you work on money and marriage, finding balance among doctrines, principles and application is particularly important. We have shared some ideas for principles. Below are a few ideas for doctrines on which the principles are based.

Principles	Doctrines
Know yourself, your vision, goals	Identity
Seek, receive and act on guidance	Obedience
Key areas of successful marriages	Agency
Your spouse is most important	Stewardship
The family is ordained of God	Plan of Salvation
Marriage partners are equal	Agency
We must leave our parents	Accountability
The best things in life are free	Plan of Salvation
Finance problems are behavioral	Stewardship
We can and must improve	Agency

From Obedience to Consecration

From the principles and doctrines, we can see that this is particularly important that we take a long-term and eternal law. From a higher perspective, or with increased vision,

> We are children of a King (identity), living worthy of the Spirit (agency), using our agency wisely (stewardship) and building the most important institution in time and eternity, the family (Plan of Salvation). We are working as equal partners (equality) to accomplish our most important mPrission in life (accountability), which is to build an eternal family (stewardship), so we can return with our spouse and families back to Heavenly Father's presence.

Key Practices of Money and Marriage

Now that you have the important principles of money and marriage, what are the practices to support those principles? Let's share a few ideas that have been helpful in our family.

1. Create your family vision, goals and SIE budget, and then work on them together**.** This is where you decide what you want for your spouse and family. Your vision and goals will directly effect how you will live and act, so write it carefully. What is important to you in your marriage? What is your vision for your relationship, family and children? What are your goals to take you to your vision? What things will you work together to accomplish as a couple? Set a price tag and date on your goals that require financial inputs

Work on your saving, income and expense plan (SIE budget) together and review it often. It is the single most important activity to help you achieve your financial vision and goals. This is part of your family roadmap, and it can help you review potential problems before they happen.

2. Make all major purchases together, and with the Lord's confirmation. Financial decisions of substance should be made by consensus, and not solely by one spouse. "Some of the most serious problems in marriage arise when financial resources are not managed carefully and in the best interest of the family."[21]

3. Agree to and follow spending limits. Set your Saving, Income and Expense Plan together and agree to the spending limits in your budget. Develop trust in each other's ability to follow the plan which you work out together. Review potential problems before they happen, as problems will always arise.

4. Sleep on it. Agree to never make a major purchase on the spot. It is too easy to get carried away in the emotion of the minute. Take time to think on it. If it is a good deal today, it will also be a good deal tomorrow – so sleep on it for a day.

5. Deal with financial disagreements agreeably. Make your financial discussions productive.

Remember again the H.A.L.T principle (hungry, angry, lonely, tired). Get something to eat before talking about sensitive financial topics. Remember that disagreements are normal, but make them respectful! Kindness is a critical skill in relationships. Set up a time each week to talk about important topics, particularly financial topics.

6. Practice Mad Money. While both spouses should know and have a say in family income and expenditures, there may be disagreements. Mad money is an amount, set aside each month, that does not have to be reported to the other spouse. Each spouse has total control over this money without comment by the other.

7. Invest in each other and the relationship. "Therefore shall a man leave his father and his mother, and shall cleave unto his wife: and they shall be one flesh."[22] Make key investments in each other, which includes: dates each week, MAD money each month, weekend getaways each quarter, and vacations, including just the two of you, each year.

Understand Why Money May Be an Issue in Relationships and a Few Recommendations

James E. Faust commented, "Money itself seems neither to make a couple happy, nor the lack of it, necessarily, to make them unhappy, but money is often a symbol of selfishness."[23] To minimize money problems in marriage, we should recognize potential problem areas and understand how to eliminate them.

In a survey conducted by *Worth* magazine, couples admitted to fighting about money more than anything else. A staggering 57 percent of those surveyed agreed with the statement, "In every marriage, money eventually becomes the most important concern."[24]

The following are five of the most common financial problems in marriage and tips to eliminate or minimize the impact of these problems.

1. Lack of Financial Knowledge

The reasons people lack knowledge regarding personal finance are the same reasons people go into debt: ignorance, indifference, compulsiveness, and pride.

What can be done?

- **Ignorance:** To address ignorance, you must learn about finance. Finish this series. Make learning a lifelong process. Write out your personal and family goals and complete your Personal Financial Plan. Learn what you need to do and then set goals to get your financial house in order.

- **Indifference:** To correct indifference, you must become exact in all you do. Keep good records of your saving, income and expenses and get on a budget. Keep learning about the principles of personal finance. Develop and follow a budget—it is the most important

financial tool you will ever use. Most importantly, take responsibility for your spending because no one else will.

- **Compulsiveness:** To counteract **c**ompulsiveness, do not give in to your natural inclinations. The apostle Paul wrote, "the natural man receiveth not the things of the Spirit of God: for they are foolishness unto him: neither can he know them, because they are spiritually discerned."[25] Learn to live a disciplined life. Jason Payne, CFP, encourages his clients to ask the following question, "Does this action get me closer to or farther from my personal and family goals?"[26] If it brings you closer to your goals, do it. If not, don't.

- **Pride:** To address pride, the key is to put God first in your life. Ask yourself, "Does this action bring me closer to God through obedience to His commandments or take me farther away?" The truth is that people will never truly love you simply because you have more toys. Destroying yourself financially to maintain a lifestyle you cannot honestly support is a classic example of attempting to serve both God and man. It doesn't work.

2. Lack of Communication

Communication between spouses is critical; it is one sign of respect. A lack of communication between spouses, especially in areas of finance, may indicate a lack of respect for each spouse's financial goals and attitudes.

<u>What can be done?</u>

Make communication a priority. Be willing to understand, discuss, and reconcile financial attitudes early in your relationship. Commit to resolving financial misunderstandings before they escalate and to implementing family processes that promote trust and mutual discussion.

Develop a communication plan where the two of you can meet regularly—ideally daily or weekly—to discuss important issues. Set up a weekly stewardship meeting where you discuss budgets, investments, and other financial matters. This should be among your most important meetings, with church meetings, family home evening, temple attendance, and weekly dates. L. Tom Perry calls this a family executive committee meeting. He wrote:

> There are two areas I would determine to improve if that privilege were granted to me to have young children in our home once again. The first would be to spend more time as husband and wife in a family executive committee meeting learning, communicating, planning, and organizing to better fulfill our roles as parents. The second wish I would like, if I could have those years over, would be to spend more family time. This includes more consistent, meaningful family home evenings.[27]

3. Differences in Financial Personality Types and Family Baggage

You and your spouse were likely brought up differently. How you were brought up plays a major role in shaping your financial personality—your attitudes and beliefs about personal finance, including how money is handled, how planning is done, and who pays the bills. Common financial personality types include the following:

- **The Miser** usually pays cash for everything. Money is power, and so the miser is in control—he or she insists on paying the bills and keeping the books. The family never talks about money, and there is no financial planning as a family. The family also never knows where they are financially—only the miser knows.

- **The Spender's** motto is "shop 'til you drop." The spender always feels that things will work out, so there is no need to plan. There is no budgeting or planning for major purchases or for the future. The spender jokes that if he or she can't take it to heaven, then the spender isn't going!

- **The Selfish Provider:** The selfish provider says that because he or she earns the money, it is his or her privilege to decide where the money goes. The spouse has to ask whenever money is needed. There are no goals, no budget, and no plan for large purchases or future retirement or education—all of these will be delivered by the selfish provider. The spouses are not equal partners, and there is no planning for the future.

- **The Sleeper:** The sleeper always feels that disasters and crises happen to other people. The sleeper does not need to plan because things always work out. There is no planning and no communication of goals and objectives because of the sleeper believes that goals and objectives aren't needed.

- **The Wise Steward:** The wise steward always pays the Lord first. He or she saves a part of everything he or she earns. The wise steward shares basic financial information with his or her family, including with children. He or she plans for the future, saves in the present, and teaches children to do the same.

<u>What can be done?</u>

Understanding financial personality types is an important step in becoming unified as a couple. Recognize that you and your spouse grew up differently. Accept it and work on becoming wise stewards together. While you cannot control how you were brought up, you can control how you work together and the example you will be to your children.

Work together as equal Christ-like partners to become wiser financial stewards. Work through communication problems and develop common goals. Know what you both want to accomplish in life and work together as a team.

Robert D. Hales said, "If the example we have received from our parents was not good, it is our responsibility to break the cycle. . . . Each person can learn a better way and in so doing bless the

lives of family members now and teach correct traditions for the generations that follow."[28]

4. Lack of Shared Goals

One of the major reasons for problems in marriage is the lack of shared goals. Both partners have ideas of what is important to them. If those goals are not shared, then bad feelings can exist when one spouse puts a higher priority on a goal than another.

What can be done?

Take some time apart to individually write down your goals. Next, as a couple, discuss each other's goals with the sole purpose to understand one another. At this point, don't evaluate or criticize your spouse's goals but simply seek to understand why they are important to him or her. Then, as a couple, develop and prioritize your family's goals and write your Family Financial Plan, incorporating both your family and personal goals. Work together toward the most important goals for your family. Finally, write down other family goals, such as starting your family, educating your children during secondary school and college, charitable giving, owning a business, saving for a big purchase, or enjoying recreation and vacations. While these other family goals may not appear to be financial in nature, they will have a direct impact on your family's finances. Incorporate these other family goals into your long-term Family Financial Plan.

Remember to always keep your priorities in order. Pay the Lord first—an honest tithe (10%) and generous offerings. Pay yourself second through savings, and invest your money wisely. Get out of debt and stay out. Prepare for emergencies with cash reserves, food storage, and adequate insurance. Save for your children's education and missions and for your retirement. Allocate funds wisely for other personal and financial goals.

5. Lack of Gospel Maturity

Problems arise when spouses fail to live their lives consistently with the way they know they should live. One spouse may have a greater desire to serve in the church and give to others, while the other may desire other more worldly things. Views of what it means to be a disciple of Jesus Christ may be different.

What can be done?

As you study, ponder, pray, and live Christ's teachings, you are worthy to be influenced by the Spirit. You then can have strength and inspiration to recognize your weaknesses and to know what you need to do. With that knowledge, you can work so that your weaknesses can be made strengths with God's help (see Ether 12:27).

Gospel maturity is doing those things necessary to bring us back to God's presence. King Benjamin gave us the method for becoming mature in the gospel:

> For the natural man is an enemy to God, and has been from the fall of Adam, and will be, forever and ever, unless he yields to the enticings of the Holy Spirit, and putteth off the natural man and becometh a saint through the atonement of Christ the Lord, and becometh as a child, submissive, meek, humble, patient, full of love, willing to submit to all things which the Lord seeth fit to inflict upon him, even as a child doth submit to his father.[29]

Remember your ultimate goal, "Behold he that hath eternal life is rich."[30] Remember David O. McKay's statements on an interview with Christ. Work on those things that will be asked first, particularly your relationship with your spouse. Choose wisely, for you are God's steward and will be held accountable to Him for your choices.

Recommendations for Money and Marriage

The following are a few ideas that have been helpful in my marriage. Please note that I am not a family therapist or expert in family matters but am only a teacher with a few ideas.

1. Bring Christ more into your relationship, family and finances

If personal finance is part of the gospel of Jesus Christ, then we should bring him into our marriages and finances. At your marriage, you not only made covenants with each other but also with God. Keep Him at the center of your marriage, and as you come closer to Him, you come closer to each other.

We have no better example of a loving spouse than our Savior Jesus Christ. He was always kind, never put down others, always spoke with love, never let outside concerns impact those He loved most (you and I), and did what He had to do willingly, because He wanted to just for us. We should strive to be the same.

2. Develop unity and family vision and goals as a couple

Strive to become unified in all you do with your spouse. Work together to have a unified vision of the type of marriage you want, the type of family, your environment in the home, how you will view finances and other challenges.

Develop and work on specific family goals as a couple. Saving should be a weekly activity. Opinions should be discussed freely and openly without fear of ridicule. Agree to disagree agreeably.

If you have concerns about your partner's spending, or your role in managing money, make sure you express those thoughts and opinions in a "Christ-like" manner, using D&C 121: 34-46 as a guide.

3. Delegate Action but Share Responsibility

It's not unusual for one spouse to play the primary role in managing the finances, but it is critical that both are involved and aware. Make sure both are involved. If one partner has more knowledge, it is his or her responsibility to teach the other. Remember Marvin J. Ashton's counsel, "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."[31]

Don't hide your spending, assets, or liabilities from each other. Be certain you can clearly articulate all assets and liabilities and locate the necessary back-up documentation. Remember, if you are ever unable to meet your financial responsibilities, your spouse will have to do the work.

Managing the various dimensions of your partnership is a shared mutual responsibility. While some financial decisions may be delegated, major decisions must be agreed upon beforehand. I recommend setting a limit, such as $20, and discussing any purchases over this limit beforehand. This limit may increase as the value of your assets and income increase.

4. Separate Real from Imagined Problems

Too often, arguments over money are about entirely different things. Separate out the real from the imagined problems. Finances and the things you own are tangible assets, and hence it is easy to project emotional issues onto these money matters.

Think carefully before discussing these concerns. Make sure there isn't a larger problem at the core. Set up a time when you can discuss spending. Avoid discussing finances at a time or place that may cause stress. Remember the HALT principle—important discussions may need to be delayed if either spouse is Hungry, Angry, Lonely, or Tired.

5. Always be kind and assume the best

Kindness is the single biggest predictor of whether you will stay together as a couple—so be kind. Always assume that your spouse is doing the best they know how with the knowledge base they have. Then, when you have areas of concern, work together to build the knowledge base so everyone comes at the problem from a similar perspective.

6. Keep the Romance Alive

L. Tom Perry counseled, "Perhaps it would also be appropriate to have a date with our wives each week, to remind us of the great blessing they are in our lives."[32] I further encourage time alone with your spouse, without the kids, each quarter and each year. After all, when the kids are grown, there will still be the two of you.

Understand and Create Your Family Financial Plan

Part of preparing your Family Financial Plan is to review how you were brought up and how finances were handled in your family. Use The Family – Key Questions on Money and Marriage (LT21) as your starting point. It asks 23 questions in the different areas of finance to help you understand how you were brought up. Then at the end of the document, you can add your vision, goals, plans and strategies, constraints and accountability. Following is an example of a Family Plan that may be interesting.

Vision

- This is from your Plan for Life. It may also include:
    - My vision is for a spouse where we balance each other, and are able to help each other with life's ups and downs.
    - It is one with which we share responsibility, in all the things we do, in our relationship, rearing of our children, finances, spirituality, and in trying to be better.
    - We have the same or similar goals, and we help each other work toward those goals.
    - We have different responsibilities in the family, and work to help each other as equal partners.
    - We recognize our most important priority in time and eternity is our spouse, and we do all things necessary to keep the relationship with our spouse and children alive and growing.

Goals

- My ultimate goal is to help my spouse, children and I return to Heavenly Father's presence.
- I will create an environment of love and respect where all want to be better.
- I will treat my spouse as an equal partner with different responsibilities, that will change from time to time.
- I build the self-esteem of my spouse, and will always assume they are doing their best and doing what is in the best interest of the family.
- I will show appreciation for my spouse and the things they do for me and the family.
- I will always see the good in my spouse, and will always support them in the things they want to accomplish.
- I will never discipline or touch my spouse or children in anger.

Plans and Strategies

- We are equal in all things
- We will do those things that bring the spirit into our home, including daily scripture study, family prayer night and morning, companionship prayer every night, church attendance each Sunday, fulfilling our church responsibilities, temple attendance, and paying a full tithe and a generous fast offering.
- We will strive to keep the relationship alive, by going on a date each week (a fixed expense), quarterly weekends away, and an annual vacation without kids.

- We will develop family memories by going on two family vacations each year, and being together at family holidays.
- For married spouses, we will spend every other year together as a family.
- We remember who we are, children of the Most High God, and we act accordingly
- We strive to be like our Savior Jesus Christ
- We budget and give now when we are poor
- We are honest in all our doings—we hide no assets or liabilities from each other
- We have weekly "Companionship Meeting" each week where we discuss our vision, goals, budgets, etc.
- We invest in our children, *Come Follow Me* each day, PPI's each Fast Sunday, FHE each Monday, and we teach them Personal Finance in the home
- We invest in ourselves: daily individual scriptures study and exercise, suffient sleep to stay healthy, and we invest to build skills and talents

Constraints

- Things that can affect this vision include abuse, addiction, pornography, and disobedience to God's commandments.
- Other constraints include putting money before God, not recognizing the source of our blessings, and allowing other things to take priority over spouse and family.
- As long as we are doing those things to bring the Spirit into our home and are working to strengthen the testimony of myself, spouse, and family, it will help us to avoid these problems.

Accountability

- I will share this vision and goals with my spouse and children. They will know our family goals and plans, and can help remind me when I falter.
- We will teach these things through weekly Family Home Evenings and daily scripture study, and in the small one-on-one moments with our children.
- They will be reinforced through my example and through weekly attendance at Church meetings.

Additional Plans and Strategies

Following are some examples of strategies that may give ideas to help you in your planning for marriage and families. These are taken from Money and Marriage Suggestions (LT41) that have been useful in my family. I have divided it into four areas, spiritual, temporal, family, and individual.

Plans and Strategies

Spiritual

- Remember who you are, a child of the Most High God
- Strive to be like your Savior Jesus Christ

- Attend the temple as often as you can, with a minimum of once a month
- Budget and learn to give now when you are poor and have nothing
- Memorize your Patriarchal Blessing, the "Proclamation on the Family," "The Living Christ," and other scriptures that are important to you. Ours include D&C 121:34-46, D&C 11:7, Jacob 2:18-19, Alma 37:32-37 and Alma 7:22-24

Temporal

- Remember "Life is Good." Be glad for the blessing of living.
- Live within your means
- Be honest in all your doings--hide no assets or liabilities from each other
- Have weekly "Companionship Meeting" each week (at a specified time and day)
    - Discuss your budget, financial situation, and other key concerns with your spouse each week during this Companionship Meeting
    - Learn to save and invest wisely
    - Never go into debt except for education, a modest home, and perhaps a first car
    - Save 20% gross of every dollar you earn after school, with 15% for retirement

Family

- Develop your own family vision, goals and plans together, and then work together to accomplish them
- Develop your vision of what it means to be a success in life. Have it confirmed by the Spirit
- Be equal in all things—both have the responsibility for finances and spirituality.
- In the process of daily living, make sure you make memories each day
- Have Family Home Evening each week
- Have companionship prayer each night
    - On even days of even years the spouse says the prayer
- Have family prayer each night before dinner and morning before breakfast
- Have family scripture study each weekday
- Plan a Family service project each quarter
- Invest in each other
    - Go on a date each week (budget a certain amount each week)
    - Go on a weekend-out date each quarter
    - Go on a week vacation each year (just the two of you)
    - Wives will likely outlive their husbands, so make sure both spouses know about all finances and assets
- Invest in your children
    - PPI's with children each Fast Sunday
    - Time with Parents each Monday (budget a certain amount each week)
    - Teach your children about Personal Finance in the home.
    - Help children build their own Personal Financial Plan

Individual

- Get great and use Quicken, Mint.com or other personal finance software program

    - It will save you lots of time and money in the future
- Leave your father and mother and be one – it's more fun
- Invest in yourself
    - Read your scriptures individually every day
    - Do those things necessary to exercise and stay healthy
    - Continue to build your skills and talents, consistent with your budget
- Be active in your ward and community
- Serve diligently in whatever calling you have – magnify it well
- Learn to always assume the best, be kind, and forgive quickly

My spouse adds "If you live like most people won't for the first ten years after school, you will live like most people can't for the years after that."

Summary

If "no other success can compensate for failure in the home,"[33] then the family should be our most important priority. There are 10 key principles of marriage and money that are helpful. They are:

Know yourself, your vision, goals and budget
Seek, receive and act on the Spirit's guidance
Understand and live the 9 key areas of successful marriages
Your spouse is the most import
The family is ordained of God
Marriage partners are equal
Spouses are to leave their parents and become one.
The best things in life are free.
Finance problems are generally behavioral problems
We can and must change and become better.

Key practices of money and marriage are:

Create your family vision, goals and budget, and work on them together
Make all major purchases together, and with the Lord's confirmation
Agree to and follow spending limits
Sleep on it
Deal with financial disagreements agreeably
Practice MAD money
Invest in each other and the relationship.

Five common problems regarding finance in marriage are:

1. Lack of financial knowledge.
2. Lack of communication.

3. Differences in financial personality types and family baggage.
4. Lack of shared financial goals.
5. Lack of gospel maturity.

Suggestions for improving your marriage include:

1. Bring Christ more into your relationship, family and finances
2. Develop unity and family goals as a couple.
3. Delegate action but share responsibility.
4. Separate real from imagined problems.
5. Always be kind and assume the best.
6. Keep the romance alive.

Finally, we shared some ideas for your Family Financial Plan, including your vision, goals, plans and strategies, constraints and accountability.

Assignments

Financial Plan Assignments

This section of your financial plan deals with relationships and money. First, try to understand how your parents handled their personal finances. This can be done either through discussions with your parents or through reviewing your memories of how you were brought up. Read through Family - Key Questions on Money and Relationships (LT21) and answer the first three questions on the family. How was personal finance modeled and taught in your family? Continue to answer the questions regarding savings, education and missions, retirement, and investing.

The harder questions are the descriptive ones. As you think through these areas, think about how you should manage your finances as a couple and how money should be handled in your family. Set goals regarding how you want to manage your money and things you and your spouse will and will not do so you can be an example to your children of the proper way for a couple to manage money.

Finally, put together your Family Plan including your vision, goals, plans and strategies, constraints and accountability. How will your family be different? How will it be the same?

Learning Tools

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

Family - Key Questions on Money and Relationships (LT21)

This document asks important questions that should be considered when thinking about money and marriage. It asks about how you were brought up, how your parents taught you, and attitudes toward critical financial topics.

Money and Marriage Suggestions (LT41)

This document shares additional plans and strategies that I have found helpful as I counsel with my children and their future spouses.

Review Materials

Terminology Review

Family Baggage. This refers to the way an individual was brought up in their understanding and management of their finances.

Financial Personality Types. This relates to the different ways people manage their finances. They can be divided into various types: miser, spender, unequally yoked, selfish provider, sleeper, and wise steward.

Proclamation on the Family. An inspired document from a living prophet on the importance of the family unit both in this life and in eternity.

Review Questions

1. What are the 10 major principles of money and marriage? Why are they so important?
2. What are the five major issues in money and marriage discussed in this chapter? Why are they so important?
3. Why is your spouse and the family so important? What will you do to ensure they get the attention they deserve?

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[1] David O. McKay, General Conference, Apr. 1964
[2] D&C 38:27.
[3] "The Family: A Proclamation to the World," *Ensign*, Nov. 1995, 102
[4] L. Tom Perry, "Fatherhood, an Eternal Calling," *Ensign*, May 2004, 71.
[5] Bruce C. and Marie K. Hafen, "Crossing Thresholds and Becoming Equal Partners," *Ensign*, Aug. 2007, 27.
[6] Ibid.
[7] Brooks/Cole Publishing, 1993
[8] D&C 38:27.
[9] Italics added, Gordon B. Hinckley, "Proclamation on the Family," 1995.
[10] Italics added, L. Tom Perry, "Fatherhood, an Eternal Calling," *Ensign*, May 2004, 71.
[11] Bruce C. and Marie K. Hafen, "Crossing Thresholds and Becoming Equal Partners," *Ensign*, Aug. 2007, 27.
[12] Gordon B. Hinckley, "Proclamation on the Family," 1995.
[13] Robert D. Hales, "Understandings of the Heart," BYU Devotional, Mar. 15, 1988
[14] "Each a Better Person," *Ensign*, Nov. 2002, 99
[15] Marvin J. Ashton, "Guide to Family Finance," Liahona, Apr. 2000, 42.
[16] Genesis 2:24
[17] Doctrine and Covenants 6:7, 11:7
[18] Matt 25:14–18

[19] "One for the Money," *Ensign*, Jul. 1975, 72
[20] Galatians 6:7
[21] Marriage and Family Resource Manual, A: Strengthening Marriages, 8: Managing Family Finances, Intellectual Reserve, 2000, 35.
[22] Genesis 2:24.
[23] "The Enriching of Marriage," *Ensign*, Nov. 1977, 9
[24] Eric Tyson, *Personal Finance for Dummies*, IDG Books Worldwide, 2000, 10
[25] 1 Cor. 2:14
[26]Interview, Nov. 26, 2006
[27] "Therefore I Was Taught," *Ensign*, May 1994, 36
[28] "How Will Our Children Remember Us?" *Ensign*, Nov. 1993, 10
[29] Mosiah 3:19
[30] Doctrine and Covenants 6:7
[31] "Guide to Family Finance," *Liahona*, Apr. 2000, 42
[32] "Family Traditions," *Ensign*, May 1990, 19
[33] David O. McKay, General Conference, Apr. 1935, p. 116

33. Family 2: Teaching Children Financial Responsibility

Introduction

To a large degree, parents hold the destiny of their children in their hands. The lessons they teach both by precept and example may have eternal consequences for their children. To illustrate this point, N. Eldon Tanner shared a verse that he learned as a child.

> I am the child.
> You hold in your hand my destiny.
> You determine, largely, whether I shall succeed or fail.
> Teach me, I pray, those things that make for happiness.
> Train me, I beg, that I may be a blessing to the world.[1]

This verse discusses two important questions: (1) what are those things that will make for happiness and (2) what must children learn to become a blessing to the world?

As I have thought through this first question, I have determined that we must teach the things that bring happiness both in this life—the temporal things—and in the hereafter—the spiritual things. The Family Proclamation teaches "Happiness in family life is most likely to be achieved when founded upon the teachings of the Lord Jesus Christ."[2] We also know,

> And again, inasmuch as parents have children in Zion, or in any of her stakes which are organized, that teach them not to understand the doctrine of repentance, faith in Christ the Son of the living God, and of baptism and the gift of the Holy Ghost by the laying on of the hands, when eight years old, the sin be upon the heads of the parents.[3]

As I thought about the second question, I thought about this counsel from Robert D. Hales, "Teach our children by example how to budget time and resources. Help them learn self-reliance and the importance of preparing for the future."[4]

Teaching children financial responsibility is the parents' job. Joseph B. Wirthlin commented:

> Too many of our youth get into financial difficulty because they never learned proper principles of financial common sense at home. Teach your children while they are young. Teach them that they cannot have something merely because they want it. Teach them the principles of hard work, frugality, and saving.[5]

Clearly both the spiritual and temporal are both important parts of the teaching process. We must begin this process when our children are small, but it is never too late to start.

Please know that I write from the position of a father and not as one who has been trained in counseling. When I was first married, I had seven theories about raising children. Now, 34 years later, I have seven children and no theories. However, the following are a few ideas that may be helpful in teaching your children financial responsibility.

Objectives

There are three objectives from this chapter that you should remember:

A. Understand the importance of your family vision and teaching your children
B. Understand the principles of teaching children financial responsibility
C. Know when to teach children financial responsibility
D. Understand some plans and strategies for teaching your children.

Understand the Importance of your Family Vision and Teaching Your Children

If you have children, have you thought about your vision and your goals for your relationship with them? Important questions to consider include:

- What responsibilities do you have? What do the scriptures say? Is teaching an important part of your vision and responsibilities?
- What type of relationship do you want to have with your children? How are you planning to develop that relationship? What is your "sacred duty" to your family?

What happens if we don't strengthen the family and teach our children?

- What are the problems that we have because of the "disintegration of the family" and parents who do not each their kids?[6]
- How are we going to work to ensure that doesn't happen in our family?
- You have already developed a Family Vision from the previous section on Money and Marriage. Continue to work and refine it as you think through these sections

We are concerned for our youth. Joe J. Christensen reminds us:

> In our day, many children grow up with distorted values because we as parents overindulge them. . . . We as parents often attempt to provide children with almost everything they want thus taking away from them the blessing of anticipating, of longing for something they do not have. One of the most important things we can teach our children is to deny themselves. Instant gratification generally makes for weak people. How many truly great individuals do you know who never had to struggle?[7]

Our youth need to be stretched. Neal A. Maxwell commented:

> A few of our wonderful youth and young adults in the Church are unstretched. They have almost a free pass. Perks are provided, including cars complete with fuel and insurance—all paid for by parents who sometimes listen in vain for a few courteous and appreciative words. What is thus taken for granted . . . tends to underwrite selfishness and a sense of entitlement.[8]

Children should not always get what they want. Christensen quoted Fred Gosman, a noted child psychologist, when he said:

> Children who always get what they want will want as long as they live. And somewhere along the line it is important for the character development of our children to learn that "the earth still revolves around the sun" and not around them. Rather, we should train our children to ask themselves the question, how is the world a better place because they are in it?[9]

These are important parts of helping our children become both temporally and spiritually responsible.

Understand the Principles of Teaching Children Financial Responsibility

Much has been written about the best ways to teach children about finance. The following are a few ideas I have found helpful:

1. Know Yourself, Your Vision, Goals and Plans. It is critical that you know yourself. You must have our vision of what you want your family to be like, and then develop your personal and family goals and your plans to achieve them. If you have not written your goals down, you should do so now. Know what you want out of life and family.

2. Teach by example to seek, receive and act on the Spirit's guidance. Your children will learn this most critical principle from you. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Teach by Example Individually. N. Eldon Tanner counseled on the importance of our actions when he stated:

> It is most important, therefore, that we are always on the alert, remembering that one teaches more effectively by example than by precept. Let us never forget the old axiom, "Your actions speak so loudly that I cannot hear what you say."[10]

Teaching by example should always be our starting point as we seek to teach others, and especially as we seek to teach our own children.

4. Teach by Example as a Couple. Marvin J. Ashton commented:

> In the home, money management between husband and wife should be on a partnership basis, with both parties having a voice in decision- and policy-making. When children come along and reach the age of accountability, they too should be involved in money concerns on a limited partnership basis. Peace, contentment, love, and security in the home are not possible when financial anxieties and bickering prevail.[11]

The article then proceeds to outline five ways to involve children in money matters on a limited partnership basis:

> 1. Pay an honest tithe and generous offerings.
>
> 2. Teach family members early the importance of working and earning.
>
> 3. Teach children to make money decisions in keeping with their capacities to understand.
>
> 4. Teach family members to contribute to the total family welfare.
>
> 5. Teach family members that paying financial obligations is part of developing integrity and honesty.

5. Pay an Honest Tithe and Generous Offerings. As a wise steward, it is important that you pay the Lord first in all you do. Ashton advised, "If our tithing and fast offerings are the first obligations met following the receipt of each paycheck, our commitment to this important gospel principle will be strengthened and the likelihood of financial mismanagement will be reduced."[12]

6. Teach Family Members Early the Importance of Working and Earning. Working and earning are critical skills for our children. The scripture, "In the sweat of thy face shalt thou eat bread"[13] is not outdated counsel. It is basic to personal welfare. Ashton commented "One of the greatest favors parents can do for their children is to teach them to work."[14]

7. Teach Children to Make Money Decisions in Keeping with Their Capacities to Understand. Help your children become wise financial stewards early. Ashton counseled:

> Based upon appropriate teaching and individual experience, children should be responsible for the financial decisions affecting their own money and suffer the consequences of unwise spending. "Save your money" is a hollow pronouncement from a parent to a child. "Save your money for a mission, bicycle, doll house, trousseau, or car" makes understandable sense.[14]

8. Teach Family Members to Contribute to the Total Family Welfare. The "Guide to Family Finance" further counsels:

> Help family members understand the family financial situation. As children mature, they should understand the family financial position, budget, and investment goals and their individual responsibility within the family. Encourage inexpensive, fun projects, understandable to the children that contribute to a family goal or joy.[14]

9. Teach family members they are accountable for their financial choices and you will not reward bad behavior. Help family members understand that you will not bail them out of their poor financial choices—they, not you or the government, are accountable. There are consequences to the choices they make and natural consequences are a good teacher. You teach like the Savior. The Lord said: "Whom I love I also chasten"[15] and "My son, despise not the chastening of the Lord . . . For whom the Lord loveth he chasteneth."[16]

10. Teach Family Members That Paying Financial Obligations Is Part of Developing Integrity and Honesty. Marvin J. Ashton stated, "[Those] who ignore or avoid their creditors are entitled to feel the inner frustrations that such conduct merits, and they are not living as Latter-day Saints should!"[17] We should teach family members and others that as disciples of Jesus Christ, we should be honest in all of our dealings.

Finding Balance

As you work on building your family and considering how you will teach your children, finding balance among doctrines, principles and application is critical. We have shared some ideas for principles, although you will likely consider many more.

Principles	Doctrines
Understand yourself, your vision and goals	Identity
Seek, receive and act on the Spirits guidance	Obedience
Teach by example individually	Stewardship
Teach by example as a couple	Stewardship
Pay a full tithe and fast offering	Agency
Teach the importance of work	Accountability
Teach to make money decisions	Stewardship
Teach we all contribute to family welfare	Agency
Teach and model accountability for our choices	Agency
Teach to be honest with finances	Accountability

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being good parents

or teaching our children wisely, both of which are applications; rather, from a higher perspective, or with increased vision,

> We are children of Heavenly parents (identity), trying to live worthy of the Spirit (obedience), and who have a vision of what is important (Plan of Salvation). We are wisely making choices (agency) in teaching our children who they really are (identity) so they can come unto Christ (stewardship), make good choices in their lives and finances (accountability), and become unified and find joy in their families (Plan of Salvation) and ultimately become more like their Savior and accomplish their individual and family vision and goals.

Understand Plans and Strategies for Teaching Children Responsibility

The Lord has stated, "The glory of God is intelligence, or, in other words, light and truth. Light and truth forsake that evil one. But I have commanded you to bring up your children in light and truth."[18] Bringing up children in light and truth is a big responsibility. What do you teach your children? When do you teach them? How do you teach them?

When my wife and I were first married, we had seven theories on raising children and no kids. Now we have seven children and no theories. Following are some general plans and strategies for teaching children financial responsibility, divided into age groups. These would be included in your Family Plan discussed earlier.

Plans and Strategies

Young Children

- Teach young children:
  - To know they are children of God
  - To pray
  - To love their family and friends
  - To share with and have compassion for others
  - To be thankful for their blessings
- From a temporal framework, teach young children:
  - To set and achieve goals
  - To learn to enjoy and work
  - To learn to save for things they want
  - To love and help others.

Pre-Teenagers

What do you teach pre-teens? Pre-teens are older and are starting to develop a sense of what money is and what it can purchase. The Lord has said, "Behold, ye are little children and ye cannot bear all things now; ye must grow in grace and in the knowledge of the truth."[19] How do you grow in grace and in the knowledge of the truth?

Teach pre-teens:

- To recognize that all things come from God and that everything is His
- To understand that we are stewards over everything we have
- To always pay the Lord first

At the same time, teach pre-teens:

- To work
- To save and pay themselves second
- To be disciplined and frugal
- To recognize that there are many things more important than money

Teenagers

Teenagers are on the cusp of becoming men and women. Alma, in speaking to his sons, gave the wonderful counsel, "O, remember my son, and learn wisdom in thy youth. Yea, learn in thy youth to keep the commandments of God."[20] How do you learn to keep the commandments of God when it comes to finances?

Teach teenagers:

- To be accountable for their actions
- To serve and to give
- To not covet
- To recognize the Lord's hand in their lives

At the same time, teach teenagers:

- To differentiate between income and wealth
- To differentiate between good and bad liabilities and assets
- To spend less than they earn
- To develop and live on a budget.

College Students and Older Children

Alma further counseled his sons, "Counsel with the Lord in all they doings, and he will direct thee for good"[21] How do we get closer to God? And how does doing so help with our challenges?

Teach young adults:

- To counsel with the Lord in all they do
- To be thankful for their blessings
- To continue to learn to serve and give
- To expect financial setbacks and challenges, but to know that setbacks and challenges produce growth of character and strength
- That conduct on the journey is as important as your destination.

At the same time, teach young adults:

- To develop habits of frugality and discipline

- To save and invest wisely
- To further commit to setting goals, budgeting, and earning as much as they can.

When helping children financially with their education, give them money for necessities, rather than for consumption spending, and hold them accountable for the money given.

Married Children
Teaching married children is the most challenging of all. Perhaps the best counsel is from Doctrine and Covenants 121:41, which states:

> No power or influence can or ought to be maintained by virtue of the priesthood, only by persuasion, by long-suffering, by gentleness and meekness, and by love unfeigned; By kindness, and pure knowledge, which shall greatly enlarge the soul without hypocrisy, and without guile.

Once your children are married and are establishing their own family units, you will need to alter your teaching style. Rather than teaching specific truths, I recommend applying the following principles:

- Realize that your own retirement planning comes first, and helping your children with money problems comes second.
- Stay out of your adult children's family matters.
- Teach by example. Be a good example of a wise financial steward by having your priorities in order.
- Minimize discussions of what children and grandchildren will inherit or receive as gifts.
- Minimize gifts of cash to adult children as part of a negotiation strategy.
- Help adult children recognize when they need financial help and to accept it graciously.
- Assure your children that they will not receive any inheritance until they have established a mature, disciplined, and adult lifestyle and profession.

Summary

To a large degree, parents hold the destiny of their children in their hands. The lessons they teach both by precept and example may have eternal consequences for their children. This chapter addressed two important questions, "What are those things that will make for happiness?" and "What must children learn to become a blessing to the world?" I delineated these as the spiritual and temporal things we should teach our children as we teach them about financial responsibility.

It is critically important to teach children financial responsibility. As parents, we have the responsibility to teach our children; if you do not teach your children, who will? Key things we should commit to teaching our children include:

- To deny themselves
- To stretch for what they want

- To recognize they will not get everything they want
- To obey the commandments
- To appreciate what they have

We then discussed principles of financial responsibility. While these are not the only principles, they are among the most important. They include:

- Understand yourself, your vision and goals
- Teach by example to seek, receive and act on the Spirits guidance
- Teach by example individually
- Teach by example as a couple
- Pay an honest tithe and generous offerings
- Teach early the importance of work and earning
- Teach children to make money decisions in keeping with their capacity to understand
- Teach we all contribute to family welfare
- Teach and model accountability for our choices and you will not reward bad behavior
- Teach that paying financial obligations is part of integrity and honesty development.

The final area we discussed plans and strategies of when to teach financial responsibility to young children, pre-teenagers, teenagers, college students and older children, and married children. Each of these areas outlined important spiritual and temporal truths that each age group should learn.

Assignments

Financial Plan Assignment

Teaching children financial responsibility is a lifetime process, not something that occurs once and then they know it for the rest of their lives. It is challenging and time consuming, but it also can be a somewhat predictable process. Determine first how your parents taught you financial responsibility. Then determine how you want to teach your children financial responsibility.

Review Materials

Terminology Review

Limited Partnership Basis. A process of teaching children about finance based on their age and consistent with their ability to learn.

Review Questions

1. What are the principles of teaching children responsibility? Are these the only principles?
2. What should you teach young children about personal finance?
3. What should you teach married children about financial responsibility?

[1] "Teaching Children of God," *Ensign*, Oct. 1980, 2
[2] "The Family: A Proclamation to the World," *Ensign*, Nov. 1995, 102
[3] D&C 68:25.
[4] "Strengthening Families: Our Sacred Duty," *Ensign*, May 1999, 32
[5] "Earthly Debts, Heavenly Debts," *Ensign*, May 2004, 40
[6] Gordon B. Hinckley, "Proclamation on the Family," 1995
[7] "Greed, Selfishness, and Overindulgence," *Ensign*, May 1999, 9
[8] "Sharing Insights from My Life," BYU Devotional, Jan. 12, 1999
[9] Joe J. Christensen, "Greed, Selfishness, and Overindulgence," *Ensign*, May 1999, 9
[10] "Teaching Children of God," *Ensign*, Oct. 1980, 2
[11] *Liahona*, Apr. 2000, 42
[12] "Guide to Family Finance," *Liahona*, Apr. 2000, 42
[13] Genesis 3:19
[14] "Guide to Family Finance," *Liahona*, Apr. 2000, 42
[15] D&C 95:1.
[16] Hebrews 12:5-6.
[17] "One for the Money," *Ensign*, Jul. 1975, 72
[18] Doctrine and Covenants 93:40
[19] Doctrine and Covenants 50:40
[20] Alma 37:35
[21] Alma 37:37

34. Family 3: Financing Children's Education and Missions

Introduction

In the Church of Jesus Christ, in addition to education goals, single young men ages 18–25 and single women ages 19–25 are encouraged to have another goal: to serve a mission. A mission is an opportunity for service as they go to a place assigned by Church leaders and serve for 24 months for men and 18 months for women. These young men and women put school and dating on hold during this service and work full-time in the service of their Savior Jesus Christ. The cost is covered by the young men or women individually or with help from the family if available. I served in Taipei, Taiwan nearly 40 years ago, two daughters served in the Washington, D.C. South and Rome Italy, a son served in the Arkansas Little Rock, my parents served in Manchester England, and my brother and his wife served in Nauvoo Illinois. When we talk of missions, we are referring to this service opportunity to forget yourself in the service of others for a specific period of time.

L. Tom Perry commented on the challenge facing families for financing education and missions. He wrote:

> Today a long-range family financial plan is clearly needed if children are to have the blessings of missions and education. It would need to be carefully worked out and prepared to meet these requirements. The avoidance of debt is essential; living within [your] income, fundamental.[1]

Clearly, a long-range family financial plan is needed. But how do you plan for the large expenses that educations, missions, and other goals entail?

We have a responsibility to continually improve ourselves so we can be a blessing to ourselves, our families, and the world around us. Education can help us fulfill that responsibility. Gordon B. Hinckley said the following about the importance of education:

> It is so important that you young men and you young women get all of the education that you can. The Lord has said very plainly that His people are to gain knowledge of countries and kingdoms and of things of the world through the process of education, even by study and by faith. Education is the key which will unlock the door of opportunity for you. It is worth sacrificing for. It is worth working at, and if you educate your mind and your hands, you will be able to make a great contribution to the society of which you are a part, and you will be able to reflect honorably on the Church of which you are a member.[2]

Regarding serving missions, Spencer W. Kimball said:

> The question is frequently asked: Should every young man fill a mission? And the answer has been given by the Lord. It is "Yes." Every young man should fill a mission.[3]

Clearly, both education and missions are important, whether for yourself or for your children. For parents, the challenge is knowing how to prepare a family financial plan today to help pay for the steadily rising costs of education and missions. This chapter offers a few ideas to help you as you put that plan together.

Objectives

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

A. Decide how education relates to your vision and goals and principles of financing education and missions
B. Understand the process of selecting investment vehicles for financing education and missions for your children
C. Understand how to save for your children's education and missions and how to reduce the cost of education and apply for aid
D. Understand and create your mission and education plans.

Decide How Education Relates to Your Financial Goals and the Principles

The following table depicts the average earnings and estimated lifetime earnings according to level of education in 2012. While the absolute numbers have changed slightly since 2012, the relative importance of education has not (see Table 1).

Table 1. Annual and Lifetime Earnings by Level of Education[4]

Level of Education	Annual Earnings*	Lifetime Earnings
Not a high school graduate	$24,325	$973,000
High school graduate	$30,600	$1,304,000
Two-year vocational	$38,675	$1,547,000
Associate's degree	$43,175	$1,727,000
Bachelor's degree	$56,700	$2,268,000
Master's degree	$66,775	$2,671,000
Doctorate	$81,330	$3,252,000
Professional	$91,200	$3,648,000

*Annual earnings is lifetime earnings divided by 40 years.

Generally, as a person's level of education increases, so does his or her potential for higher lifetime earnings. But why obtain a college education rather than a vocational degree? And is education a good investment? Gordon B. Hinckley said:

> You young people, the little decisions that you make can so affect your lives. Shall I go to school or not? Shall I continue on with my education? That is a big decision for some of you. Our doctrine suggests, although there may be some circumstances that would affect that decision . . . that the more education you receive, the greater will be your opportunity to serve. That is why this Church encourages its young people to get the schooling that will qualify them to take their places in the society in which they will become a part. Make the right decisions. Take a long look.[5]

Principles of Financing Education and Missions

While education is important, it is costly. The average costs for schooling are high and are steadily rising. However, the cost of ignorance is even higher. How can you save funds for your own education or your children's education? What is your vision for your children and grandchildren?

There are two parts to saving for education. The first is the actual saving. How do you save for education in the least painful manner? The second part is the investing of that money wisely so you can eliminate or minimize taxes, leaving more money for your children's education when it is needed.

There are six important principles of financing education and missions:

1. Teach your children who they are, that they are children of God, and model it yourself. Be an example of a Christ-like person, and teach them to work and to earn, consistent with their age and abilities. Teach them to be accountable for their spending, just as they are for their words and thoughts, and teach them to share the things they have—none of it belongs to us.

2. Teach your children to learn to seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Help your children to save for their own (and other family member's) education and missions consistent with their abilities to earn. Encourage your children to set savings goals that will help them save for their own missions and education. Goals are critical for children at every age. Many of the goals I set as a child are the same goals I have today—my age has not changed my goals.

Set up investment or savings accounts for your children when they are young and encourage them to contribute their savings to these accounts as they are able. Help them by contributing to these accounts on a monthly basis as well. Give your children opportunities to earn money that is earmarked, after paying the Lord, specifically for their missions and education. I also recommend using this goal as a means of teaching your children about investing for the long-term.

4. If you choose to help, develop Education and Mission Plans consistent with your personal vision, goals and budget. Nothing happens without a plan. Develop a savings plan to help save for your children's education and missions. Plans that require work and contributions by children have a better chance of teaching the principles discussed than those that rely solely on parental contributions. Share your savings plan with your children as to what you will do and what you expect your children to do in saving for their education and missions. Then follow through on your plan.

5. If you choose to help, start saving for your children's education and missions NOW. The best time to begin saving for your children's education and missions is now. Begin early. In our family, once a child was born we immediately opened an education and mission account. Saving earlier and saving more has been a blessing in our children's lives.

6. Invest wisely and tax-efficiently. Use wisdom in your investments as you save for your children's missions and education. Follow the process of selecting investment vehicles discussed earlier in the chapters on Investments. Carefully think through your decisions and write a good Investment Plan for your assets—then follow that plan (see the chapters in this course on Investments). Decide now not to use the money in these accounts except for their assigned uses.

I recommend setting aside separate investment accounts specifically labeled "Mission Fund" or "Education Fund" for each child. With personal finance software, such as Quicken, it is easy to manage multiple accounts for different children at multiple financial institutions.

Finding Balance

As you work on preparing for your children's missions and education, finding balance among doctrines, principles and application are important in helping you become better and better prepared. Below are ideas for doctrines on which the principles are based.

Principles	Doctrines
Teach to seek, receive and act on the Spirit's guidance	Obedience
Teach financial responsibility	Agency
Teach children to save	Stewardship
Develop mission/education plans	Accountability
If you choose to help, start now	Stewardship
If help, invest your funds wisely	Accountability

From Obedience to Consecration

If you choose to help with your children's education and mission expenses, you are not only saving for our children's missions and education,

> We are children of the most high God (identity), trying to live worthy of the Spirit (obedience), with the decision to help our children save for missions and education (agency). For those who choose to help (at least with part), we believe in the importance of helping our children work toward worthy mission and education goals (Plan of Salvation). We will help our children as planned by saving and investing resources wisely (accountability), so we can help offset some of the costs of these worthy goals (agency), so we can help ourselves and our children attain their individual missions and our personal and family vision and goals.

Understand the Process of Selecting Investment Vehicles for Financing Education

In financing education, there are some sources of money that should be used before other sources. Following the correct priority refers to the process of determining the least costly sources of money for education and taking advantage of these sources first. The following list outlines the process of selecting investment vehicles for financing education:

1. Free Money

Free money does not need to be paid back and consists of scholarships, grants, and tax savings. Free money is the best type of money for education.

Scholarships are generally awarded based on merit and do not need to be repaid. Encourage your children to keep their grades high and to apply for as many scholarships as they can. Remind them that every dollar they receive in scholarships is a dollar they do not need to earn themselves.

To receive scholarships from schools and private sources, students must complete an additional application, which may be completed online or in hard-copy form. Use a scholarship search engine to learn which scholarships and grants your children are eligible for, and apply for each individually. Inquire at local recruiting offices about how to obtain armed forces scholarships. Use the Internet to view additional scholarship information—reliable sources that offer this information free of charge are provided at the end of this chapter. Do not pay for scholarship information, and be aware that you may get lots of advertisements selling scholarships—if you have to pay money to get a scholarship, it is usually a scam.

Grants are generally awarded based on financial need. Encourage your children to apply for grants and scholarships—even if they don't think they have a chance. They may be surprised. Pell Grants are federal grants that are awarded based on need; the amount students receive varies from $606 to $5,920 per year for the 2017–2018 school year. In order to apply for a Pell Grant, students must fill out a FAFSA (free application for federal student aid) form at www.fafsa.ed.gov. Applying online streamlines the application process considerably.

Tax savings are given by states to encourage investment in education. For example, some states, such as Utah, allow parents to take a percentage of their contributions to the state's 529 Savings

Plan as a tax credit from their state taxes. For 2019 in Utah, if parents sign up for the 529 Savings Plan before their child turns 19, parents, grandparents, or other relatives (the account owners) can deduct five percent of their contribution to the 529 Savings Plan from their state taxes per child, up to $2,000 per individual ($4,000 if married filing jointly). If parents and grandparents contribute $4,000 a year at a five percent tax credit, that equates to $200 in free money ($4,000 × 5 percent) to save for your children's or grandchildren's education in 2019. 529 Plans will be discussed in greater detail later in this chapter.

2. Personal and Family Savings

Personal and family money is that contributed from your children's personal savings and any other help contributed by parents, grandparents, and other relatives.

Personal savings consists of your children's personal money. Generally, if your children help pay for their own education, they will use their resources more wisely. Start the process of teaching your children to become financially self-reliant as soon as you can, and help your children to finance as much of their own education as possible.

Family savings: Saving for your children's education should be a family activity. After you have started saving for your retirement, find ways to save for your children's education.

- *Tax-eliminated investing* involves investing money for your children's education in investment vehicles for which you pay no taxes on the earnings from your investment savings. Examples of these investment vehicles include 529 Savings Plans, which offer the broadest category of things that can be purchased with these funds; Coverdell Education Savings Accounts, or Education IRAs, which are the next best alternative; and certain types of U.S. savings bonds, which are highly restrictive. Investment earnings on these vehicles are not taxed.

- *Tax-efficient investing* means saving for your children's education in a tax-efficient and wise manner. Invest in mutual funds that are no-load, have low expense ratios, are diversified, and have low turnover ratios. Keep your money in these funds until needed.

- *Tax-deferred investing* means saving for your retirement and using some of your retirement money to help pay for your children's education. While I do not recommend this alternative, you can take up to $10,000 of your retirement 401(k) and Roth 410(k) for your children's education without the normal 10 percent penalty. However, if you take the money from a tax-deferred account, such as a 401(k), you will have to pay taxes on the distribution as ordinary income.

3. Employment

Have children work when possible to offset educational expenses. Most colleges offer federal work-study programs to help with education costs. Some universities provide thousands of student employment opportunities from their own school funds.

Studies show that working fewer than 20 hours per week will not typically have a negative impact on grades. I recommend that undergraduate students enrolled in 12 or more credit hours should work no more than 20 hours per week. This should help cover rent and food expenses.

4. Loans

Loans are debt. If you must use loans to help cover your educational expenses, borrow only the amount you need and not the amount you may be eligible to receive. Use loans wisely and pay them off quickly.

There are five key questions you should ask about any loan:

1. Does the borrower or the government pay the interest on the loan during school?
2. Do you have to start repaying the loan immediately or after graduation?
3. Do the students or the parents take out the loan?
4. Is the interest rate fixed or variable? If it is variable, what is the highest rate you would potentially pay over the life of the loan?
5. What are the costs and loan fees? Are they negotiable?

There are three main types of loans. The most cost-effective type is a subsidized loan, where someone else pays the interest while the student is in school. Generally, these have lower interest rates as well. The next-best loan is an unsubsidized loan, where the borrower pays the interest while the student is in school. Unsubsidized loans also tend to offer lower interest rates. The third type is a private, or alternative, loan, which are not recommended because of their substantially higher costs.

Subsidized loans are those where the interest payments are made by the sponsoring institution until the student graduates or leaves school. The following is for the 2017–2018 school year:

- *Subsidized federal loans* are subsidized by the U.S. federal government, which pays the interest while the student is in college. As a general rule, federal loans are generally less expensive than private, non-federal loans and a better choice, as federal loans enjoy some tax-payer subsidy. A federal loan recipient must be a citizen, permanent resident, or eligible non-citizen with a valid social security number. Recipients must also have a high school diploma or a GED equivalent; be admitted as a regular student in an eligible degree or certificate-seeking program; register or have registered for Selective Service for males; complete the FAFSA; be making satisfactory academic progress (SAP); and not be in default on a federal student loan or grant.

- *Direct Subsidized federal Stafford loans* are low-interest loans that the student begins to repay six months after he or she graduates or drops below half-time enrollment for a full six months. Therefore, the student controls when repayment begins. The government pays the interest on the loan while the student is in school. A Stafford loan is signed in the student's name, and the student is responsible for repayment. Annual loan limits are

based on class standing and range from $100 to $6,000 for undergraduate students.

For the 2017–2018 school year, the interest rate on Stafford loans is fixed at 4.45%, and there is a 1.069% origination fee. An independent student (a student who doesn't have to provide parent information on the FAFSA), may be eligible for even more loan money.

- *Subsidized university loans:* The college or university a student attends may have its own institutional short-term loan program. For example, loans available to BYU students include short-term loans that are used to cover tuition. These loans are taken out in the student's name and must be repaid the same semester they are borrowed. They charge no interest but do require a $20 processing fee and a credit check.

  Sometimes specific university departments offer loan programs as well. These university-sponsored, long-term, subsidized loans are similar to the subsidized Stafford loan in that interest does not accrue on the loan until the student begins to repay the loan 9 months after he or she graduates. These loans are in the student's name and require a cosigner. The interest rate on repayment is 6.50% and they are generally paid off in 120 months.

Federal unsubsidized loans are loans where borrowers are responsible for the paying the interest while they are in school.

- *Direct Unsubsidized Stafford loans* are low-interest loans that a student must begin to repay six months after he or she drops below half-time enrollment and stays below for a full six months—regardless of whether or not he or she has graduated. With unsubsidized Stafford loans, interest grows while the student is in school. The student may either choose to pay the interest while in school or let it accumulate and be added to the original amount borrowed. An unsubsidized Stafford loan is signed in the student's name and the student is responsible for repayment. Annual loan limits are based on class standing and range up to $12,500 for undergraduate students and $20,500 for graduate students. A fixed interest rate of 4.45% for undergraduates and 6.00% for graduates applies, with a 1.069% origination fee.

- *Direct Parental Loans for Undergraduate Students (Direct PLUS)* are available to the parents of undergraduate students to help with school-related expenses. In this type of loan, the parent is the borrower, receives the loan funds, and is responsible for repayment. To apply, students must complete the FAFSA. Interest rates on the PLUS loan are fixed at 7.00%. The parent can borrow the amount of the cost of attendance minus any other financial aid the student is receiving. Repayment begins six months after the student graduates, discontinues, or drops below half-time status. A 4.276% origination fee applies, so these are more expensive.

- *Grad PLUS loans* are available to graduate students as a supplement to the Stafford loan. The Grad PLUS loan is based on credit worthiness and does not require a cosigner. This loan is especially helpful for expensive graduate programs because students can borrow

any amount up to the full cost of attendance minus other financial aid received. The 7.00% fixed interest rate makes it less expensive than private or alternative loans, although there is a 4.276% origination fee. Repayment begins six months after the student graduates, discontinues, or drops below half-time status.

Private alternative loans (also referred to as alternative loans) should be avoided. They are based on credit worthiness and may require a cosigner. They are much more expensive than federal unsubsidized loans. Currently, many of these loans have a 14.5% variable interest rate, which means the interest rate could rise above an already high rate. Private alternative loans have higher interest rates and may have up-front or back-end fees. Interest starts to accrue on the loan immediately. While the student does not have to begin repayment until he or she graduates, the interest accrues while he or she is in school. If the student did not pay the 14.5% annual interest on the loan while he or she studied for five years, the loan amount borrowed could double in size. Read the fine print carefully before signing for this type of loan.

As a general rule, federal loans are less expensive that private, non-federal loans and a better choice if borrowing is necessary. Federal loans enjoy some tax-payer subsidy and more flexible payment options. Be aware of aggressive marketing campaigns of private-alternative loans. They are very expensive and often catch the unprepared or unaware.

5. Individual Development Accounts (IDA)

Individual development accounts provide matched savings to low income Utah savers only. The Utah plan is a public-private partnership funded by a broad spectrum of community partners to encourage savings. In 2019, they match $3 for every dollar students save up to a maximum of $4,500. For example, if a student saves $1,500 over 24 months ($62.50 per month), the program will match the savings up to $4,500 for the program. They can also save lesser amounts. To be eligible for this match, students must be in the program for 12 to 24 months, attend a basic money management course (the BYU Finance 418 Financial Planning course meets this criteria), have income to save, and meet the income eligibility criteria (see Table 2). Participants must have no more than $10,000 in net assets excluding one car and one house. Proceeds from the account may be used to purchase one of four productive assets: first homes, business start-ups, post-secondary education including vocational training, and assistive technology for work related activities. More information can be found at www.faircredit.org/services/individual-development-accounts or at (877) 787-0727.

6. Credit Cards and Payday Loans

Although you may be tempted to use credit card funds to finance education, credit cards are a very expensive way to borrow money. I strongly discourage you from using them to cover tuition or other school expenses. This is one of the worst and most expensive way to finance schooling and is most often the result of poor planning.

The worst way to finance your education is through Payday Loans. These are short-term loans of

two weeks, and should NEVER NEVER even be considered.

Table 2. Individual Development Account Earning Limits for 2019

The following are income eligibility by family size.

Family size	Income	Family Size	Income
1	$24,280	5	$58,840
2	$39,920	6	$67,480
3	$41,560	7	$76,120
4	$50,200	8	$84,760

* For families with more than 8 children, add an addition $4,320 for each person.

7. Parent's Retirement Accounts

Taking money from your (or your parents) retirement accounts is absolutely not recommended to help pay for your children's education. Your first priority is to save for retirement for you and your spouse. Then and only then, if you have resources available, should you help your children with their education. Try to find other alternatives. Taking from your retirement accounts is expensive and not tax-efficient. Do NOT consider this as an option.

Recognize How to Save for Your Children's Education

There are a number of different financial vehicles and financial assets that can help you save for your children's education. The key is to begin saving as soon as you possibly can, setting aside a certain amount of money each month and investing that money wisely.

The following are investment vehicles or accounts that can help you save for your children's education; the first three have tax benefits while the final two do not.

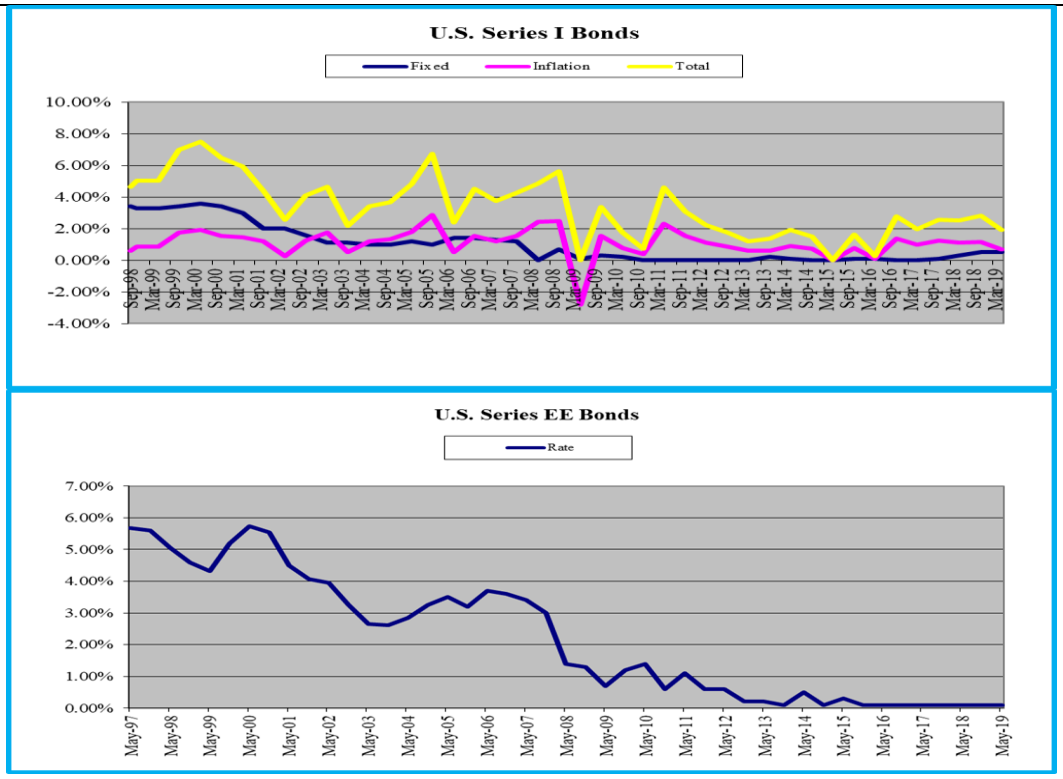
1. Series EE and Series I Bonds

Series EE and Series I bonds are issued by the U.S. government. These bonds are generally taxable, can be purchased by anyone with a social security number, and are available in amounts up to $5,000 per year for paper bonds and $5,000 per year for online bonds. A benefit of purchasing these bonds for educational purposes is that the earnings are tax-free if the principal and earnings from these bonds are used to pay for qualified educational expenses (these expenses are restrictive and include only tuition and required fees). If the earnings are used for other purposes, the interest from the bonds will not be taxed until the bonds are cashed and then the earnings will be state tax-free. I bond rates are 1.90% and EE bond rates are 0.1% until October 31, 2019 and reset every 6 months (see Charts 1).

These bonds have competitive interest rates that change every six months and can be purchased in small denominations (as low as $25) online at www.treasurydirect.gov. They have a minimum maturity of five years; if they are cashed before that time, there is a three-month interest penalty. (Savings bonds are discussed in more detail in the Cash Management chapter).

It is important to note that if your modified adjusted gross income is above specified limits in the year bonds are cashed, you cannot exclude the interest income from your income taxes. These limits are listed in Table 3.

Chart 1. I and EE Bond Interest Rates Over Time



Your modified adjusted gross income is your adjusted gross income, adding back certain items such as foreign income, foreign-housing deductions, student-loan deductions, IRA-contribution deductions, and deductions for higher-education costs.

2. Coverdell Education Savings Account, or Education IRA

An Education IRA is a type of individual retirement account that allows parents to save money for their children's secondary and higher education. Funds in an Education IRA accumulate interest tax-free, and the account creator determines how to invest the funds and how the funds will be spent. Eligible expenses include college tuition, elementary school tuition, secondary school tuition, and the purchase of books and supplies. If the money is withdrawn for expenses that are not related to education, federal taxes will be incurred at the creator's tax rate and the creator must pay a 10 percent penalty charge.

Table 3. U.S. Government EE/I Savings Bonds MAGI Income Limits

Year	Filing Single	Married Filing Jointly
2015	$77,200–92,199	$115,751–145,749
2016	$77,550–92,550	$116,300–146,300
2017	$78,150–93,150	$117,250–147,250
2018	$79,700–94,700	$119,550–149,550
2019	$81,100–96,100	$121,600–151,600

A Coverdell Education IRA has a contribution limit of $2,000 per year in 2019, which may be phased out as your income increases beyond specific limits (see Table 4). While funds must be used by the time a child reaches age 30, they can be transferred to other children.

Table 4. Education IRA MAGI Phase-Out Range

Year	Amount	Single Range	Married Filing Jointly Range
2015	$2,000	$95,000–$110,000	$190,000–$220,000
2016	$2,000	$95,000–$110,000	$190,000–$220,000
2017	$2,000	$95,000–$110,000	$190,000–$220,000
2018	$2,000	$95,000–$110,000	$190,000–$220,000
2019	$2,000	$95,000–$110,000	$190,000–$220,000

Your modified adjusted gross income is your adjusted gross income, adding back certain items such as foreign income, foreign-housing deductions, student-loan deductions, IRA-contribution deductions, and deductions for higher-education costs. Earnings beyond these limits ($95,000 single and $190,000 jointly) result in a phase-out of allowable interest deductions, which totally phase out at $110,000 and $220,000.

3. 529 Plans

529 plans are college savings plans created by state governments. These differ from state to state and from year to year. Their purpose is to help parents and others prepare for the future costs of education or to prepay tuition costs for a specific in-state university. In Utah, parents can save up to a maximum of $485,000 per child in these accounts in 2019. There are two major types of 529 plans: 529 Prepaid Tuition Plans and 529 Savings Plans.

With a **529 Prepaid Tuition Plan**, parents pay a specific amount of money in exchange for a promise that tuition is guaranteed to be paid when the child enters college. The advantage of having this plan is that you know tuition will be covered, regardless of increases in tuition cost. This plan may be useful if you think your child will not be eligible for financial aid by the time he or she is ready to enter college.

The disadvantage of this plan is that it may not be offered in the state where your child wants to attend school. Additionally, it does not allow you to choose your investments. Given your different investment options when your children are young, you could be more aggressive with your money and gain higher returns. Also, remember that having assets in this plan reduces your

child's eligibility to receiving financial aid.

With a **529 Savings Plan**, the control of the funds resides with the parent, who chooses the investments from among a set of approved investment alternatives that are set up in each state. Earnings are tax-free if the principal and earnings are used for approved higher-education expenses, which are generally quite broad in scope. Some states may even offer tax deductions on contributions made to your local 529 funds; check the guidelines in your state. Assets in these plans are not considered the student's funds, which increases a student's eligibility for financial aid. Most investment advisors would agree that this is the best way to save for your children's education.

A disadvantage of the 529 Savings Plan is that it may not cover all college expenses. Also, since you choose the investments, there is a risk of loss involved. Parents can save up to a maximum of $485,000 per child in 2019.

4. Tax-Efficient Investing

Tax-efficient investments do not offer any tax advantages to help you save for education expenses. 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' performance 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 to save for your children's education.

- **Know the impact of taxes.** As an investor, you must be particularly concerned about the effects of taxes because they represent one of the largest expenses you will have to pay when you 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:

  $$\text{Return}_{\text{after tax}} = \text{Return}_{\text{before tax}} * (1 - \text{marginal tax rate})$$

  Your after-tax return is equal to your before-tax return multiplied by the result of one minus your marginal tax rate. It is important for you to know your marginal tax rate. Your marginal tax rate encompasses your federal, state, and local taxes and is the tax rate you pay on your last dollar of earnings. (See the chapters on Tax Planning for a more in-depth explanation).

  You want to invest in assets with the highest after-tax return. 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, and unrealized capital gains (the capital gains on an asset that has not been sold yet) are not taxed until the asset has been sold. To understand the impact of taxes, you must calculate the estimated after-tax return of each asset you are considering. Remember that just even though an asset may have some tax

advantages, it may not be the best asset to invest in for future education expenses.

- **Replace ordinary income with long-term capital gains.** Long-term capital gains are taxed at a much lower rate than ordinary income. Earn as much of your income as possible in the form of long-term capital gains. Spend your time picking good, diversified, and tax-efficient mutual funds, and then hold those funds for a long time.

- **Minimize turnover and taxable distributions.** Every time you sell an asset, you set up a taxable event (a transaction that has tax consequences). Using a buy-and-hold strategy minimizes the impact of taxes and reduces your transaction costs.

  You can also minimize turnover and taxable distributions by selecting your mutual funds wisely. Invest in those funds that do not have a history of trading actively (i.e., funds that have low turnover or trading, such as index funds or low turnover mutual funds). These funds will reduce the amount of taxes you must pay each April.

- **Replace interest income with stock dividend income.** Changes in the tax law made in 2004 have reduced taxes on dividends from individual company stocks or stock mutual funds. 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.

- **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 and 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 for tuition expenses.

5. Custodial Accounts

Custodial accounts are set up by parents or grandparents with the help of a brokerage house or bank for their children or grandchildren. These accounts have the benefit of the estate and gift tax exclusion that allows individuals to give $15,000 per year ($30,000 per couple) in 2019 to any number of recipients without any effect on the giver's estate tax threshold amount. (This concept is discussed further in the chapter on estate planning). Parents, friends, and others can put money in these accounts to help children save for education or other personal goals.

An advantage of this type of account is that the funds can be invested in all types of financial assets: stocks, bonds, mutual funds, and so on. Money from these accounts can also be used to pay for many purchases not covered by other types of education savings vehicles, including miscellaneous fees, travel costs, and so on.

However, this type of account has no tax advantages, and the money is considered the child's money as soon as he or she is of age, so the issuer cannot take the money back to use it for other purposes. Also, since this money is considered the child's money, it may reduce the amount of additional financial aid that is available to the child. Based on these disadvantages, I do not recommend the use of custodial accounts.

Recognize How to Save for Your Children's Missions

While there are a number of different investment vehicles with specific tax advantages to help you save for your children's education, there are no similar vehicles to help you as you save for your children's missions. For most families, the two main investment strategies for saving for your children's missions will be using tax-efficient, wise investing and using custodial accounts.

Tax-Efficient, Wise Investments

Since there are no tax advantages to help you save for mission expenses, it is critical that you invest wisely and tax-efficiently. 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' performance by comparing their returns after taxes and transaction fees to the appropriate benchmarks. See the five suggestions for investing tax-efficiently on the previous pages.

Custodial Accounts

See previous section entitled "Custodial Accounts."

How to Reduce the Cost of Education and Apply for Aid

The following list outlines some ways you can reduce the cost of your children's education and apply for financial aid:

1. As discussed previously in this chapter, begin early. I recommend parents begin saving for their children's education and missions as soon as the children are born.

2. Fill out the FAFSA on the Internet at www.fafsa.ed.gov during your child's junior or senior year of high school. Follow the instructions and take action early (usually after your federal tax forms are completed). To have your federal aid in place by fall semester, it is wise to submit the FAFSA by January 1, unless you are planning to marry. Make an appointment with a counselor if you have questions.

3. Talk with the financial aid representatives at your child's preferred college during his or her senior year of high school. These representatives will guide you through the application process and help you determine your child's eligibility for aid.

4. If you are going to BYU, contact your OneStop Counselor (D-148 ASB) at 801-422-7075.

5. Look on the Internet for other sources of available aid. The following are some helpful websites that offer information about financing your education:

BYU specific:

- www.onestop.byu.edu—BYU's website for commonly accessed student services (D-148 ASB). Call their direct line for an appointment at 801-422-7075.
- www.scholarships.byu.edu—BYU's scholarship guide.
- Financialaid.byu.edu—BYU's financial aid guide.
- nsfp.byu.edu—National Scholarships, Fellowships, and Programs office.

Other:

- www.fafsa.ed.gov—The Free Application for Federal Student Aid form must be filled out to apply for any federal financial aid.
- www.nslds.ed.gov—Provides the student a centralized, integrated view of their Title IV loans and grants.
- www.fastweb.monster.com—Matches student profiles to a database of scholarships.
- www.collegeboard.com—Connects student profiles to a database of scholarships, internships, and loans.
- www.srnexpress.com—Contains resources on scholarships, fellowships, internships, and loan forgiveness programs.
- www.wiredscholar.com—Provides good information on college preparation.
- www.finaid.org—Contains comprehensive information on loans, scholarships, and savings plans.

Understand and Create Your Mission and Education Plans

As you think about developing mission and education plans, consider the questions from the creative process discussed earlier. They are:

These decisions should be made carefully and prayerfully with your spouse and within your family goals and budget. Following are a few ideas to help as you put your mission and education plans together for your children and grandchildren.

There is nothing in the scriptures that says parents must pay for their children's missions and education. It is an individual choice parents make, If you choose not to help with education or missions, ideas include:

- **Vision**
  - Because we love you and believe in your ability to go on your mission and

achieve your educational goals without our help, we're choosing not to contribute to your education and mission goals.

- **Goals**
  - We believe a mission and education are great goals but will mean more to you if you sacrifice to achieve them yourself, not if we make it too easy to attain.

Chart 1. Summary Education and Mission Plans

Education and Mission Savings Plans Comparison Chart 2019
MBA620/Fin418/Fin200 Financial Planning (4/11/19)

	Education or Mission: No Tax Benefits		Education Saving: With Tax Benefits			
	Taxable Account	**Custodial Account (UGMA/UTMA)**	**Series EE/I**	**Education IRA**	**529: Prepaid Tuition**	**529: Savings Plan**
Highlights:	Can be opened by anyone	Can be opened by anyone for a child, although NOT RECOMMENDED as assets become the child's generally at age 18.	Can be considered a cash management, savings, and educational vehicles by contributor.	An investment account available to contributors who earn less than $110K (for single filers) and $220K (for joint filers)	Contributions today are guaranteed to cover tuition costs in the future.	A state-sponsored investment account for the benefit of anyone -- your child, your cousin, your neighbor, yourself
Offered by:	Brokerages, mutual fund companies, banks	Brokerages, mutual fund companies, banks	US Government	Brokerages, mutual fund companies, banks	States (usually with help from a financial services companies)	States (usually with help from a financial services companies)
Contribution limits:	None	None	$10,000 per year for EE and I bonds and $5,000 more if use tax refund	$2,000 per student per year	Depends on plan -- Up to $485,000 max per student	Depends on plan -- Up to $485,000 max per student
Income limits:	None	None	Income limits apply if earnings are above limits in the year cashed	Contribution limits phase out if income exceeds limits	No income limits	No income limits
Returns:	Depends on what type of investments the account uses to invested. We recommend wisely investing in low-cost and tax-efficient mutual/index funds.	Depends on what type of investments the account uses to invested. We recommend wisely investing in low-cost and tax-efficient mutual/index funds.	EE bonds are 0.1% and I bonds are 2.83% for the 6 month period ending April 2019.	Depends on what type of investments the account uses to invested. We recommend wisely investing in low-cost and tax-efficient mutual/index funds.	These are invested by the College and guarantee tuition is fully paid upon the child's admittance.	Depends on the choice of assets and the allocation of those assets. Most state Plans give you options on how the funds are invested; however, you cannot invest outside given options.
Tax-deductibility:	None. However, wisely investing assets in low-cost and tax-efficient mutual/index funds can reduce taxes substantially	None. However, wisely investing assets in low-cost and tax-efficient mutual/index funds can reduce taxes substantially	Contributions are already taxed, so earnings and capital gains are state tax-free. However, if principle and interest are used for eligible education expenses, then both federal and state tax free.	Contributions are already taxed. If earnings and principle are used for eligible education expenses, then earnings are both federal and state tax-free.	Contributions are after-tax. Some states give a tax deduction for contributions to a certain limit. If principle and interest is used for qualified expenses, then earnings are both state and federal tax free.	Contributions are after-tax. Some states give a tax deduction for contributions to a certain limit. If principle and interest is used for qualified expenses, then earnings are both state and federal tax free.
Effect on financial aid:	Considered to be an asset of the parent, which means the assets will be considered in the financial aid calculation	Considered to be an asset of the student, which means a large portion of the assets will be considered in the financial aid calculation	Assets are considered to be property of the account owner, which unless the owner is also the beneficiary means only a small portion of the assets will be considered in the financial aid calculation	Considered to be an asset of the student, which means a large portion of the assets will be considered in the financial aid calculation	Considered to be the student's resource and thus reduces financial aid dollar-for-dollar	Assets are considered to be property of the account owner, which unless the owner is also the beneficiary means only a small portion of the assets will be considered in the financial aid calculation
Investment flexibility:	Assets can be invested in stocks, bonds, mutual funds, and cash equivalents available from the financial institution. Investments can be bought and sold as often as desired.	Assets can be invested in stocks, bonds, mutual funds, and cash equivalents available from the financial institution. Investments can be bought and sold as often as desired.	Bonds must be held at least 5 years for full interest. An interest penalty of 3 months will be assessed on all bonds cashed before 5 years.	Assets can be invested in stocks, bonds, mutual funds, and cash equivalents. Investments can be bought and sold as often as desired within the financial institution.	Plan administrators invest all assets.	Assets are professionally managed. Depending on the plan, participants can choose from two to almost 30 mutual fund-type investments. Investment choice may be changed once every 12 months.
Qualified expenses:	None	None	Tuition, fees, supplies and special needs. Room and board are not qualified expenses. Qualified expenses are reduced by scholarships and other aid.	Tuition, room, board, fees, supplies, and special needs related to the attendance of a qualified elementary, secondary, or post-secondary institution	Tuition at a college within the plan (some plans will also cover room and board)	Tuition, fees, room, and board at qualified higher-education institutions
Ability to transfer account:	Very flexible	Very flexible	None	Account may be transferred to other brokerage or mutual fund, or to a 529 plan, subject to fees and penalties.	Depends on plan	May transfer to another 529 plan once every 12 months
Interaction with Hope and Lifetime Learning Credits:	None	None	None	Credits can be claimed in the same year as tax-free withdrawal provided that the distribution is not used for the same expenses for which a credit is claimed.	Credits can be claimed in the same year as tax-free withdrawal provided that the distribution is not used for the same expenses for which a credit is claimed.	Credits can be claimed in the same year as tax-free withdrawal provided that the distribution is not used for the same expenses for which a credit is claimed.
Control of the account:	Contributor has full control of the assets	In most states, account assets become property of the student at age 18 so NOT RECOMMENDED.	In most states, control of account will always remain with contributor.	In most states, account assets become property of the student at age 18.	In most states, control of account will always remain with contributor.	In most states, control of account will always remain with contributor.
Must use funds by:	No age limit	No age limit	No age limit	Age 30	Varies by plan	Varies by plan
Assignability to other relatives:	Can be assigned to others	Cannot be assigned to others	Cannot be assigned to others	Immediate family, including cousins, step-relatives, and in-laws	Immediate family, including cousins, step-relatives, and in-laws	Immediate family, including cousins, step-relatives, and in-laws
Penalty for non-qualified withdrawals:	None	None	Selling before 5 years results in a 3 month interest penalty	Earnings are taxed as ordinary income to contributor, plus a 10% penalty	Earnings are taxed as ordinary income to account owner, plus a 10% penalty	Earnings are taxed as ordinary income to account owner, plus a 10% penalty
Contribution deadline:	None	None	None	Tax-filing deadline for the year of the contribution	Depends on the plan	Depends on the plan
Sources of information:	Schwab.com, vanguard.com or other mutual fund company	Schwab.com, vanguard.com or other mutual fund company	Treasurydirect.gov	www.irs.gov	my529.org	my529.org

- **Plans and Strategies**
  - We will allow you to save for this goal and will give you opportunities to earn and save money.

- **Constraints**
  - None.
- **Accountability**
  - We currently do not plan to have the resources saved to be able to contribute to these worthy goals, but we will help when and if we can.

If you choose to help with education, ideas include:

Vision

- From your Plan for Life. Other ideas include:
  - We believe that getting an education will make a great difference in life and make you better spouse, parent, and a contributor to the Kingdom and the world
  - A good education will help make you a better spouse, parent and contributor to the Kingdom of God and the world

Goals

- We will contribute $____ per month to help you with tuition, books, and room and board. It will not cover your entire education but it will help you get through.
- We will begin teaching the importance of getting an education at an early age
- We will offer opportunities to earn money to save for education
- We will support you as much as is possible given our financial situation for your education
- Getting a good education is a great ways to thank the Lord for His goodness and love
- We will support you as much as is possible given our financial situation

Plans and Strategies:

- We will set aside __% of our income after each child is born to help attain this important goal
- We will pay for education with 529 Savings Plans, Education IRA Savings Accounts, and taxable accounts for weddings and other needed items
- We will contribute $_ per month into a 529 Savings Plan to help you with your education
- We will match you 2 for 1 (or some multiple) of the amount of money you save for your education
- Our help will not cover your entire education but will help you get through with reduced needs
- Any scholarships are assumed you have earned to go toward your education amount.

Constraints

- This help is available for full-time students at an institute of higher learning (or trade school) as long as your previous semester GPA is a "C" or better and you are taking an institute class from the Church of Jesus Christ of Latter-day Saints.

Accountability

- We will help you with this worthy goal as long as you meet our constraints for help.

As you can tell from the previous examples, you can be very creative in the requirements to receive this help.

Summary

Education is important. Generally, as a person's level of education increases, his or her amount of lifetime earnings increases as well. There are many different ways to finance an education; reduce the cost of education as much as possible by utilizing available investment vehicles and financial assets.

There are five important principles of financing education and missions: teach your children who they are, that they are children of God, and model it yourself help your children to seek, receive, and act on the Spirit's guidance, help your children to save for their own missions and education, if you choose to help, develop education and mission plans for your children, invest funds wisely and tax-efficiently consistent with your risk, and start now.

In financing education, there are some sources of money that should be used before other sources. Following the process refers to determining the least costly sources of money for education and taking advantage of these sources first. The following list outlines the priority investment vehicles for financing education:

1. Free money
2. Personal and family savings
3. Employment while attending school
4. Loans
5. Individual development accounts
6. Credit cards (strongly discouraged)
7. Retirement accounts (very strongly discouraged)

There are several ways to reduce the cost of education and apply for financial aid. Begin the process early, fill out the FAFSA form, talk with financial aid representatives at your child's preferred college, and look on the Internet for other types of aid available.

Assignments

Financial Plan Assignments

If you choose, helping finance your children's education and missions may be an important part of helping your children prepare for life. Whether you can help out a lot or just a little, every little bit helps. The key is to save wisely using available investment vehicles and to save the most you can in the most tax-efficient manner if you choose to help.

Your assignment is to put together your Mission and Education Plans for your children. Review the investment vehicles you can use to save for your children's education. What are your priorities of money for education? Which vehicles should you use first and why?

Review the investment vehicles you can use to save for your children's missions. Which vehicles should you use first and why?

Planning now for your children's education and missions and following through on that plan will go a long way to helping make sure the resources are available when your children go to school and on missions.

If you or a child will attend BYU in the coming two years, go to go financialpath.byu.edu and map out your or your child's customized financial plan for college and see whether you are on track to graduate financially well-positioned for life, or whether you may be on a path to graduate with excessive debt.

Review Materials

Terminology Review

529 Prepaid Tuition Plan. This is an education plan where you can prepay tuition for a child and you know tuition will be covered, regardless of raises in costs of tuition. May be useful if you think your children will not be eligible for financial aid.

529 Savings Plan. This is an education plan where you can put money aside after tax and it grows tax free if principle and earnings are used for qualified educational expenses. Control of the funds resides with the contributor, who chooses the assets within options provided.

Custodial Accounts (UGMA/UTMA). These are investment vehicles that are managed for the child until the child turns a certain age. They can be invested in all types of financial assets, stocks, bonds, mutual funds, etc. UTMA (Uniform Gift to Minors Account) has fewer restrictions and may include real estate. These can be used for any educational or other expenses, including missions. The risks are there are no tax advantages and it is considered the child's money as soon as the child is of age—it cannot be taken back by the issuer. I prefer a tax-efficiently invested account.

Direct PLUS Loan. These are loans available for parents of undergraduate, dependent students to help with school-related expenses, and the parent is responsible for interest during school. Repayment begins six months after student graduates, discontinues, or drops below half time, and the parent is the borrower.

Direct Subsidized Loans. These are loans direct from the Federal government. The government pays interest while student is enrolled in school at least half-time, and repayment begins 6 months after student graduates or drops below half-time enrollment.

Education Savings Account (Coverdell or Education IRA). The investment vehicle is similar to a Roth IRA where you invest in this account with after tax dollars, and if you use the proceeds for qualified educational expenses, distributions are tax-free. You choose your investments and the proceeds can be used for eligible elementary, secondary and post-secondary education expenses.

Employment. This is working during college to help offset the cost of educational expenses.

Family Money. This refers to the use of personal savings and help from parents or other family. Find out which ones you are eligible for on a scholarship search engine and apply for each

Free Application for Federal Student Aid (FAFSA). This is the application form for obtaining government student aid.
Free Money. This is money you do not physically work for and is not paid back. It includes scholarships and grants.
Grad PLUS Loan. These are loans available for graduate students to help with school-related expenses. The student is responsible for interest during school, repayment begins six months after student graduates, discontinues or drops below half time, and the graduate student is the borrower.
Grants. Money given to individuals for education on the general basis of need.
Individual Development Accounts (IDA). These are matching resources from local and other sources to encourage saving for specific goals including education. They must be used for education, or home purchase, or to start a business, you must be in the program for 12 to 36 months maximum, and must attend a basic money management class (Fin418 and MBA620 both count), reside in Utah, be 18 or older, have income to save and meet needs criteria.
Modified Adjusted Gross Income. This is your adjusted gross income adding back certain items such as foreign income, foreign-housing deductions, student-loan deductions, IRA-contribution deductions and deductions for higher-education costs.
Pell Grant. A type of government grant to help students attend college.
Private Alternative Loans. These unsubsidized loans are much more expensive than federal unsubsidized loans, interest starts immediately and accrues, and you must begin paying the loan back immediately. The student is the borrower. These have higher up-front fees and may require a cosigner. Read the fine print VERY CAREFULLY.
Scholarships. Money given to promising students because of their shown abilities in specific areas. There are many scholarships available, but you have to find and apply for them individually.
Series EE and Series I Bonds. US savings bonds with the special tax advantage that earnings on the bonds are tax-free if used for paying tuition and fees
Subsidized Loans. Loans where another party pays the interest while the student is in school. Interest begins 6 months after the student graduates or drops below half-time enrollment.
Subsidized University Loans. These are loans offered by the university to students attending school.
Unsubsidized Federal Loans. These are loans for both grads and undergrads where the student responsible for interest during school, repayment begins six months after student graduates, discontinues, or drops below half-time enrollment for a continuous 6 months. The interest is not subsidized.

Review Questions

1. What is the general trend of education costs?
2. What is the relationship between education level and annual earnings?
3. What are the recommended priorities of money for financing an education?
4. What are some examples of "free money"?
5. What is the most important part of saving for your children's education and missions?

Case Study 1

Data

Anne and Bryan, ages 35 and 38, are planning for their children's educations. They are looking at the Education IRA, Series I bonds, and the 529 Savings Plan. They have three children, ages 2, 4, and 7, and earn a combined income of $50,000 per year. They save 20 percent of their income for their goals, of which 3 percent is earmarked for their children's education. They would like any tax breaks they can receive, as their cash flow situation is tight. Since they live in Utah, the Utah 529 Plan allows participants a 5 percent tax credit on contributions up to $2,000 for individuals and $4,000 filing jointly in 2019 on their Utah State taxes.[6]

Application

Which education vehicle should they use, and how much will they save in taxes?

Case Study 1 Answers

If their intent is to save money, the preferred vehicle is the Utah 529 Savings Plan. They can contribute up to a maximum of $446,000 total per child (aggregate maximum) in 2018. For current benefits, they can receive a 5% tax credit on contributions up to $1,960, totaling $95 ($3,940 and $196 for married filing jointly in 2018). Assuming they put the entire planed amount in the 529 Savings Plan ($50,000 * 3%), they can contribute $1,500 total, or $500 per child. They would be able to deduct the $1,500 * 5%, or $75, as a tax credit from their Utah state taxes and save that $75 as free money.

The Education IRA and Series I bonds have no current tax advantages, but they will save money on taxes in the future if principle and earnings are used for qualified education expenses.

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[1] "For Whatsoever a Man Soweth, That Shall He Also Reap," *Ensign*, Nov. 1980, 7

[2] "Inspirational Thoughts," *Liahona*, Jun. 1999, 3

[3] "When the World Will Be Converted," *Ensign*, Oct. 1974, 8

[4] Anthony P. Carnevale, Stephen J. Rose, and Ban Cheah, "The College Payoff: Education, Occupations, Lifetime Earnings," Georgetown University Center for Education and the Workforce, 2012.

[5] Pocatello, Idaho, Regional Conference, Idaho State University, Jun. 4, 1995

[6] http://www.uesp.org/About-UESP/Plan-Benefits/Tax-Advantages.aspx, July 31, 2019.

35. Your Future 1: Learning to Give

Introduction

We have spent a significant amount of time together during this course working on your vision and 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.

Why should we learn about finance (we talked about this the first day of class)? This is an important questions as you can only manage your finances in one of two ways:

- With an eternal perspective, which says that everything is the Lord's and that we are stewards over these resources to bless His children, or
- With the world's perspective, which is any other way.

How we answer this question will have a big impact on what we do with our lives and resources

Objectives

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

A. Understand giving and the myths and realities of giving
B. Understand the principles of wise giving
C. Understand how to give effectively
D. Understand how to create your individual/family giving plan.

Understand Giving and the Myths and Realities of Giving

We all wrestle with learning to give. A good starting point is defining "giving." We can take a number of perspectives here, as usual. From a narrow (i.e., temporal) perspective, some may say it is sharing what they have with others. But where did they get it? Where did they get the intelligence to get it? Who gives them their breath to work for it to get it? Who gave them their bodies that they could use for it?

From our broader (i.e., eternal) perspective, it is the sharing of the things we have been given by God with our families and our fellow men. It is sharing God's gifts with others.

Some have wondered if giving was inherited or learned. The Lord through the prophet Joseph said: "See that ye love one another; cease to be covetous; learn to impart one to another as the gospel requires."[1]

Elder Mark E. Petersen said: "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."[2]

Some have wondered whether giving was expected or required. The Lord has said: "For of him unto whom much is given, much is required"[3] and "For unto whomsoever much is given, of him shall be much required."[4] "But behold, they have not learned to be obedient to the things which I required at their hands, but are full of all manner of evil, and do not impart of their substance, as becometh saints, to the poor and afflicted among them."[5]

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."[6] Any discussion on giving takes us back to the first chapter of this course, where we discussed the key doctrines and principles of personal finance. Those principles were ownership, stewardship, agency and accountability.

Once we understand these principles, giving becomes easier. I also find comfort in the scripture "See that ye love one another; cease to be covetous; learn to impart one to another as the gospel requires."[7] We are not born as givers; rather, we learn to give as we become more committed Christians. We also come to understand that giving is not a one-time event but a Christ-like attribute. Mark E. Petersen wrote:

> 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."[8]

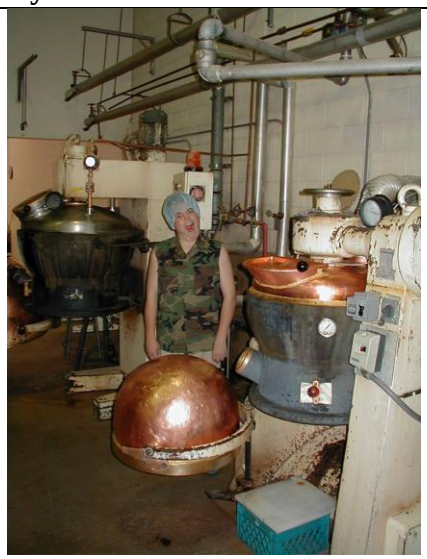
An Illustration

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, 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 racks (see Picture 3), and the packing tables (see Picture 4).

Picture 1. Introduction to Candy Making

Picture 2. Candy Heaters



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).

Picture 3 The Drying Rack

Picture 4. The Packing Tables

Picture 5. The Candy Store

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 by Heavenly Father as to what is good and what is bad, the commandments. 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, the more we share with others, the greater our joy will be later on.

Myths and Realities of Giving

There are five myths of giving that need to be recognized:

Myth 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.[9]

Myth 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, neuro-chemically, and spiritually, then we are giving people."[3]

Picture 6. Youth Helping Themselves in the Candy Store

Picture 7. Youth in the Candy Store

Myth 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."[3]

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."[10]

Myth 4. If the Government would do its job correctly, We would 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."[11]

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."[3]

Myth 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.

While the myths are many and varied, the realities are far different.

Reality 1. We have been commanded to give. The prophet Jacob taught: "Think of your brethren like unto yourselves, and be familiar with all and free with your substance."[12]

Reality 2. Givers make more money. Research has shown when comparing similar people, ages, family size, religion, race, etc., giver's make more money than non-givers (and that is statistically attributable to the gift). People who do volunteer work to better financially than non-volunteers. Even those who give blood do better than non-givers.[13]

Reality 3. Giving shows our Love for God. King Benjamin stated: "And behold, I tell you these things that ye may learn wisdom; that ye may learn that when ye are in the service of your fellow beings ye are only in the service of your God."[14]

Sister Carol B. Thomas commented: "Sacrifice is an amazing principle. As we willingly give our time and 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."[15]

Reality 4. Giving helps others. King Benjamin further counseled: "But ye will teach them to walk in the ways of truth and soberness; ye will teach them to love one another, and to serve one another. And also, ye yourselves will succor those that stand in need of your succor; ye will administer of your substance unto him that standeth in need."[16]

Reality 5. Giving helps us change to 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."[17]

Reality 6. Giving helps us repay an un-payable debt. There is one final debt, a debt we can never repay. And while we can never repay the debt, we can try.

> 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.[18]

Our recommendations for giving include:

- Be a Christian in word and deed
- Be a diligent full tithe-payer
- Be generous with fast offerings
- Be generous with other offerings
- Be generous by contributing to missionary work
- Be generous by blessing the poor with your help
- Look for other ways to share your resources and bless God's children
- Share your resources anonymously with friends
- Share yourself along with your resources
- Bless your family/extended family with resources

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."[19]

The following are a few principles we should remember as we give:

- **1. Understand Yourself, Your Vision, Goals and budget.** What is your vision for giving? What would you like to accomplish? Make sure what you are planning to do is in the best long-term interest of those you love, and that you take care of your own needs first. What are your resources? We cannot become like our Savior without giving. "Inasmuch as you have done it unto one of the least of my brethren, ye have done it unto me."[20]

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received. God know things we do not. As we seek the Spirit diligently through study and prayer, live worthy of the Spirit's guidance, and then act on it once it is received, we will be the most effective in our giving. For behold, again I say unto you

that if ye will enter in by the way, and receive the Holy Ghost, it will show unto you all things what ye should do."[21]

3. 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."[22]

4. 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."[23] Giving should be a sacrifice where our pocketbooks show where our hearts really are.

C. S. Lewis wrote: "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."[24]

5. 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.[25]

6. 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.[26]

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."[27]

7. 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.[28]

Finding Balance

As you work on giving, finding balance among doctrines, principles and application is important in helping you become better at giving. We have shared some ideas for principles, although I am sure you can find others that are important to you. Below are a few ideas for doctrines on which the principles are based. As you strive to increase your ability and effectiveness in giving, in addition to what you are learning, I recommend you study and ponder the doctrines and principles supporting giving.

Principles	Doctrines
Know yourself, your vision and goals	Identity
We should give as the Spirit directs	Obedience
We are to give out of love	Agency
We are to give sacrificially	Accountability
We are to give wisely	Gratitude/Agency
We are to give of abundance	Stewardship
We are to give freely	Stewardship

From Obedience to Consecration

Giving is not an activity to be checked off as part of a daily checklist; rather, it is part of a Christ-centered life. The key is what we become. As such, we are not just giving to help others; rather,

> We are children of Christ (identity), living worthy of the Spirit (obedience), using the blessings that God has shared with us wisely (stewardship) to take care of our spouses and family (stewardship and accountability). Then using of our abundance, we help build the kingdom of God (Plan of Salvation) through loving, serving and helping our fellowman (accountability), to accomplish our personal missions and our individual and family vision and goals.

Understand How to give Effectively

To give effectively, we should follow correct principles. Principles I follow when choosing a charity are as follows:

- They help in harmony with my personal vision, goals and values.
- They help people both locally and worldwide and make the world a better place.

- They 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.

I remember as a young college student, recently returned from a mission, teaching a lesson in church on the subject of fast offerings. Spencer W. Kimball said.

> Sometimes we have been a bit penurious (stingy) and figured that we had for breakfast one egg and that cost so many cents and then we give that to the Lord. I think that when we are affluent … we should be very generous and give, instead of the amount we saved by our two meals of fasting, perhaps much, much more—ten times more where we are in a position to do it. I know there are some who couldn't."[29]

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.[30]

I thought "ten times nothing is still nothing" and decided to give 10 times the cost of that day's meals. Later, when I got married, my wife and I decided to give fast and other offerings as a percentage of our income. I later went back, and found that the percentage we chose to give was the same percentage I had chosen while in college.

Since then, what 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.[31]

My Personal Priorities

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 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."[32]

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.[33]

The Lord said, "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."[34]

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. Latter-day Saint Charities (Humanitarian Services/Perpetual Education Fund). Latter-day Saint 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 Latter-day Saint Charities and the Perpetual Education Fund (PEF), every penny of every dollar you give goes to those in need. Latter-day Saint 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, Boy Scouts of America, United Way, and Habitat for Humanity.

Understand and Create Your Giving Plan

As a final part of this class and textbook on personal finance, I recommend we all put together an individual or family Giving Plan. We have plans for insurance, budgets, investing, retirement, and estate planning, should we not also include plans for how we will give back and make the world a better place?

As you put together your Giving Plan, I would hope you would think through how you will give, both institutionally, which is through your Church and other institutional contributions, as well as personally, which entails more direct personal and family contributions and service. I believe both types of giving are important. As a final part of this plan, think through how you intend to teach your children to give, for your children learn from you, and unless you teach them, it may be difficult for them to learn.

Giving is an intensely personal act. As such, it is not reported to me nor handed in, but I do recommend that you develop your Giving Plan individually and with your spouse if married. Build it consistent with your Vision, Mission, and Values statement. Make it meaningful, because next to what we do with our families, this will likely be one of the most meaningful things we will do over our lifetime.

As you put it together, visualize how you will feel at the end of your life as you accomplish the things you are planning. Is this truly what you want to do? Then make this Plan part of your personal and family goals, and work toward them as hard as you do your other goals.

As I think of giving, I think of both institutional (or indirect) and personal/individual (or direct) giving.

Institutional giving is giving through Church, through organizations set up to do good, and to help and serve in times of emergency and need. It is indirect giving, but giving none-the-less. This giving to me is giving of tithes, fast and other offerings, supporting missionaries, supporting 501(c)(3) organizations, helping financially in emergency situations, and helping financially with local food kitchens and other good causes.

Personal giving is giving directly to those in need, which includes personal and family contributions and service. This includes helping families in need, helping my friends, helping at Christmas time with Christmas giving, quarterly family service projects, helping at soup kitchens and other food drives, donating time at local genealogy libraries to find ancestors, participating in Church pageants and other faith-building activities, and providing service in local congregations and scout troops to help youth.

As you notice, it is important that we give both institutionally and personally. I like to think that whereas most goals are what you want to accomplish, giving is what you want to give back. I recommend you talk this over with your spouse and children. Help get them engaged and involved in the things you are doing to give back. Try to make this Giving Plan the culmination of your Personal Finance Plan. Use it to tie in your goals and values with your actions and efforts you are willing to give. Then finally, include in it how you will teach your children to give.

Institutional Giving Examples. Following are a few ideas shared by other students and faculty on institutional giving.

- We will pay our tithing of 10%, with additional contributions to Fast Offering of _% and the Ward Missionary Fund of _%.
- We will help support our own children as missionaries and will set apart $___ each year to help other missionaries not as fortunate.
- We will give blood twice a year.
- We will go on a senior mission at age 65.
- We will participate in the _____ Pageant if and when accepted. We will apply every other year.
- We will work at the Genealogy Library or do indexing for two hours each week.

Personal Giving Examples. Following are a few ideas for personal giving.

- We will set apart $___ each Christmas and work with our children to help a family who is in need.

- Each Christmas we will prepare "homeless bags" of food, clothing, and change to give to those in need.
- We will set aside $____ each year to give back to BYU and other Church schools.
- We have set a goal to save $___ for a school scholarship to allow others who are not as fortunate go to school.
- We will have a "Family Service Saturday" four times a year where we will go and do service for others, i.e., food kitchens, school work days, etc.

Giving Plan Example

Family giving plans are as individual as the families putting them together. The key is to catch your vision, set goals with the Lord's help and then to do it. Here are a few ideas in each of the areas.

Vision

- This is likely from your Plan for Life. Other ideas include:
  - We will have made giving an important part of our lives, budgets and characters. It is through serving and giving that our children will know what we truly believe and that we are truly Christians.
  - We will be "Christ's hands" wherever we live, and will strive through our service to have "His image" in our countenances.[35]
  - Many missionaries and friends who could not have served or done without our help will be there to express appreciation for the help we gave.
  - We will have kept the faith and our covenants.

Goals

- We will be generous in giving back to God in terms of our time, talents and resources since it is all His anyway.
- We have and follow our plans for institutional, personal, individual and family giving.
- We will teach our children to give through both word and example, in serving others and family service projects.
- We will serve in our local congregations in whatever way we are needed.
- Our resources will be God's resources in our family and other service projects.

Plans and Strategies

- We will be observant and listen to the Spirit for opportunities to help and serve.
- We will do a family service project quarterly, and will help out with all Young Men and Women service projects.
- We will attend the temple each week, and will spend 1-2 hours a week doing genealogy or indexing
- We will give blood as often as we can

- We will create a "Family Foundation," where children are all board members, and we distribute 5% of the assets each year to needy people.
- We will serve formally in the temple beginning at age 60.
- We will go on our first senior mission at age 65.
- Institutionally, We will pay annually 10% tithing, __% for fast offering, __% for missionary work and __% to our favorite college for scholarships.
- Personally, We will set aside $____ a month to help others.
- We will have a family personal giving budget and will involve the children in deciding its use
- We will teach children about finance through our Family Foundation

Constraints

- Key constraints are living on a budget and saving 20% of every paycheck, with 15% going to retirement and __% earmarked for personal giving.
- On personal giving, our family will jointly decide who we will help, how much, and how that help will be given, as well as the service projects each quarter.
- Institutional giving will come directly from our paycheck each month for tithes and other offerings.
- Sin will be a big constraint, so we need to always keep our promises and covenants.

Accountability

- We will share our vision and goals with Heavenly Father in prayer each day
- My accountability partners will be my spouse and children.
- We will discuss as a family our giving plans in Family Home Evening (a weekly meeting of the family to teach and have fun together).
- We will also discuss and schedule our quarterly family service projects.
- Moreover, we will also discuss the criteria as a family on who we will help with our personal giving, how much we will give (which will change depending on the situation) and the process of giving.
- I will be held accountable for this giving by my spouse and children.

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:

- Giving makes us poorer. Those who give are happier and healthier and are considered leaders by others.

- People are naturally selfish. Selfishness is a learned behavior. When we are at our best in all our faculties, we are givers.
- Giving is a luxury. Giving is a necessity. We need to give to be the best people we can be and to become more like our Savior Jesus Christ.
- The government provides assistance, so we do not need to give. We must take our place as givers and support the communities and people who need the services we can provide. We need it as much as they do.
- You need money to give. Giving is a state of your heart, not a state of your checkbook.

The realities of giving are:

- We have been commanded to give.
- Givers make more money.
- Giving shows our love for God.
- Giving helps others.
- Giving helps us change to become more like Christ.
- Giving helps us repay an unrepayable debt.

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.

Finally, just as we have a vision and goals for what we want to accomplish, we should have a vision and goals for what we want to give. It is important for us to "learn to give" and to prepare our individual/family "Giving Plan."

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?

Think about your family/individual Giving Plan. Please note that this is not to be handed in now but to be included in your PFP after it is returned. Include your vision, goals and plans on your personal and family "giving plan." How will you handle both your institutional (through Church and other institutional contributions) and personal (individual and family contributions and service) giving?

Develop your Action Plan. What is your giving plan for tithes, offerings, and other contributions? What is your giving plan for door-to-door, phone, and other solicitors? How will you teach your children to give?

Learning Tools

The following Learning Tool may be helpful to you as you learn to give:

Tithing Share Transfer (LT08)
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

Terminology Review

Family Giving Plan. A family plan which states how the family will give, to whom it will give to, as well was what the family will or will not do or give to.
Giving Plan. A plan on your thoughts on your personal and family giving. It discusses how you will handle both your institutional (through Church and other institutional contributions) and personal (personal and family contributions and service) giving.
www.charitynavigator.org. a website on information about various charities which file Form 990 with the IRS. However, they do not include religious organizations listed as "church or convention or association of churches" which are exempt from filing Form 990.

Review Questions

1. Learning to give takes us back to the doctrines and principles of finance. What are the key doctrines of finance from the different perspectives, and the key principles of 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?

[1] D&C 88:132.
[2] "Honesty, a Principle of Salvation," Ensign, Dec. 1971, 72.
[3] D&C 82:3.
[4] Luke 12:48.
[5] D&C 105:3.
[6] Monson, Thomas S. " A Gift Remembered," *New Era*, Dec. 2001, 4
[7] D&C 88:123.
[8] Honesty, a Principle of Salvation," *Ensign*, Dec. 1971, 72.
[9] Brooks, Arthur C. "Why Giving Matters," *BYU Magazine*, Summer 2009, 25–28
[10] Deut. 16:17
[11] Mosiah 2:17
[12] Jacob 2:17.
[13] Arthur C. Brooks, "Why Giving Matters," BYU Magazine, p. 25-28, Summer 2009.
[14] Mosiah 2:17.
[15] "Sacrifice: An Eternal Investment," *Ensign*, May 2001, 63.
[16] Mosiah 4:16-17.
[17] "Living Welfare Principles," *Ensign*, Nov. 1981, 92; emphasis in original.
[18] Mosiah 2:20-21.
[19] Robbins, Lynn G. "Tithing—a Commandment Even for the Destitute." *Ensign*, May 2005, 34
[20] Matt 25:20.
[21] 2 Nephi 32:5.
[22] 1 Corinthians 13:3
[23] *Lectures on Faith*, comp. N. B. Lundwall, Salt Lake City: Bookcraft, n.d., 58
[24] Mere Christianity [1952], 67.
[25] Mosiah 4:24, 27
[26] Luke 21:1–4
[27] Hales, Robert D. "Couple Missionaries: A Time to Serve." *Ensign*. May 2001, 27
[28] Mosiah 18:27–28
[29] In Conference Report, April 1974, p. 184.
[30] *Mere Christianity*, 1952, 67
[31] *Discourses of President Gordon B. Hinckley*, Vol. 2, Intellectual Reserve, 2005, 330
[32] D&C 64:23.
[33] Romney, Marion, G. Caring for the Poor—A Covenantal Obligation," *Ensign*, Nov. 1978, 87
[34] D&C 42:30.
[35] Alma 5:14.

36. Your Future 2: Decide to Decide So You Can Create with Confidence

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 and each of the 16 sections. 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!*[1]

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:

A. How do we bring Christ into our finances
B. Take a look back on the course and our learning framework
C. Understand some key decisions you must make to be truly successful in life
D. Learn about resources for additional readings on the subject of personal finance
E. Understand what wise financial stewards know.

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!

How do we bring Christ into our Finances

The first day of class we shared why we should want to bring Christ more into our finances. M. Russell Ballard stated: "In my judgment, we never will have balance in our lives unless our finances are securely under control."[2] Christ can help us bring balance into our lives and finances, and to bring our finances and lives more under control. We shared four different steps to bringing Christ in more.

Seek to learn and love the Savior and His atonement more. We study, pray, learn more about Him, and contemplate His amazing atonement and what it means in our lives. Christ knows us by name and loves us perfectly, and has designed a detailed, individual, and customized curriculum (called life) exactly tailored to our needs, mission and destiny. Managing our finances is one of the pieces of that curriculum and is simply part of the gospel of Jesus Christ.[3] Hopefully this class was a beneficial part of your curriculum.

Strive to change daily and become more like Him. God's grace, repentance and the atonement of Jesus Christ are perfect tools to help us change and to become more like our Savior. He has given us everything we need to become more like Him. He has taught through His servants that "a" pattern to change behavior is to understand doctrines and principles, and have them confirmed by the Spirit.[4] We have consistently shared in each class those doctrines and principles.

Learn to apply His words and create our lives more closely with Him. As we strive to develop and grow, application is an invitation to learn and create.[5] As we do, we become creators with God of ourselves, our families and our lives. We create each day in our prayers, families, the environment in our homes, budgets, goals and our lives. We are all creators, and learn best when we learn and follow the Master Creator, even Jesus Christ. You have created each and every day of class.

Always remember Him. We need Christ's inspiration and guidance daily if we are to return with our families to His presence. We already covenant to "always remember Him" each week in the Sacrament. We must strive to keep those and our other covenants. We must remember that our conduct on our journey is as important as our final destination.[6] We must, like the pioneers, make "a covenant and a promise to keep all the commandments and statues of the Lord" (D&C 136:2) as we daily remember the Savior and follow the covenant path.

Take a Look Back at the Course and Learning Framework

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 remember that personal finance is simply part of the gospel of Jesus Christ and that you keep your priorities and your personal and financial goals in order.

A Look Back at our Learning Framework

As you look back on this course, I hope you feel it has helped you better understand the importance of having a correct perspective on personal financial issues. The first key part of the learning framework is personal finance is simply the temporal application of eternal principles.

Many of us, before we took this class, start in the wrong place, at application when we had a problem or challenge. Although this is understandable, it does not produce the spiritual power, protection and direction we need. David A. Bednar wrote:

> Somehow we seem to be drawn to application as the primary way to 'fix' things, to make life better. . . And far too often we emphasize application without the necessary understanding and divorced from the doctrinal content. . . Whatever the reasons, *emphasizing the application to the exclusion of fundamental doctrines and principles does not produce spiritual power, protection, and direction*. . . Appropriate applications are necessary but can never stand alone. What is needed is a balance among doctrines, principles and application. . . *The answers always are in the doctrines and principles. And the doctrines and principles need to be in us*.[7]

We helped you to think differently in this class. It was through a new learning framework. It asks three critical questions that lead to learning.

> 1. Why should we [learn and become better at personal finance] (this is "why" or a doctrine)?
> 2. What are the principles on which how we [learn and become better at personal finance are based] (this is "what" or a principle)?
> 3. How do we [learn and become better at personal finance] (this is "how" or an application)?

These three questions directed us to three areas: doctrines, principles and application. The second key of our learning framework was that doctrines and principles, confirmed by the Spirit, change behavior.

Doctrines

Boyd K. Packer taught, "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. . . That is why we stress so forcefully the study of the doctrines of the gospel."[8]

However, we learned that it is not enough to know the doctrines—we must understand them as well. David A. Bednar commented on the importance of understanding when he wrote,

> President Packer did not teach that simply knowing true doctrine changes us. Rather, doctrine must be understood. The word understanding in the scriptures frequently is

> linked to and associated with the heart and refers to a revealed result or conclusion. Thus, true doctrine confirmed in the heart as true by the witness of the Holy Ghost changes attitudes and behavior. Knowing true doctrine is necessary but is not sufficient. Understanding true doctrine both in our minds and in our hearts is essential to a righteous attitude and actions.[9]

Following are the five most important doctrines that we have learned in this class that can produce that spiritual power, protection and direction promised by Bednar that we so much need in our lives and our finances.

Identity. Identity is who we really are, children of God. Identity involves the way we see ourselves, as well as the way we perceive ourselves to be seen by others.

The scriptures teach we are "all the children of God by faith in Jesus Christ."[10] Paul reminds us, "And if children, then heirs; heirs of God, and joint-heirs with Christ."[11] Bruce R. McConkie said, "No doctrine is more basic, no doctrine embraces a greater incentive to personal righteousness . . . as does the wondrous concept that man can be as his Maker."[12]

The Proclamation on the Family reminds us, "All human beings—male and female—are created in the image of God. Each is a beloved spirit son or daughter of heavenly Parents, and, as such, has a divine nature and destiny."[13] As children of heavenly Parents, we are known by name and loved unconditionally. For God said, "This is my work and my glory—to bring to pass the immortality and eternal life of man."[14]

As children and heirs of all God has, we can accomplish anything that the Lord commands us, including obeying the commandments to live within our means, stay out of debt, and to save. "It is this doctrine of identity that defines our potential destiny of godhood. If one does not correctly understand his divine identity, then he will never correctly understand his divine destiny. They are, in truth, inseparable partners."[15] Russell M. Nelson said, "If the Lord were speaking to you tonight, He would urge you to understand your identity—to know who you really are."[16]

Obedience. Obedience is the source of divine guidance and power in our lives. As we choose to obey God's commandments and listen for the promptings of His Spirit, we will be guided in all we do, including our financial choices. Declared by Joseph F. Smith, "Obedience is the first law of heaven."[17] As such, it should be a critical component of our doctrine and understanding.

The scriptures state, "There is a law, irrevocably decreed in heaven before the foundations of this world, upon which all blessings are predicated—And when we obtain any blessing from God, it is by obedience to that law upon which it is predicated."[18] Blessings are predicated or built upon our obedience. When we fail to obey the commandments or sin, "this eventually, but invariably, leads to diminished happiness and forfeited blessings."[19]

Obedience is a misunderstood doctrine. Spencer W Kimball said, "The very first thing before beginning our world here, the Lord said, 'I'm going to give you your . . . agency. I want men and

women that are strong because it is right to be strong. I don't want weaklings who are righteous only because they have to be righteous.'"[20] Dale G. Renlund reaffirmed this when he said,

> Our Heavenly Father's goal in parenting is not to have His children do what is right; it is to have His children choose to do what is right and ultimately become like Him. If He simply wanted us to be obedient, He would use immediate rewards and punishments to influence our behaviors. But God is not interested in His children just becoming trained and obedient "pets" who will not chew on His slippers in the celestial living room. No, God wants His children to grow up spiritually and join Him in the family business.[21]

James E. Faust said, "Obedience leads to true freedom. The more we obey revealed truth, the more we become liberated."[22] Robert D. Hales said, "Obedience makes us progressively stronger, capable of faithfully enduring tests and trials in the future. Obedience in Gethsemane prepared the Savior to obey and endure to the end on Golgotha."[23] Finally, how do we know when we truly are becoming obedient? Ezra Taft Benson said, "When obedience ceases to be an irritant and becomes our quest, in that moment God will endow us with power."[24]

Stewardship. Stewardship is an amazing doctrine, and I divide it into three key areas, "whose" we are, that blessings are responsibilities, and that we are responsible to "make use of the means the lord has provided."[25]

The Psalmist wrote: "The earth is the Lord's, and the fullness thereof; the world, and they that dwell therein."[26] Scripture reminds us the Lord is the creator of the earth[27], the creator of worlds, men and of all things[28], the supplier of our breath, the giver of our knowledge[29], the giver of our life[30], and the giver of all we have and are.[31] Paul reminds us whose we are when he wrote, "For ye are bought with a price: therefore glorify God in your body, and in your spirit, which are God's."[32] All things belong to the Lord, including ourselves.

We are the Lord's hands here on earth, and are not to be "commanded in all things."[33] We are to "make use of the means the Lord has provided"[34] in accomplishing our finances and other challenges.

We are all the Lord's stewards over the things we have and are, especially ourselves. As His stewards, we need to be wise in how we spend the time and resources in our care. We are counseled to "not spend money for that which is of no worth, nor your labor for that which cannot satisfy."[35] We need to understand those things of eternal and true value and work toward them.

There are great blessings promised to wise stewards. "And whoso is found a faithful, a just, and a wise steward shall enter into the joy of his Lord, and shall inherit eternal life,"[36] and, "And he that is a faithful and wise steward shall inherit all things."[37] Surely this is a wonderful doctrine and a key to our understanding and being wise stewards over our family and financial blessings.

Agency. Agency is "the ability and privilege God gives people to choose and to act for themselves."[38] The Lord said, "Behold, I gave unto him [men and women] that he should be an agent unto himself."[39] The prophet Joshua wrote, "And if it seem evil unto you to serve the Lord, choose you this day whom ye will serve; . . . but as for me and my house, we will serve the Lord."[40] As we serve the Lord, we become more like Him.

Agency is critical to the Plan of Salvation. The Lord, in speaking to Moses said, "Wherefore, because that Satan rebelled against me, and sought to destroy the agency of man . . . I caused that he should be cast down."[41] The Lord through the prophet Joseph said, "That every man may act in doctrine and principle pertaining to futurity, according to the moral agency which I have given unto him, that every man may be accountable for his own sins in the day of judgment."[42]

When we were created spiritually, we were given knowledge, and in the Garden, we were given our agency. "The Lord said unto Enoch: Behold these thy brethren; they are the workmanship of mine own hands, and I gave unto them their knowledge, in the day I created them; and in the Garden of Eden, gave I unto man his agency."[43]

As we come to understand agency, we will learn that we must use it correctly or we will lose it. We can choose to take drugs and alcohol, but the coming addictions reduce our agency in the future, especially our agency to choose what we want to do and become. We can choose to disobey the law of chastity, but the coming guilt, disease, and broken relationships limit our choices later, including our chance for an eternal family. We can choose to not live on a budget, but the coming lack of savings for future needs such as missions, education and retirement cannot be avoided. There are consequences to our choices. Perhaps that is why the Lord reminds us to take an eternal perspective when He said: "Hearken ye to these words. . . *Treasure these things up in your hearts, and let the solemnities of eternity rest upon your minds*."[44]

Accountability. Accountability is how we are accountable to God for our choices. The second Article of Faith reminds us that, "We believe that men will be punished for their own sins, and not for Adam's transgression.[45] The Apostle John understood ultimate accountability and wrote, "And I saw the dead, small and great, stand before God; and the books were opened: and another book was opened, which is the book of life: and the dead were judged out of those things which were written in the books, according to their works."[46]

Alma expands our understanding about accountability when he taught, "For our words will condemn us, yea, all our works [including how we manage our finances] will condemn us; we shall not be found spotless; and our thoughts will also condemn us."[47]

The Lord said to the Prophet Joseph, "It is wisdom in me; therefore, a commandment I give unto you, that ye shall organize yourselves and appoint every man his stewardship; That every man may give an account unto me of the stewardship which is appointed unto him."[48]

David A. Bednar reminds us that "The gospel is so much more than a routine checklist of discrete tasks to be performed; rather, it is a magnificent tapestry of truth "fitly framed"[49] and

woven together, designed to help us become like our Heavenly Father and the Lord Jesus Christ, even partakers of the divine nature."[50]

Dallin H. Oaks affirms this and reminds us,

> From such teachings we conclude that the Final Judgment is not just an evaluation of a sum total of good and evil acts—what we have done. It is an acknowledgment of the final effect of our acts and thoughts—what we have become. It is not enough for anyone just to go through the motions. The commandments, ordinances, and covenants of the gospel are not a list of deposits required to be made in some heavenly account. The gospel of Jesus Christ is a plan that shows us how to become what our Heavenly Father desires us to become.[51]

Personal finance is a very complex process. When it comes to changing our behavior, we cannot do it on application alone. We need balance between doctrines, principles and application if we are to accomplish the things God would have us accomplish in our lives, including our finances. If we do application on its own, we can accomplish some things, but we miss the "spiritual power, protection and direction" promised. As we come to understand the key doctrines of the gospel, we gain the spiritual power, protection and direction to accomplish what we need. For us to accomplish all the things we need to in our lives and in our finances, we must understand the doctrines and principles. As Bednar said, "The answers always are in the doctrines and principles. And the doctrines and principles need to be in us."[52]

Principles

We have discussed many different principles in each of the 16 areas of your Personal Financial Plan. The key areas of your of your Personal Financial Plan included principles in each of these areas:

Your Plan for Life	Education Plan
Financial Statements	Mission Plan
Cash Management Plan	Auto/Toy Plan
Tax Plan	Retirement Plan
Credit Plan	Housing Plan
Insurance Plan	Giving Plan
Family Financial Plan	Investment Plan
Saving, Income and Expense Plans	Consumer Loans and Debt Plan

Most started with:

- Understand yourself, your vision, goals and budget.
- Seek, receive and act on the Spirit's guidance
- Understand the key areas of whatever topic we were discussing.

In addition, we discussed four general principles of personal finance on which the doctrines are

based, namely:

- Ownership. None of what we have is ours.
- Stewardship. We are stewards over all God has shared with us.
- Agency. The right to choose is one of God's greatest gifts to each of us.
- Accountability. We will be held accountable for every decision we make, including our financial decisions.

If our decisions recognize and apply these four key principles, then we are basing our decisions on the correct perspective.

Application

The third key to our framework was that application was an invitation to learn to apply His word and create our lives more closely with Him. We shared the creative process—the application of information in each of the 16 key areas. We are all creators, and we shared the process on how we apply these things to become better. God gave us life and He created a plan for us. This class and your PFP has been your chance of creating a Plan for this wonderful life He has given you?

We shared the most important parts of the creative process on how we change to become better. It is:

- Vision
    - What is your vision for yourself and your life? What would you like to accomplish in your lifetime? What do you hope to have accomplished when you have completed your life? How does Heavenly Father see you?
- Goals.
    - What goals will take you to your vision? What goals should you have? What goals are you willing to work toward?
- Plans and Strategies.
    - What are your plans for achieving your goals? What must you do to achieve your vision?
- Constraints.
    - What things will keep you from achieving your vision and goals? What are the things you should be careful of to make sure you can accomplish your goals?
- Accountability.
    - Who will you be accountable to for your vision and goals? Who will be your accountability partners to help you achieve them?

Finally, we shared that our conduct on our journey is as important as our destination. We must daily stay on the covenant path and do those things so we can have the guidance of the Spirit in our lives. Remember the revelation in D&C 136.) Many have underestimated the role it played in refocusing Brigham Young and the Church. "By helping the Saints remember that their

conduct on the journey was as important as their destination, the revelation helped transform the westward migration from an unfortunate necessity into an important shared spiritual experience."[53] As we remember the importance of our daily conduct, it helps us to keep focused on our ultimate long-term vision and goals, to returning to Father's presence; to keep our priorities in order and reminds us of the importance of being worthy of the guidance of the Holy Spirit; and it changes personal finance from being an unfortunate necessity into an important shared spiritual experience as we make the journey with our spouse and family.

Why is this learning framework important?

This learning framework is important for five reasons:

1. It can help us ask the right questions to help us understand and accomplish what we need.

2. It reminds us where the answers really are. Instead of jumping to application, the answers are in the doctrines and principles.

3. It helps us lift our perspective and vision. "With increased vision comes increased motivation."

4. Its helps us take a long-term perspective rather than a checklist approach to life. It is all part of the gospel.

5. This framework reminds us of the importance of Christ and of our daily conduct.

6. It changes our thinking from doing our "mundane acts of obedience" into "holy acts of consecration" to our Savior Jesus Christ.

Your Personal Financial Plan

We shared ideas and experiences on how you can apply the creative process to the things learned in this class, how you can create your vision of what you want to become, one step at a time. This process is applicable to all areas of your PFP.

Finally, you have followed the words of Ezra Taft Benson who said "Plan your financial future early, then live your plan."[54] You have done that with your PFP, the "spiritual creation" of your lives. Now is the hard work, to take your Plan and make your "physical creation" a reality. Your Personal Financial Plan includes 16 separate Plans, including your:

What is critical for you to become truly rich? This is an important question for you to answer early in your life, or you may get to the end of your life and not know what was truly important. Hopefully, we have helped in this process.

- You have your priorities in order and you strive to see things correctly, that is, to see

them as God sees them.

- You have the hope in Christ first, and then you seek riches–if you desire them.[55]
- You understand what is important in eternal life and you work accordingly[56]
- You think long-term[57] and follow the commandments of Jesus Christ.
- You know that commandments are protective—not restrictive.
- You live like millionaires, you practice discipline, charity, and frugality.

Life is Good

There is a three word summary for this class. It is simply that "Life is good." "Life is good" is an acronym to help you remember the things we wanted you to get out of this class. They relate to the key things you will have learned and are hopefully doing now. It includes the key parts of your Personal Financial Plan. It represents:

L Love the Lord, and always put and pay Him first.
I Invest your money wisely, consistent with your goals and risk tolerance.
F Find happiness where it is to be found, in your spouse, family and service.
E Enjoy the journey and give back, as its all God's anyway.

I Invest in yourself and family, and save for missions and education.
S Save 20% of everything you earn, and allocate 15% for retirement.

G Get and stay out of debt, and strive to be debt free except to God.
O Organize yourself, and know your vision, goals, plans and budgets.
O Operate on a budget, and get very good at planning
D Do good, be good, and get better, as we all strive to become more like our Savior.

As a missionary in England, Gordon B. Hinckley and his companies shook hands each morning and told each other "life is good."[58] We hope that we can all do the same and remember each day that same message.

Summary

In summary, the purpose of our learning framework was to help us to bring Christ into our finances. Following was the purpose and what our learning framework shared.

1. We seek to learn, understand and love the Savior and His atonement more. We shared that personal finance is simply part of Christ's gospel and part of Christ's customized curriculum for each of us.

2. We strive to change daily and become more like Christ. We shared that the best way to change behavior was to learn doctrines and principles and to have them confirmed by the Spirit.

3. We learn to apply His words and create our lives more closely with Him. We shared that application is an invitation to apply His words and create our lives more closely with him. Application is an invitation to learn and create

4. We always remember Him. We need Christ's inspiration and guidance daily if we are to accomplish our vision and goals; as such, we need to remember that our conduct on the journey is as important as our destination.

Understand Some of the Key Decisions You Must Make to Be Truly Successful in Life

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 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![59]

In this course, we have discussed many critical decisions that I hope you will be well equipped to make as you "decide to decide."

It is not enough to know what to do. You must commit or bind yourself to do it! The Lord said "And thus ye shall become instructed in the law of my church, and be sanctified by that which ye have received, and ye shall bind yourselves to act in all holiness before me."[60]The sweet Psalmist of Israel wrote "Commit thy way unto the Lord; trust also in Him; and He shall bring it to pass."[61]

The following are nine key decisions we have taught in this course that I believe you must make to be truly successful in life and then 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 yourself. Believe that God is interested in you as an individual, that He has a plan and a mission for you individually 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."[62]

2. Decide to Listen

Take the Holy Ghost as your guide. Decide now that in all you do, you will live worthy of the Spirit and will listen to its guidance

> By following the rules, you will never make a serious mistake … without being warned. You will never take the wrong road, you will never go around the wrong bend, or make the wrong decision without your having been warned. That pattern is the pattern of the Latter-day Saint. You were confirmed a member of the Church, and you had conferred upon you the gift of the Holy Ghost to be a guide and a companion to you."[63]

3. 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.

4. Decide to Work

Work hard, smart, and with the Spirit. Hard work is necessary for you to reach your goals. Decide now to work hard and smart, to work as hard and as efficiently as you can, and to pray for Father's help as you work that you will do the right things and in the right way, and that you can work beyond your natural abilities. Rex D. Pinegar said: "If you and I are to reach the summit of our divine potential, we must work each step of the way. The path may be rugged, difficult, unheralded; but it can be successfully climbed if we are willing to work with all our strength and commitment."[64]

5. Decide to Create and Achieve

Create and achieve your vision and 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."[65]

Your vision and 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 have a thoughtful good, timely, and well-thought-out vision and goals. Then work toward them. As you set your personal and family vision and goals, keep a long-term perspective on your goal-setting.

6. Decide to Budget and Stay Out of Debt

Always spend less than you earn and stay out of debt. 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. Spencer W. Kimball stated:

> 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.[66]

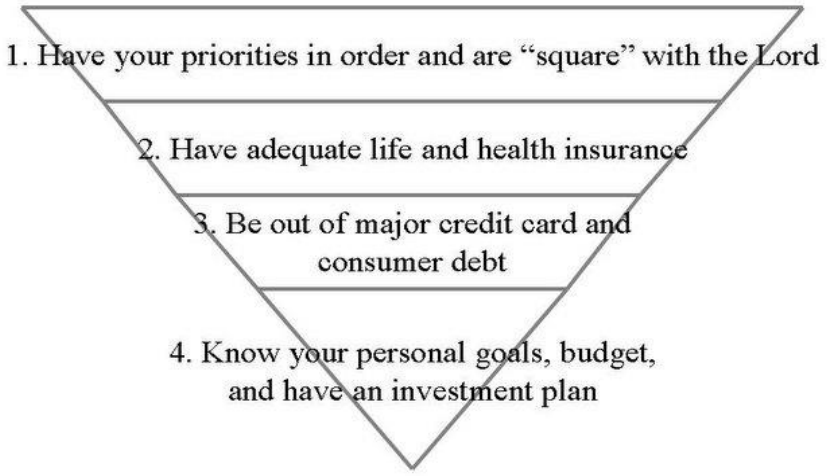
Decide now to budget; decide to stay out of debt; and decide to keep your priorities in order. Always pay the Lord first and pay yourself second. By doing this, you will learn to manage your finances instead of allowing your finances to manage you.

7. 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.

Chart 1. The Top of the Investment Hourglass



If you can answer these affirmatively, you are ready to invest

8. 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.

9. 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.

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.

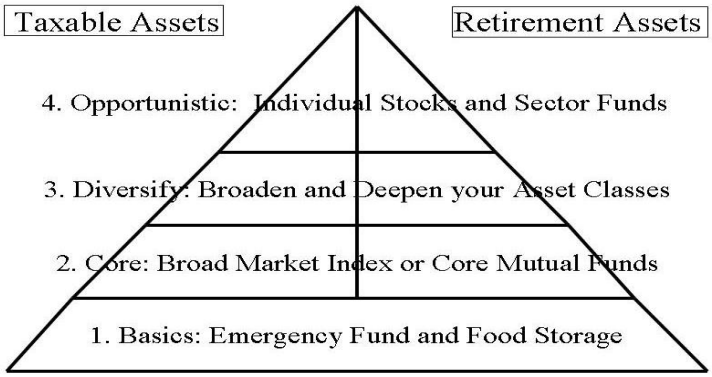
10. Decide to Decide

Live the gospel of Jesus Christ daily. It is the best cure for your finances and your life. With His help we can "commit thy way unto the Lord; trust also in Him; and He shall bring it to pass."[67] He will help us get our financial houses in order.

You have done much this semester. You have caught your vision and developed good goals and plans which will lead you to financial self-reliance. You have determined what will keep you from your vision and goals, and you will strive to overcome these things. Finally, you have developed accountability partners to help you in your quest. Decide now to keep these good habits for the rest of your life! Rex D. Pinegar said:

> You, our beloved young men and women, are in the most critical period of life. Youth is the time when habits are formed, when ideas are adopted. It is the time of decision. Decide today to heed these words of our prophet: "Decide to decide!"[68]

Chart 2. The Bottom of the Investment Hourglass



Following Christ is critical. He will make all the difference in your life. Remember He will give you success (Alma 26:27).

Pray, plan and work for your vision and goals. My father, who was 82 at the time, came and spoke to my class. He gave, what I consider, the best advice when he said: "The key to life is to live like our Savior and to obey the commandments of God. If you will do this, you will have the Spirit. And if you have the Spirit, you will be successful."[69]

Dallin H. Oaks counseled and said, "Some people live the gospel with "short, frenzied outbursts of emotion," followed by long periods of lapse or by performance that is intermittent or sputtering. What we need in living the gospel is "the tranquil and steady dedication of a lifetime."[70] He concluded:

> 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.[71]

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.

In summary, remember Nephi's counsel:

> And now, my sons [and all of us], remember, remember that it is upon the rock of our Redeemer, who is Christ, the Son of God, that ye must build your foundation; that when the devil shall send forth his mighty winds, yea, his shafts in the whirlwind, yea, when all his hail and his mighty storm shall beat upon you, it shall have no power over you to drag you down to the gulf of misery and endless wo, because of the rock upon which ye are built, which is a sure foundation, a foundation whereon if men build they cannot fall.[72]

Understand What Wise Financial Stewards Know

In the more than 19 years I have taught courses in personal finance, I have realized that certain principles are critical for developing good financial habits. Following are the 12 things I believe we should know about personal finance as we strive to follow Jesus Christ, become wiser financial stewards, to return with our families to His presence, and to accomplish our divine missions for which we were sent here to earth.

1. Wise Stewards Know Who they are and Why

They know they are a child of God and understand the doctrines that God wants them to:

- Spiritual: Bring them to Christ
- Temporal: Help them to become better stewards
- Family: Help them return with their families back to Heavenly Father's presence, and
- Individual: Help them to accomplish their divine missions, destiny and work.

They recognize that if they are living their lives and finances correctly, it will lead them to accomplish the above doctrines, and to help them become more like Jesus Christ.

2. Wise Stewards Recognize Their Stewardship

They understand 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 to us
- Accountability: they will be held accountable for all their choices, including their financial choices

They know that nothing they have is their own, it is all God's, and they listen to the Spirit and act accordingly.

3. Wise Stewards Create

They understand the creative process and know that creation is a spiritual gift. They have a vision of who they are, what they can accomplish, and what they should do (the spiritual creation).

They truly understand "they are children of God"[73] and "can do all things with His help." Then with that help, they create their vision, set appropriate goals, develop tactical plans, determine constraints, and then work with accountability partners to accomplish their vision.

They create themselves with confidence each new each day with their prayers, goals, budget and lives.

4. Wise Stewards Have Their Priorities in Order

They seek first the kingdom of God and His righteousness.[74] 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, things that the world seeks, but the gift of 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.[75]

5. Wise Stewards Plan Their Future Early and Live Their Plan

They follow Ezra Taft Benson's counsel when he said, "Plan your financial future early, then live your plan."[76] They prayerfully seek a vision for their lives, set their goals, plan their lives, 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 vision, goals, plans (budgets, debt reduction, savings, investing, giving, retirement planning, etc.), constraints and accountability.

6. Wise Stewards Know Money Cannot Buy Happiness

They know what money can do, which is to 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.

7. 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.

8. 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.

9. 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.[77]

Wise stewards choose to be responsible in all their choices.

10. Wise Stewards Remember the Four Critical "Ifs"

Wise stewards remember four critical "ifs." These are not just the things they must know, but things they must *do* if they are to return with their families back to Heavenly Father's presence.

> **1. The scriptures make us wise, IF we learn to read and ponder 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."[78]
>
> **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."[79]
>
> **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. Nephi counseled "Nevertheless, . . . thou knowest the greatness of God; and he shall consecrate thine afflictions for thy gain."[80]

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.[81]

The brother of Jared knew about storms. When he came to the ocean on his way to the promised land, he had three problems: air, light and navigation. The Lord helped the brother of Jared with each problems.

- The Lord instructed the brother of Jared to put holes in the top and in the bottom of the ships. We will instruct us in our lives as well.
- The Lord touched the stones, which gave light to the ships. The Lord will also touch our hearts and our lives, and give us light as well.
- The Lord sent the storms, to blow Jared and his family toward the promised land. Likewise the storms He sends today (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.

d. We can "be of good cheer" IF we will heed a living prophet's counsel

Thomas S. Monson said,

> I testify to you that our promised blessings are beyond measure. Though the storm clouds may gather, though the rains may pour down upon us, our knowledge of the gospel and our love of our Heavenly Father and of our Savior will comfort and sustain us and bring joy to our hearts as we walk uprightly and keep the commandments. There will be nothing in this world that can defeat us. My beloved brothers and sisters, fear not. Be of good cheer. The future is as bright as your faith.[82]

At the beginning of this course, I talked about how principles and 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."[83]

David A. Bednar said,

> President Packer did not teach that simply knowing true doctrine changes us. Rather, doctrine must be understood. The word understanding in the scriptures frequently is linked to and associated with the heart and refers to a revealed result or conclusion. Thus, true doctrine confirmed in the heart as true by the witness of the Holy Ghost changes attitudes and behavior. Knowing true doctrine is necessary but is not sufficient. Understanding true doctrine both in our minds and in our hearts is essential to a righteous attitude and actions.[84]

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."[85] If you do this, you WILL be successful and you will find happiness in this life and the life to come. Finally, remember Nephi's counsel:

> And now, my sons [and daughters], remember, remember that it is upon the rock of our Redeemer, who is Christ, the Son of God, that ye must build your foundation; that when the devil shall send forth his mighty winds, yea, his shafts in the whirlwind, yea, when all his hail and his mighty storm shall beat upon you, it shall have no power over you to drag you down to the gulf of misery and endless wo, because of the rock upon which ye are built, which is a sure foundation, a foundation whereon if men build they cannot fall.[86]

Learn about Resources for Additional Readings on the Subject of Personal Finance

Thank you for your diligence in completing this work. I know it has been challenging and tough. I hope you feel it has been worth it. 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

- George S. Clayson, *Richest Man in Babylon,* USA: Signet Press, 1955.
- Napoleon Hill, *Think and Grow Rich,* New York: Random House Publishing, 1960.
- Richard Paul Evans, *The Five Lessons a Millionaire Taught Me,* Salt Lake City: Arcadia Press, 2004.
- Thomas Stanley and William Danko, *The Millionaire Next Door,* New York: Pocket Books, 1996.
- David Bach, *The Automatic Millionaire: A Powerful One-Step Plan to Live and Finish Rich,* USA: Broadway Books, 2004.

Investing

- William Bernstein, *Four Principles of Investing: Lessons for Building a Winning Portfolio*, New York: McGraw-Hill, 2002.
- Tim Sanders, *Love Is a Killer App: How to Win Business and Influence Friends*, New York: Three Rivers Press, 2002.

General Budgeting

- James Christensen and Clint Combs, *Rich on Any Income: The Easy Budgeting System That Fits in Your Checkbook*, USA: Shadow Mountain, 1985.
- Steven B. Smith, *Money for Life: Budgeting Success and Financial Fitness in Just 12 Weeks*, USA: Dearborn, 2004.

Marriage and Money

- Jeffrey R. Hill and Bryan Sudweeks, "*Fundamentals of Family Finance: Living Joyfully Within Your Means*," BYU Publishing, 2016.
- Bernard E. Poduska, *Love and Money: How to Share the Same Checkbook and Still Love Each Other*, USA: Deseret Book Company, 1995.

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 was your vision for this class? 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 doctrines and principles, the "whys" and "whats" 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 it 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] M. Russell Ballard, "Keeping Life's Demands in Balance," Ensign, May 1987, 13.

[3] For a discussion of this topic, see Sudweeks and Hill, "Personal Finance is Part of the Gospel of Jesus Christ," unpublished manuscript, 2019.
[4] For a discussion of this topic, see Sudweeks and Hill, "Doctrines and Principles, Confirmed by the Spirit, Change Behavior," unpublished manuscript, 2019.
[5] For a discussion of this topic, see Sudweeks and Hill, "Application is an Invitation to Learn and Create," unpublished manuscript, 2019.
[6] For a discussion of this topic, see Sudweeks and Hill, "Conduct on our Journey is as Important as our Destination," unpublished manuscript, August 2019.
[7] Italics added, David A. Bednar, Increase in Learning, Deseret Book, 2011, p. 170.
[8] Boyd K. Packer, "Little Children," *Ensign*, Nov. 1986, 17.
[9] Bednar, p. 153.
[10] Gal. 3:26.
[11] Romans 8:17.
[12] Bruce R. McConkie, *The Promised Messiah: The First Coming of Christ* (Salt Lake City: Deseret Book, 1978), 133.
[13] Spencer W. Kimball, "The Family: A Proclamation to the World," 1995.
[14] Moses 1:39.
[15] Tad R. Callister, "Our Identity and Our Destiny," BYU Speeches, Aug. 14, 2012.
[16] Russell M. Nelson, "Identity, Priority, and Blessings," BYU Speeches, Devotional, Sep. 10, 2000.
[17] Joseph F. Smith, "Discourse," *Deseret News*, Nov. 12, 1873, 644.
[18] D&C 130: 20-21.
[19] Dale G. Renlund, "Choose Ye This Day," Ensign, November 2018.
[20] Spencer W. Kimball, in Brisbane Area Conference 1976, 19, as quoted in Dale G. Renlund, "Choose Ye This Day," Ensign, Nov. 2018.
[21] "Choose you this Day," Ensign, Nov. 2018.
[22] James E. Faust, "Obedience: The Path to Freedom," Ensign, May 1999.
[23] Robert D. Hales, "If Ye Love Me, Keep My Commandments," Ensign, May 2014.
[24] Quoted in Donald L. Staheli, "Obedience—Life's Great Challenge," Ensign, May 1998, 82.
[25] Alma 60:21.
[26] Psalms 24:1, see also Deuteronomy 10:14; Psalms 89:11, D&C 104:14-15; and numerous others.
[27] John 1:3.
[28] D&C 93:10.
[29] Moses 7:32.
[30] Mosiah 2:26.
[31] Mosiah 2:21.
[32] 1 Cor. 6:20.
[33] D&C 58:26
[34] Alma 60:21.
[35] 2 Nephi 9:51.
[36] D&C 51:19.
[37] D&C 78:22.
[38] Guide to the Scriptures, "Agency."
[39] D&C 29:35.
[40] Josh. 24:15.
[41] Moses 4:3.
[42] D&C 101:78.
[43] Moses 7:32.
[44] Italics added, D&C 43:34.
[45] A of F 1:2.
[46] Rev. 20:12.
[47] Alma 12:14.
[48] D&C 104:11-12.
[49] Ephesians 2:21.
[50] Bednar, "Exceeding Great and Precious Promises," *Ensign*, Nov. 2017.
[51] Dallin H. Oaks, "The Challenge to Become," Ensign, Nov. 2000.
[52] David A. Bednar, Increase in Learning, Deseret Book, 2011, p. 170.
[53] Chad M. Orton, Revelations in Context, "This Shall Be Our Covenant," Intellectual Reserve, USA, 2016.
[54] Ezra Taft Benson, "To the Elderly in the Church," *Ensign*, November 1989, p. 4.

[55] Jacob 2:18-19.
[56] Matt. 16:26.
[57] D&C 43:34.
[58] Sheri L. Dew, Go Forward with Faith: The Biography of Gordon B. Hinckley (1996), 76.
[59] Spencer W. Kimball, Ensign, May 1976, p. 46; italics added.
[60] D&C 43:9.
[61] Psalm 36:4.
[62] 1 Nephi 7:12
[63] William D. Oswald, "Obedience is the First Law of Heaven," Ensign, Jan 2008.
[64] "Decide to Decide," *Ensign*, Nov. 1980, 71.
[65] *Ensign*, May 1976, 46
[66] Marvin J. Ashton, One for the Money, 1992.
[67] Psalms 37:5.
[68] "Decide to Decide," *Ensign*, Nov. 1980, 71.
[69] Clinton W. Sudweeks, visit to my Finance 418 Personal Finance class, Fall 2012.
[70] "The Dedication of a Lifetime," CES Fireside, Oakland, California, May 1, 2005.
[71] Ibid.
[72] Helaman 5:12.
[73] Psalms 82:6.
[74] Matthew 6:33
[75] Jacob 2:18-19
[76] Ezra Taft Benson, "To the Elderly in the Church," *Ensign*, Nov 1989, 4.
77 Robert Kiyosaki and Sharon Lechter, Rich Dad Poor Dad, Time Warner Book Group, USA, 1998, p. 197.
[78] Alma 37:35.
[79] D&C 18:11-12.
[80] 2 Nephi 2:2.
[81] Ether 12:27
[82] Thomas S. Monson, "Be of Good Cheer," *Ensign*, May 2009, 92).

[84] Bednar, p. 153.

[86] Helaman 5:12.

Personal Finance Glossary

% Rank in Category. This is the number the fund ranks in its category or versus the benchmark. It is the top percentile, i.e., the lower the number the better.

12-b1 fees. These are fees paid by the shareholders to market the fund to other possible shareholders. These are just marketing fees. Avoid them.

401k Plans or Roth 401k Plans. These are defined contribution plans where employees contribute a percent of salary up to a specified amount. Employers may contribute a matching amount (free money) to encourage participation.

403b Plans or Roth 403(b) Plans (also called Tax Sheltered Annuities). These are defined contribution plans, and are the same as 401k but for non-profit tax-exempt companies and institutions (i.e., schools).

457 Plans. These are defined contribution plans, the same as 401k plans but for state and municipal workers and tax-exempt organizations.

529 Prepaid Tuition Plan. This is an education plan where you can prepay tuition for a child and you know tuition will be covered, regardless of raises in costs of tuition. May be useful if you think your children will not be eligible for financial aid.

529 Savings Plan. This is an education plan where you can put money aside after tax and it grows tax free if principle and earnings are used for qualified educational expenses. Control of the funds resides with the contributor, who chooses the assets within options provided.

60% Solution budgeting method. A process of budgeting where you determine your gross salary each month, take 60% of that amount and only spend that amount each month. Do not spend beyond that amount. This leaves 20% of your salary for long-term goals and 20% of your salary for taxes at year-end.

Account maintenance fees. These are fees for maintaining your account.

Account Transfer Fees. These are charges for moving assets either into our out of an existing account.

Account Transfer Fees. These are charges for moving assets either into our out of an account.

Accountability. This is a principle is that states we are accountable for every choice we make. We do not make choices with no consequences or accountable; rather, we will be held accountability for the decisions and choices we make.

Accumulation Stage (of retirement). This first stage of retirement begins when you first begin to work and is the time where you accumulate assets which you will later use for retirement needs.

Accumulation strategies. These are possible strategies to use while you are in the accumulation stage of retirement. They could include to save 20% of every dollar you earn after school, with 10% into the company 401k (or Roth 401k), 5% into the taxable account for retirement , and 5% into children's mission and education funds; save 20% of every dollar, with the priority of maxing out the Roth IRA for both yourself and your spouse, 3% into education IRAs for kids, etc.; or convert funds from traditional 401k and IRA accounts into Roth accounts with a minimum tax impact if financially viable.

Action Plan. This is your plan to accomplish our individual and family goals.

Active management. Active management is the process of trying to beat market returns by the active buying and selling of mutual funds and stocks.

Active portfolio management. It is the process of using publicly available data to actively manage a portfolio in an effort to beat the benchmark after all transactions costs, taxes, management, and other fees. However, to do this successfully you must do this consistently year-after-year, and not just from luck.

Actively managed funds. These are funds where the portfolio managers try to beat the performance of a benchmark through the active purchase and sell of securities in their asset class. Actively managed funds generally have higher management fees which must be overcome through higher returns

Adjustments. Adjustments are deductions from total

income allowed by the IRS to get your Adjusted Gross Income (AGI). These include (among others):qualified medical savings contributions (flexible spending accounts), contributions to individual retirement accounts (IRA), contributions to Health Savings Accounts (HSAs), student loan interest and tuition and fees deduction (IRS 970) (within limits), one-half self-employment tax, etc. Losses include net capital losses (up to $3,000), sole proprietorship losses, and active participation real estate losses

Advanced Health Care Directive. This document, also known as a living will or personal or advance directive, is a legal document where a person specifies what actions should be taken for their heath care if they are no longer able to make decisions for themselves due to illness or other reasons.

After-tax return. This is your return after you pay taxes. It is calculated as: after-tax return = before-tax * (1 – marginal tax rate) and your marginal rate includes both your federal, state and local (if any) taxes.

Agency bonds. Bonds issued by government agencies which were authorized by Congress including the Federal National Mortgage Association (FNMA), Federal Home Loan Banks (FHLB), and Government National Mortgage Association (GNMA).

Agency. This principle is that we have choice in our lives. We are agents of will, who can make choices consistent with our beliefs and values. Moreover, the gift of "choice" is man's most precious inheritance, and we should protect it carefully.

Annual Percentage Rate (APR). The APR is a rate that is generated from a precise calculation specified in Regulation Z. It only takes into account the fees going into the loan and does not take into account the time value of money.

Annuities. These are financial products developed and sold by insurance companies designed to accept and grow funds, and then, upon annuitization, pay out a stream of payments for a specified length of time. Annuities can be structured many different ways, such as payments for life for annuitant or spouse (i.e., for life of both), duration of payments (i.e., 20 years certain or life, whichever is longer), the type of payments (i.e., fixed or variable), etc. The different ways in which annuities can be structured (they are insurance products) provide the flexibility to construct an annuity contract to be meet your needs. However, it also increases expenses.

Annuitization. The process of determining what percent of retirement assets should be annuitized to ensure sufficient funds for the recipient's life.

Annuity types. These are the different types of annuities.

Application. Application is the "how' of how we do things. It is how we apply the doctrines and principles in our lives.

Appreciating assets. These are assets which may or which have historically appreciated in value.

Asset allocation funds. These are mutual funds which rotate asset classes among stocks, bonds, and cash for the best return. Asset allocation funds invest the fund's assets in the asset classes expected to perform the best over the coming period of time.

Asset allocation. This is the process of managing risk in your investment portfolio. Asset allocation is the process of allocating assets between various asset classes. It determines the risk of the portfolio and is the percentage allocated to each of the different asset classes.

Asset backed bonds. Bonds backed by specific holdings of the issuing company, such as equipment or real estate.

Asset classes. Asset classes are broad categories of investments with specific (and similar) risk and return characteristics. Asset classes 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.

Assets under management. This is another way an investment advisor is paid. It is calculated as a percentage of your assets under management, i.e., if you have $500,000 with an advisor and their fee is 1.0% per year, you will pay them $5,000 per year.

Assets. These are things that you own that have value.

Auto Loans. Auto loans are consumer loans that are secured with an automobile. Because they are secured, they have a lower interest rate than an unsecured loan or credit card. They normally have a maturity length of 2 to 6 years. The risk is that you

will often be left with a vehicle that is worth less than what you owe on it.

Automobiles and Other Vehicles. These are depreciating assets, such as cars, trucks, and RVs that normally must be inspected and licensed.

Average Amount Borrowed. This is the average amount borrowed over the life of the loan. In leasing, it is the (Net capitalized cost + residual)/2.

Average compensation. The average of the years of salary considered in making the defined benefit calculation.

Average Daily Balance (ADB): A common way of calculating interest to charge. Computed by adding each day's balance for a billing cycle and then dividing by the number of days in the cycle.

Average Indexed Monthly Earnings (AIME). The average lifetime earnings indexed for inflation is your top 35 highest earning years up to age 60. It entails adjusting each year's earnings total to reflect its value in the year in which eligibility is requested.

Average Monthly Interest Rates. This is the Annual Percentage Rate (APR) divided by 12.

Average tax rate. This is the average amount of every dollar you earned that was paid for federal income taxes. It is generally calculated at income taxes paid divided by AGI or Total income.

Baby bonds. A bond with a par value of less than $1,000.

Balance sheet (personal). This is a financial snapshot of your financial position on a given date.

Balanced funds. These are mutual funds which purchases both stocks and bonds generally in a specific percentage or relationship, i.e. 60% stocks and 40% bonds. Their benefit is that they perform the asset allocation, stock selection, and rebalancing decision for the investor.

Balloon loans. These are loans which payments including interest and principle are not sufficient to pay off the loan at the end of the loan period, but require a large "balloon" payment at some point in the future to fully pay off. This type of loan is not recommended.

Balloon Mortgages. These are mortgage loans whose interest and principal payment won't result in the loan being paid in full at the end of the term. The final payment, or balloon, can be significantly large. These loans are often used when the debtor expects to refinance the loan closer to maturity.

Bankruptcy Chapter 13. This process prepares a repayment plan in which the court binds both the debtor and the creditors to terms of repayment. The debtor retains property and makes regular payments to a trustee out of future income to pay creditors over the life of the bankruptcy plan.

Bankruptcy Chapter 7. This process liquidates assets and uses them to pay creditors according to precedence in the Bankruptcy Code. It is the quickest, simplest and the most frequently selected (75%) kind of bankruptcy filing. Certain debts cannot be waived by Chapter 7 bankruptcy such as child support, student loans, drunk driving fines, etc.

Basic Health Insurance. This is basic health coverage which covers hospital, surgical and physician expense insurance. It covers hospital insurance, which is hospitalization expenses including room, board, nursing, and drug fees; surgical insurance, which is the direct costs of surgery including the surgeon's and equipment fees; and physician expense insurance, which covers physicians' fees including office, lab, X-ray, and fees for other needed tests.

Bearer bonds. Bonds with coupons attach that pay interest only to the bearer upon surrender of the coupons.

Behavioral finance. Behavioral finance is an upcoming field of financial theory that attempts to further understand securities prices through understanding investor behavior. It came about because the assumptions which Finance makes, that people make rational decisions and people are unbiased about their predictions of the future are not always valid. Behavioral finance tries to incorporate "personal behavior" in an effort to extend finance beyond its narrow assumptions.

Benchmark. This is the relevant index for the specific category tracked by Morningstar or other fund monitoring company.

Bend Points. Calculating your PIA from AIME is divided into three calculations called "bend points" because the formula, when graphed, appears as a series of line segments joined at these amounts. These bend points change year to year.

Beneficiaries. The people who receive the property or assets.

Bidding and the Winner's Curse. Bidding may lead to a suboptimal result when you bid your fair value. Assuming everyone else has the correct value, if you won you overpaid.

Blend stocks. These are stock that are a part of both value and growth.

Bond interest and bond fund distributions. These are taxed at your Federal and state Marginal Tax Rate.

Bond mutual funds. Bond mutual funds are funds which invest a majority of their assets in bonds of specific types of companies or institutions. These funds generally have a specific objective, i.e. "corporate," "government", "municipals," "growth," etc. which relates to the types of bonds the mutual fund invests in. In addition, most have a specific maturity objective as well, which relates to the average maturity of the bonds in the mutual fund's portfolio.

Bond rating companies. A private sector company that evaluates the financial condition of the bond issuing company, its revenues, profits, debt, and other critical areas, and gives the company a rating which indicates the relative safety of the bond. They only rate corporate and municipal bonds. They include: Standard & Poor's, Moody's, and Fitch's.

Bond ratings. Bond ratings are measures of the riskiness of a company. Ratings run from "AAA" (Standard & Poor's) or "aaa" (Moody's) for the safest to "D" for the extremely risky. Ratings categorize bonds by default risk, the risk of the company being unable to repay the bond

Book-entry bonds. Bonds which are registered and stored electronically, similar to stock purchases.

Breakeven Analysis. This is a form of loan analysis that does not take into account the time value of money, but is simple to calculate. You calculate all new costs and fees for the new loan, and savings in principle and interest over the old loan. You then divide all new costs by monthly savings which will give you your breakeven point in months. If your breakeven point is less than 4 years, it may be a good idea, 5-7 years, it might be considered, or greater than 7 years, be careful. You may likely move before 7 years.

Budgeting Process. These are the steps you take to create your budget. It includes: 1. Know what you want to accomplish, 2. Track your spending (your expenses), 3. Develop your cash budget, 4. Implement your budget, 5. Compare it to actual expenses, then make changes where necessary to achieve your goals.

Budgeting the Better Way. This is a budgeting process where you pay the Lord first, and yourself second, then pay your bills. This makes paying yourself a higher priority.

Budgeting the Old Way. This is a budgeting process where whatever was left at the end of the month went into savings. The challenge is that there is never anything left at the end of the month.

Business risk. Risk that the bond's value will decline due to problems with the company's business.

Buyer's broker. This is a realtor that works specifically for the buyer and is paid by the buyer. The have a fiduciary responsibility to the buyer and not the seller which is different from the traditional buyer seller broker relationship.

Buying on margin. Buying on margin is borrowing money to invest. You borrow money from your broker and use it to purchase financial assets. If the stock goes up and you sell the stock, you make a profit due to leverage. Be careful as you can lose much more than your original investment.

Calendar Effects. The impact of tax and reporting is not consistent with theory. Behaviorists point out that returns are a function of cash flows, which tend to be concentrated around calendar turns. Institutions tend to "window dress," i.e., sell unwanted and buy desired stocks for period-end reports.

Call provision. A provision that allows the issuer to repurchase the bonds before the maturity date. Deferred calls provide more protection.

Callable bonds. Bonds which can be called, i.e. redeemed, before maturity at the option of the issuer.

Capital gains taxes. Capital gains are realized earnings from selling a financial asset at a profit. It is the sale price less the purchase price, and are divided into short-term and long-term. Short-term capital gains are gains from the sale of an asset where the asset was held for less than 366 days and is taxed at your marginal tax rate. Long-term capital gains are gains on the sale of an asset where the asset was held for more than 366 days and is taxed at a preferential federal rate. These are taxes you pay on assets held a specific period of time.

Capital gains. Capital gains are the best type of earnings as capital gains at the share level are not taxed until you sell your mutual fund shares. You decide when to be taxed. This is the difference between what you paid for the bond and what you sold it for, or the par value if you held the bond to maturity.

Capitalized cost reduction: Any reductions in capitalized cost, such as rebates, down payment, dealer incentives, trade-in, etc.

Capitalized cost: The cost to which you agree or negotiate when purchasing a vehicle.

Captive brokers. These are brokers whose company is part of a group which owns a mutual fund company. These brokers may be encouraged to sell company mutual funds which may not be the best fit for the investor but are in the interest of the company.

Carelessness. A reason for debt. We understand its costs, but we become lazy.

Cash accounts. This is money with the broker which you use to pay for purchases or receive any cash. There is a specific time between notification of purchases and when the purchases must be paid.

Cash Advance: Using a credit card to obtain cash, such as through an ATM or over the counter at a bank. This is an extremely expensive way to borrow, and carries several pricy fees.

Cash and Cash Equivalents. Cash and cash equivalents is an asset class whose major goal is liquidity and to preserve capital. Cash includes CDs, money market funds, T-bills, and commercial paper, etc. It also includes short-term interest-bearing investments such as treasury bills and savings bonds, loans to the U.S. government, commercial paper, and loans to corporations. It is a good investment asset class for money you plan to use in less than 3-5 years and don't want to take risks. It is less attractive as medium-to-long-term investments (> 5 years) as returns on cash and cash equivalents are unlikely to keep up with inflation.

Cash Dividends. Theory has shown that dividends are irrelevant in the absence of taxes and transactions costs. Behaviorists suppose that dividends can be justified by "mental accounts" which increase current income at the expense of "higher self-control" equity accounts. Older high-net worth investors value dividends more highly and concentrate in high income securities (preferred habitat) theory.

Cash-Balance Plans. A type of DBP in which provides specific annual employer contribution (generally 4-7%) each year, plus a low but guaranteed rate of investment earnings. Accounts grow at a predetermined rate, regardless of how much is in the account. Employees do not make any investment decisions.

Category. These are all funds in the same category as established by Morningstar.

CD Laddering: the process of getting a higher interest rate by buying longer term CDs and purchasing them more often. For example, 1 month CD rates are too low, but you like 6 month rates. Take the amount of money you want to invest, divide it by 6 (or any number), then invest 1/6 of your money every month in a 6 month rate. You are creating a ladder of CDs, and every month you have money coming in. You would then reinvest that in another 6 month CD.

Child's Benefit. Any child who is under 18 (19 if still in high school), is eligible for a benefit of 50% of the retired workers PIA, subject to a family maximum. Child's benefits terminate at age 18, marriage, or death. The dependent child of a fully or currently insured worker will receive a benefit of 75% of the worker's PIA (subject to family maximum) if the child is under age 18 (or age 19 is a full-time high school student), or is over age 18 and has been disabled since before age 22, and is not married.

Children's Trustee. The person who manages the assets for the children.

Children's Trusts. Trusts specifically for underage children.

Class A Shares: These shares commonly have a front-end or back-end load to compensate for the sales person's commissions. Because of the front-end loads, they usually have lower management fees.

Class B Shares: These shares commonly only have a back-end load that is paid only when the shares are sold. This load traditionally declines over time. Class B shares generally have higher expense ratios when compared to Class A shares.

Class C Shares: These shares generally have a lower front- and back-end load fees, but higher management fees.

Class R Shares: These shares are generally for

retirement purposes. Check the loads and management fees which may be substantial.

Class Y Shares: These are shares with very high minimum investments, i.e., $500,000, but which have lower management fees and waived or limited load charges. These are generally for institutional investors.

Class Z Shares: These are shares only available for employees of the fund management company.

Closed-end mutual funds. These are mutual funds with a specific number of shares outstanding. Individuals must purchase shares from existing shareholders, and shares may trade at a premium to (more than) or discount (less than) the underlying Net Asset Value (NAV). These premiums or discounts may be based more on investor demand than the underlying share value.

CLUE Report. A report, prepared by insurance companies that keep a record of all payments by insurance companies to individuals and institutions. Under the FACT Act (Fair and Accurate Credit Transactions Act of 2003) you can obtain the following Comprehensive Liability Underwriting Exchange (CLUE) reports each year: CLUE Auto: A 5-year loss history report of your automobile claims (if a loss was filed against your automobile insurance policy and if the insurance company reported the information to CLUE); and CLUE Personal Property: A 5-year loss history report of your homeowners claims.

Codicil. A document which institutes minor changes in the original will. Must be signed, witnessed, and attached to the original will.

Collateralized mortgage obligations (CMOS). More complex and specialized versions of mortgage backed bonds.

Commission costs. These are the cost associated with trading of bonds. While all bond trades incur commission costs, some newly issued bonds are sold without commission cost as the issuer absorbs the costs. Most trades however, incur commission costs, which are paid to the broker who arranged the trade.

Commissions. Commissions are the way a broker or investment advisor is paid. It is either a percentage of every buy or sell order (e.g., 20 bps per trade), or a specific charge for a trade (e.g., $9.99).

Community Property. A form of ownership is equal and only between partners. Lifetime control is shared by both spouses, consent from both is required to sell, income is shared between owners, and testamentary control in the one-half interest is unlimited unless property has right of survivorship feature (applicable in some states).

Compulsiveness. A reason for going into debt. We lack the self-control to discipline our purchases.

Computer Software budgeting method. This process uses commercially available budgeting software such as such as Mint.com (free), Quicken, Mvelopes, or others. Determine your gross salary and take home each month after taxes and other deductions, determine spending by category, and budget each category. Work to within your budget for each spending category. You will obtain receipts and credit card information directly via internet from financial institutions.

Conventional loans. These are loans that are neither insured nor guaranteed. They are below the maximum amount set by Fannie Mae and Freddy Mac of $424,000 in 2018 (single family). They require Private Mortgage Insurance (PMI) if the down payment is less than 20%.

Convertible bond. Bond which gives the holder the right to convert the bond to company stock instead of getting the cash repayment.

Convertible loans. These loans begin as a variable-rate loan and can be locked into a fixed-rate loan at the then current interest rate at some predetermined time in the future (for a specific cost).

Cooperation and Altruism. The process where we work with others and are concerned about them, not just ourselves and what we want. Cooperation may be a viable investment strategy. People's motives may lead to actions different than conventional rationality, i.e. individual selfishness, would suggest.

Corporate Bonds. (1)Bonds secured corporate debts by collateral or real property liens. (2) Debt instruments issued by corporations to fund the requirements of the companies.

Cost. These are the fees and expenses you pay to own a mutual fund or asset. Invest low cost. In a world where investment returns are limited, investment costs of any kind reduce your returns. We recommend you invest in no-load mutual funds to reduce costs.

Counseling: non-profit credit counseling agencies. These are agencies set up specifically to help people reduce the credit-card debt load in their lives. The non-profit companies have arrangements with many of the credit companies. Working with them, they can reduce or even eliminate your interest payments with specific creditors.

Counseling: For-profit credit counseling agencies. These are companies whose goal is to make money through helping people get out of debt. They often consolidate debt into a single loan with a lower rate, or get homeowners into an interest-only home loan and use the excess cash to pay down debt.

Coupon interest rate (or interest rate). The percentage of the par or face value that will be paid annually to the holder in the form of interest.

Covenants, Conditions and Restrictions (CCRs). These are legal documents that can affect what you can do with any potential homes. These can be quite restrictive as to what you can and cannot do with your home including exterior, landscaping, and other requirements. If you cannot live with the CCRs, don't buy there.

Credit Bureau: Private organizations which maintain credit information on individuals, which it allows subscribers to access for a fee. The three major credit bureaus to know are: Equifax, Experian, and Trans Union.

Credit Card: A financial instrument that allows the holder to make purchases through an open line of credit.

Credit Counseling Agencies (CCAs). These may be either non-profit or for-profit agencies to help you get out of debt. You should use these with caution.

Credit Limit: The maximum amount that one can borrow on a single credit card. This amount is often influenced by one's credit score.

Credit Report: Information collected by credit bureaus from subscribers, creditors, public court records, and the consumer.

Credit Score: A numerical evaluation of your credit based on specific criteria determined by the credit scoring company.

Credits. Credits are dollar for dollar reductions in your taxable liability. Credits are worth significantly more than deductions.

Current ratio. This is your monetary assets divided by your current liabilities. This ratio tells you how many times you could pay off your current liabilities with your liquid cash on hand.

Current Yield. It is the ratio of annual interest payments to the bond's market price.

Currently Insured Status. To be "currently insured", you must have at least 6 quarters of coverage in the previous 13 quarter period. Currently insured is adequate for eligibility for survivor benefits paid to children and for a surviving spouse caring for a qualifying child. Eligibility for other benefits generally requires fully insured status or 40 quarters of coverage

Custodial Accounts (UGMA/UTMA). These are investment vehicles that are managed for the child until the child turns a certain age. They can be invested in all types of financial assets, stocks, bonds, mutual funds, etc. UTMA (Uniform Gift to Minors Account) has fewer restrictions and may include real estate. These can be used for any educational or other expenses, including missions. The risks are there are no tax advantages and it is considered the child's money as soon as the child is of age—it cannot be taken back by the issuer. I prefer a tax-efficiently invested account.

Custody (or annual) fees. These are fees the brokerage house charges to hold the mutual funds or ETFs in your account. May be a minimum amount for small accounts ($15 per year), a specific charge per holding (8 basis points per security), or a percentage of assets for large accounts (25 basis points on assets under management).

DALBAR. DALBAR is a private company that does research on investor returns. It puts out an annual survey in a book titles "Quantitative Analysis of Investor Behavior." It discusses how average equity fund investors have done versus benchmarks over the past 20 years in the equity, fixed income, and balanced categories.

Day orders. These are orders to buy and sell securities which are good only until the end of the trading day.

Day trading. It is the process of an individual giving up all his spare time in an area in which he has little or limited competence, in an attempt to consistently beat the market and other professionals after taxes, costs and fees.

Debenture. A long-term unsecured bond. It can have a hierarchy of payment, with unsubordinated and subordinated debentures. These are bonds backed by the credit of the issuing company.

Debit Card: Unlike credit cards, debit cards act like a personal check. When used, money is taken straight from the connected account to pay for the purchased item.

Debt Cycle. It is the process of why and how we go into debt.

Debt Elimination: Expensive Debt First. This is one of the personal strategies. The logic is to pay off your most expensive debts first.

Debt Elimination: Smallest Debt First. This is one of the personal strategies. The logic is to pay of the smallest debts first. Then take the money saved to pay off all your other debts. You have success early on as you pay off the smallest debts first.

Debt Obligations or Back-end Ratio. This housing affordability ratio calculates what percent of your income is used for housing expenses plus debt obligations. It should not exceed 36% of your monthly gross income. The formula is: Monthly PITI and other debt obligations/ monthly gross income < 36%. Debt obligations include mortgage payments, credit card, student loan, car, and other loan payments. PITI = Principal, interest, property taxes, and property insurance

Debt ratio. This is your total liabilities divided by your total assets. This ratio tells you whether you could pay off all your liabilities if you liquidated all your assets. This represents the percentage of your assets financed with borrowing.

Debt Reduction Strategies. These are strategies for reducing debt. It is a six-step process: 1. Remember perspective, the "why's" and "what's." Accept that you have a debt problem; 2. Write down your goals so you know where you want to be. Stop incurring new debt; 3. See where you are by making a list of all your bills and debts. Admit the need to change your habits and lifestyle if being debt free is important; 4. Look for one-shot ways of reducing debt; 5. Organize a debt repayment Plan; and 6. Follow through on the Plan until total debt elimination.

Debt. It is the process of borrowing something with the expectation to pay it back in the future with interest.

Deductions. Deductions are IRS allowed reduction amounts (standard deduction) or taxpayer determined amounts (itemized deductions) to get taxable income from your Adjusted Gross Income.

Deep-discount and on-line brokers. These are brokers who are even cheaper than discount brokers. They do only trading, but at a 90% discount to full-service brokers. On-line can even be cheaper with other services.

Deferred. Payments are deferred until the specified time the investor elects to begin receiving the payments.

Defined Benefit Pension Plans. A Defined Benefit Pension Plan is a DBP where payments are based on a benefit payout formula. The formula is based on your salary, years worked and a company determined factor to calculate how much you will get each year. Employees do not contribute and bear no risk.

Defined Contribution Plan (DCP). A retirement plan where the employer contributes a specific amount to the employee's retirement funds while the employee is working and then has no responsibilities once the employee retires. Employer contributes to a fund, and then has no additional obligation when the employee retires. Employee may also contribute to the fund. Pension is determined by how much is invested by both the employer and employee, and how fast it grows.

Delayed Retirement Credit. Delaying payment beyond full retirement age results in a benefit increase for each year of delay. With a delay the worker's PIA is not increased and the benefits to family members is not increased.

Dental and Eye Insurance. This is insurance which covers only dental work and expenses relating to the eyes and teeth. Generally, it is only partial costs of eye exams, glasses, contact lenses, dental work, and dentures. Know your coverage, as the amount covered varies by plan provider. These plans are generally expensive, unless they are provided as part of an employer plan.

Depreciating assets. These are assets which depreciate. Often, the minute you take ownership of these assets, i.e. drive these assets off the car lot, they drop in value.

Direct PLUS Loan. These are loans available for parents of undergraduate, dependent students to help with school-related expenses, and the parent is

responsible for interest during school. Repayment begins six months after student graduates, discontinues, or drops below half time, and the parent is the borrower.

Direct Subsidized Loans. These are loans direct from the Federal government. The government pays interest while student is enrolled in school at least half-time, and repayment begins 6 months after student graduates or drops below half-time enrollment.

Disability Benefits. Workers who qualify for disability benefits are entitled to 100% of PIA until the earliest of the following: disability ends: benefits are terminated in the second month after the end of disability, or the workers dies: benefits are terminated in the month prior to the month the worker dies. If the worker attains full retirement age: disability benefits convert to retirement benefits.

Disabled Child. The disable child of a retired or disable worked is entitled to benefits past age 22 if the disability began before age 22.

Discount bonds. A bond that is sold at a discount to its par value. Generally, upon maturity the accrued interest and original investment add to the bond's par value.

Discount Points: These are payments made by the lender to reduce the interest rate on the loan. They are somewhat similar to prepaid interest. You pay more upfront in points but you will pay less on interest costs in the future. Your challenge is to minimize your overall interest costs, i.e., your effective interest rate.

Discount-service brokers. These are brokers who only perform trading, but usually at a 50% to 70% discount to full-service costs.

Discretionary accounts. These are accounts where you authorize a broker or investment advisor to make trades for you and your account. Exercise caution with this as the broker can buy and sell securities at will and you are responsible for all taxes and commission costs.

Discretionary contribution plans. Retirement plans where contributions are at the employer's discretion. These include profit sharing plans, stock bonus or ESOP plans, and money purchase plans.

Distribution Options. This is the decision as to how a distribution or payout is to be received. Make sure you understand the tax consequences of any payout or distribution option chosen.

Distribution/disposition/decumulation Stage (of retirement). This stage begins after you have retired. This is your plan as to how best take distributions from your remaining retirement and taxable accounts to minimize taxes and maximize the availability of your assets.

Distribution/disposition/decumulation strategies. These strategies help you set up a framework where you will not outlive your assets. Recommendations include taking out maximum distribution of 3.6% of total assets each year; only taking out maximum earnings from investments of previous year; or during your later years which income is less, i.e., during missions, transfer money from your tax-deferred to tax-eliminated accounts.

Distribution/Payout Options. These are options as to how you will take the benefits over your retirement.

Distributions. These are distributions of interest, capital gains, and dividends by a mutual or index fund while you own the underlying shares. Even though you have not sold the shares, you are responsible to pay taxes on this distributions because the mutual fund is a pass-through vehicle and the taxes on these distributions are paid at the shareholder level.

Diversification. Diversification is the process of allocating your assets so they are not concentrated in a single asset class. It is "not putting all your eggs in one basket". Having a diversified portfolio in many different asset classes is your key defense against risk

DNAH-ial Budgeting Method. This is a method many people use. It stands for DNAH ial - Do nothing and hope. It is not recommended.

Doctrines. Doctrines are the reasons behind why we do things. They answer the "why" questions of our lives, which are generally the most difficult questions to answer.

Down payment. This is the amount that you pay on the house to reduce the cost of the loan. Generally, lenders like a significant down payment as that indicates that the borrower is not likely to walk away from the loan. Different loans require different down payment amounts, i.e Conventional loans – 20 % recommended (but you can get in with 5%), FHA loans – 3.5%, and VA loans – 0% down payment

required.

Downgrade. A situation where a bond rating company reduces the bond rating of a bond generally due to a deterioration in the company's financial condition.

Dread Disease and Accident Insurance. This is a special insurance to cover a specific type of disease or accident. Generally it provides only for 'specific' illnesses or accidents on the "covered" list, and it provides a set maximum dollar amount of reimbursement. This insurance is generally expensive, unless included in your company's total health plan. Generally, concentrate on making your health coverage as comprehensive as possible.

Durable power of attorney. This provides for someone to act on your behalf in the event you should become mentally or physically incapacitated. This document is separate from the will and goes into effect before death. This document should be very specific as to which legal powers it transfers.

Earnings multiple approach. This is one approach for determining the amount of life insurance required. The goal is earnings replacement. The earnings multiple approach seeks to replace the annual salary stream of a bread winner for X years, normally 10 – 15 times gross salary.

Education investment vehicles. These are investment vehicles with the purpose to help you save for your children's education, i.e., Education IRA, 529 plans.

Education IRA. An Education IRA, also called a Coverdell ESA, is an investment vehicle for planning for the future cost of a child's education. The plan allows after-tax contributions each year for each child until age 18. Contributions and their subsequent earnings are tax-free when withdrawn to pay for qualified secondary and post-secondary education expenses.

Education Savings Account (Coverdell or Education IRA). The investment vehicle is similar to a Roth IRA where you invest in this account with after tax dollars, and if you use the proceeds for qualified educational expenses, distributions are tax-free. You choose your investments and the proceeds can be used for eligible elementary, secondary and post-secondary education expenses.

EE Bonds: US government savings bonds where the interest rate is set every 6 months and tied to current market interest rates.

Effective Interest Rate. This is the precise interest rate you are paying, after all costs and fees (regardless whether they are paid in the loan or out of the loan). The goal of a good loan is to have the lowest effective interest rate, which takes into account the time value of money.

Effective marginal tax rate. This is the average amount of every dollar you earned that paid for all local, state, and federal income taxes.

Emerging Market stocks and emerging market mutual funds. These are stocks or mutual funds of companies that trade in the countries not considered develop by the IMF. These are often smaller companies in smaller markets. 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.

Employee Contribution (or Salary Reduction Plans). These are defined contribution plans where employees contribute before tax dollars reducing their taxable income and earnings accumulate tax deferred. The major plans are Roth or Traditional 401k and 403b plans and 457 plans. Employees direct the funds into different financial asset options provided by the company including mutual funds, index funds, fixed income, equities, money market funds, and GICs (guaranteed investment contracts). Companies have their list of approved investment assets. Employees choose where to invest their assets subject to the company list, and employees are not allowed to invest outside of approved investment assets.

Employer Qualified Retirement Plans. These are retirement plans, established by a company, that have specific tax and other benefits to both the company and the employee. Benefits include competition, tax shelters, personal retirement for the owners, and personal retirement for the employees. They can be either defined benefit or defined contribution plans.

Employment. This is working during college to help offset the cost of educational expenses.

Endowment Effect. Sometimes we perceive that an asset's value increases by virtue of our ownership. Once you own something, its value hasn't increased or changed.

Envelope budgeting method. A process of budgeting where you prepare divide spending each month into categories, create envelopes for each category of spending, and once a bill comes, take the money from the corresponding envelope and pay the bill.

Equities (or Stocks). Equities are an asset class that provides growth and earns returns in excess of inflation. Over longer periods of time, the stock market historically has been the only major asset class to consistently outpace inflation. Equity ownership is ownership in a businesses' earnings and assets. Equity asset classes are delineated by market capitalization (which is shares outstanding multiplied by the stock's current market price), type of company (growth versus value), and geographic area. The benchmarks for equity asset classes can be generally defined as capitalization: Large, mid, and small; type: Growth, blend, and value; or geographic area: US, international, global and emerging markets. Equities have offered the highest return of the major asset classes historically and have been a good investment for long-term investing—they have consistently beat inflation over the long-term. However, they offer less stability of principal than other asset classes, and subject to short-term price fluctuations (so very risky for short-term investments).

Equivalent Taxable Yield: This is the yield you would need to earn on a fully taxable security to give the same after-tax return that you receive on a tax advantaged security, i.e., a security that has specific tax advantages (i.e., tax free for Federal or State or both).

Estate planning. The process of anticipating and arranging for the disposal of your resources to accomplish your personal and family goals after you pass away.

Estate Taxes. These are taxes, paid to the government, due on passing of an individual. Estate taxes are equal to the gift-adjusted taxable estate multiplied by the appropriate tax rate. To determine the net tax owed, calculate the total tax owed and subtract the unified gift and estate tax credit.

Estate transfer. This is the process that property interests are legally transferred from one to another, either during the person's lifetime or at death

Euro Bonds. Bonds issued by U.S. companies and sold outside of the U.S. in U.S. dollars.

Exchange rate risk. Risk that changes in exchange rates will impact profitability for firms working internationally.

Exchange traded funds (ETFs). These are portfolios of stocks similar to mutual funds which trade on organized exchanges. ETF's trade like stocks, are purchased with all the transaction/custody costs, are priced throughout the day (rather than at day's end like mutual funds), and can be sold short and purchased on margin. ETFs can be either in a unit investment trust (UIT) format or an open-end mutual fund structure. The UIT structure does not allow for reinvestment of dividends.

Excise "sin taxes" and state sales taxes. These are taxes imposed when goods are purchased.

Exclusion Amount. This is the amount of estate value that is excluded from the estate tax.

Exclusive Provider Organization (EPO). These are similar to an HMO, but operates through an insurance company. It is funded through an insurance company, with health care provided by contracted providers. Only care received from contracted providers is covered (unless in an emergency situation).

Executor or personal representative. This is the person who is responsible for carrying out the provisions of the will.

Exemptions. An exemption is an amount of money set by the government that you can deduct for each qualifying person in your household.

Expenses. This is where your money goes. There are two types of expenses: fixed expenses, which are expenses you don't directly control; and variable expenses, which are expenses you can control.

Family Giving Plan. A family plan which states how the family will give, to whom it will give to, as well was what the family will or will not do or give to.

Family Money. This refers to the use of personal savings and help from parents or other family.

Fee for-service (or traditional indemnity plans). These are health care plans where the doctor bills the patient directly, and the patient is reimbursed, to a specific percentage, by the insurance company. They provide the greatest flexibility for choosing doctors and hospitals, they define the percent of each claim the policy will cover, and they define the amount the insured must pay before a claim is eligible for reimbursement. Generally these plans are more

expensive and require more paperwork.

FHA Loans. These are Federal Housing Administration (FHA) Insured Loans. The FHA does not originate any loans, but insures the loans issued by others based on income and other qualifications. There is lower PMI insurance, but it is required for the entire life of the loan (1.5% of the loan). While the required down payment is very low, the maximum amount that can be borrowed is also low.

FICO Score: This is the most commonly used credit score. It ranges from 300 to 850.

Fill or kill orders. These are orders which must be either filled or canceled immediately. Most often these are market orders.

Financial assets/instruments. These are different types of securities that are sold in financial markets.

Financial Goals. Financial goals are personal goals with a cost attached.

Financial markets. Markets in which financial securities or assets are bought and sold.

Financial Planning. This is the process of helping yourself and others to use their resources more wisely to achieve their personal and family goals. It should help determine where you are, where you want to be, and how you will get there.

Financial Ratios. These are ratios that can help you to analyze your spending.

Financial risk. How the firm raises money could affect the financial performance of the firm and the value of the bonds.

Fixed contribution plans. These are defined contribution plans where contributions are fixed by the employer. Examples are thrift and savings plans and target benefit plans.

Fixed Income. Fixed income is an asset class that attempts to provide income and to earn returns in excess of inflation. There are two different types of fixed income assets: Taxable bonds. 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. Fixed income includes short-term bonds/bond funds, intermediate-term bonds/bond funds, and long-term bonds/junk bonds/bond funds issued by governments or corporations. Fixed income offers greater returns than cash, but with greater risk. It offers good diversification tool when holding a long-term stock portfolio, as bonds move differently than stocks. However, returns have been historically lower than stocks, they are very susceptible to interest rate and other risks, and 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.

Fixed rate mortgages (FRMs). These are mortgage loans with a fixed rate of interest for the life of the loan. These are the least risky from the borrower's point of view, as the lender assumes the major interest rate risk above the loan rate. These are the most-recommended option for new home buyers.

Fixed. Payments are a fixed amount, and are made to the investor until the end of the contract, usually till the investor dies.

Fixed-rate loans. Have the same interest rate for the duration of the loan. Normally have a higher initial interest rate as the lender could lose money if overall interest rates increase. The lender assumes the interest rate risk, so they generally add an interest premium to a variable rate loan

Floating rate bond. Bond whose interest payments fluctuate according to a specific benchmark interest rate.

Free Application for Federal Student Aid (FAFSA). This is the application form for obtaining government student aid.

Free money. This is money that is made available by a company, generally on a matching basis, to encourage greater participation in company sponsored retirement plans, i.e., 401k, Roth 403b, Keogh, etc. It is also money made available through education tax benefits, i.e. 529 plan contributions deductible from state taxes.

Free Money. This is money you do not physically work for and is not paid back. It includes scholarships and grants.

Full Retirement Age (FRA). This is the age at which a retiree will receive 100% of their entitled benefits. Receiving benefits prior to FRA will result in a reduction in benefits. Receiving benefits after FRA will result in an increase of benefits.

Full-service brokers. These are brokers who will give you all the tools, research and other advice to help you trade and invest.

Fun. Sometimes we trade for fun and entertainment instead of financial performance. This is OK, but make sure your fun money is no more than 5% of the value of your portfolio—that way you don't lose too much.

General Obligation bonds. Bonds backed by the taxing power of the issuer.

Generation-Skipping Tax. This is a tax on revenue lost when wealth is not transferred to the next generation, but to a succeeding generation. It is a flat tax, in addition to the regular estate tax, imposed on any wealth or property transfers to a person two or more generations younger than the donor.

Gift and estate taxes. These are taxes imposed when assets are transferred from one owner to another.

Gift Tax Exclusions. A gift tax must be paid on all transfers to others (other than a spouse) that are in excess of the maximums specified. The maximum specified is your exclusion.

Gift-Adjusted Taxable Estate. This is equal to your taxable estate plus any taxable lifetime gifts, which is the cumulative total of all gifts over the annual limit.

Giving Plan. A plan on your thoughts on your personal and family giving. It discusses how you will handle both your institutional (through Church and other institutional contributions) and personal (personal and family contributions and service) giving.

Global stocks and global stock mutual funds. These are stocks or mutual funds of companies that contain a mixture of U.S. and foreign or international holdings. 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.

Goals. These are things we would like to accomplish. They are often divided by time, i.e., short-term, in the next 12 months; medium-term, from 2-10 years; and long-term, beyond 10 years. They may also be divided by type, i.e., identity, integrity, and temporal goals. They will take effort and resources, but are things that are important to us and are what we want to accomplish.

Good Faith Estimates (GFE). This is an estimate from each lender (not just a Summary) of the likely costs you will likely pay as you complete the loan process. I recommend you get GFEs from each potential lender and compare them.

Government-Sponsored Health Care Plans. Government-sponsored health care plans are insurance plans which are sponsored either by the state or the federal government. These plans fall under three headings: Workers' Compensation, Medicare, and Medicaid.

Grace Period: The amount of time given by a credit card company to pay a due balance before interest starts to accrue. Normally 20 to 25 days, excluding cash advances. It does not apply if the card already carries a balance.

Grad PLUS Loan. These are loans available for graduate students to help with school-related expenses. The student is responsible for interest during school, repayment begins six months after student graduates, discontinues or drops below half time, and the graduate student is the borrower.

Grants. Money given to individuals for education on the general basis of need.

Gross Estate. This is the value of all your assets, including life insurance, pensions, investments, and any real or personal property.

Gross Income. Gross income for tax purposes is all income, unless specifically excluded or deferred.

Gross Savings Ratio. This is your income for savings divided by your gross income. This ratio tells you what proportion of your total income is being saved.

Growth stocks. These are fast-track companies whose earnings are expected to grow very rapidly. Frequently these are companies developing new technologies or new ways of doing things.

Guardian. The person who cares for minor children and manages their property.

Health Care Coverage. Health Care Coverage is divided into four areas: basic health insurance, major medical expense insurance, dental and eye insurance, and dread disease and accident insurance.

Health Care Providers. These are the major providers of health care. They fall into three types: Private health care plans, which are either fee-for-

service (or traditional indemnity plans) or managed health care (HMO, PPO); Non-group (individual) health care plans, or Government-sponsored health care plans.

Health care proxy. A health care proxy designates someone to make health care decisions should you be unable to do so for yourself.

Health Maintenance Organizations (HMOs). HMOs are prepaid insurance plans which entitle members to the services of specific doctors, hospitals and clinics. They are the most popular form of managed health care, due to their costs, which are roughly 60% of fee-for-service plans. They provide a system of doctors and hospitals for a flat fee, and emphasize preventive medicine and efficiency, and subscribers pay a relatively small co-pay for services rendered. They provide little choice of doctors and hospitals. As such, service may be less than at other facilities and referrals sometimes difficult to get.

Hedge funds. Hedge funds are less-regulated mutual funds which take much more risk than normal with the expectation of much higher returns. Generally they can take both long positions (where they buy assets) and short positions (where they short-sell assets, i.e., borrow assets and sell them). They hope to later buy back the assets at a lower price before they must return them to the borrower.

Holographic Will. A will and testament that is entirely handwritten and signed by the testator. Traditional wills require signatures of witnesses as well as the testator's signature and intent. Holographic wills are treated equally with witnessed will and need only to meet minimal requirements in order to be probated

Home Equity Lines of Credit (HELOC). Home equity lines of credit are basically second mortgages which 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. Interest rates are variable and are generally interest only in the first few years. They have lower rates of interest than other consumer loans.

Home Equity Loans. This is a personal debt strategy. You take out a home equity loan, which is a loan against the equity in your home (the difference between what the home is worth and how much you owe on it) to pay off your debts. Home equity loans are basically second mortgages which use the equity in your home to secure your loan. Normally can borrow up to 80% of your equity in your home.

Home Inspection. This is a service, usually paid for by the buyer, to alert them to potential problems with the home. Many of these problems should be fixed by the seller prior to purchase and so these problems need to be discovered and disclosed. Don't buy someone's problems.

Housing Expenses or Front-end Ratio. This is a housing affordability ratio that calculates what percent of your income is used to make mortgage payments. Housing expenses should be less than 28% of your monthly gross income. The formula is: monthly PITI*/monthly gross income <28%. PITI = mortgage principle, mortgage interest, property taxes, and property insurance.

Housing. These are appreciating tangible assets, such as land, dwellings, vacation home, or rental property used for personal goals or capital income.

Housing Ratios. As Christians, we have other important obligations that we also pay, i.e., tithing and paying ourselves, i.e., savings. As such, should have smaller houses (at least less expensive), because we pay the Lord first and ourselves second. For a spreadsheet that takes into account the fact that we pay the Lord first and ourselves second within this front-end and back-end ratio framework, see: Maximum Monthly Mortgage Payments for Christian Savers Spreadsheet (from the website).

I Bonds: Inflation linked US government savings bonds, where the rates on the bonds are tied to inflation.

Identity goals. These are goals that relate to our long-term view of who we are and how we see ourselves. These goals help us be better in our long-term view of who we are and what we want to become.

Ignorance. A reasons for going into debt. We don't understand interest and its costs.

Immediate Annuity Distribution. You can use your defined contribution plan to purchase an immediate annuity, either from your retirement Plan provider or from others outside the Plan.

Impound/escrow/reserve accounts. These accounts are that portion of a monthly payments held by the lender or servicer to pay for: Taxes, Hazard insurance, Mortgage insurance, Lease payments, and

Other items as they become due. These are for payments for items above which are over and above your monthly mortgage payments of principle and interest. These may or may not be required by your lender.

Inactivity/Minimum balance fees. These are fees because you did not have account activity during the period or because you failed to keep a minimum balance in your account.

Inactivity/Minimum balance fees. These are fees imposed because you did not trade or have account activity during the period or because you failed to keep a minimum balance in your account.

Income Statement (personal). This is a financial record your inflows and outflows of cash. It is on a cash basis. The statement is based entirely on actual cash flows, not accruals.

Income Taxes. Income taxes are a progressive tax meaning that the more you earn the more you pay.

Income-consuming assets. These are assets which require a constant infusion of cash to keep operative.

Income-generating assets. These are the best type of assets. These assets generate income or capital gains which may eventually allow you to have income without your having to work.

Indenture. A document that outlines the terms of the loan agreement.

Independent brokers. These are brokers whose company is not part of a major chain or who own a captive mutual fund company. They may be inclined to give unbiased advice as they do not sell specific mutual funds.

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Index funds. Index funds are mutual funds designed to match the returns of a specific index or benchmark. Different Index funds may track many different benchmarks, including the S&P500 (Large-cap stocks), Russell 5000 (small-cap stocks), MSCI EAFE (international stocks), Barclay Aggregate (corporate bonds), DJ REIT (Real estate investment trusts), etc. Index funds are tax efficient since they do little in buying and selling of securities, and their goal is to match the return of their relative benchmarks.

Index funds. These are mutual funds or ETFs which hold specific shares in proportion to those held by a specific index, i.e., the S&P 500 or Russell 2000. Their goal is to match the benchmark performance. Index funds have become the standard against which other mutual funds are judged.

Individual Biases. The brain does not work like a computer. Instead, it processes information through shortcuts and emotional filters to shorten the analysis time. These filters and shortcuts lead to predictable errors in investing. We must be wise to these prediction errors so we can be better investors and better stewards over our resources.

Individual Development Accounts (IDA). These are matching resources from local and other sources to encourage saving for specific goals including education. They must be used for education, or home purchase, or to start a business, you must be in the program for 12 to 36 months maximum, and must attend a basic money management class (Fin418 counts), reside in Utah, be 18 or older, have income to save and meet needs criteria.

Individual Retirement Accounts. These are retirement account created with the Taxpayer Relief act of 1997. While there are over a dozen different individual retirement accounts, the three major types of Individual Retirement Accounts are Traditional IRA, Roth IRA, and Education IRA, which is also called a Coverdell Education Savings Account (ESA).

Individual Retirement Annuity: An IRA set up with a life insurance company through purchase of annuity contract.

Inflation risk. Risk that a rise (decline) in inflation will result in a decrease (increase) in the bond's value.

Inherited IRA: An IRA acquired by the non-spousal beneficiary of a deceased IRA owner.

Initial public offerings (IPOs). These are the very first shares ever issued by a company. Investment bankers serve as underwriters or intermediaries for these IPOs

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Initial target portfolio. This your first goal for a target dollar amount as you begin building your portfolio. It is calculated by taking your emergency fund goal and dividing it by your percentage in bonds and cash.

Installment Loans. Installment loans are loans which are repaid at regular intervals and where payment includes both principal and interest. These are normally used to finance houses, cars, appliances, and other expensive items. These loans are amortized, which is the process of the payment going more toward principal and less toward interest each subsequent month. These may be secured or unsecured loans, variable-rate or fixed-rate loans.

Insurance. Insurance is a tool help you achieve your personal and family goals. It is a product that transfers the risk of certain types of losses or events from an individual to another institution. By transferring risk, it can help the individuals achieve specific goals if they die, get sick or become unable to work. But it is a tool that needs to be understood and used wisely.

Insured Worker. A worker is only entitled to receive benefits if that worker is fully insured. Workers are considered fully insured if they have worked forty quarters of work (a quarter is three months) and earned a specific amount of money per quarter.

Integrity goals. 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 and live, what we will and will not do, and characteristics and skills we wish to attain.

Interest only Option loans. These are FRMs or ARMs with an option that allows interest only payments for a certain number of years, and then payments are reset to amortize the entire loan over the remaining years. Some will take out an interest only loan to free up principal to pay down other more expensive debt. Once the interest-only period has passed, the payment amount resets, and the increase in payment can be substantial. These are generally not recommended.

Interest or finance costs. This is the average amount borrowed times the monthly interest rate. In calculation form, it is the (Net capitalized cost + residual value) / 2 times your average interest rates which is the APR/12.

Interest rate risk. Risk that a rise (fall) in interest rates will result in a decline (rise) in the bond's value.

Interest. The cost of using borrowed money. Interest must always be paid.

Interest/coupon payments. These are payments received as part of the contractual agreement to receive interest payments from a bond. Bonds which have preferential interest tax treatment, i.e., muni's and Treasuries, must still pay capital gains taxes.

Intermediate-term bonds. Bonds with a maturity of 2 to 10 years.

Internal Rate of Return (IRR). This is a form of loan analysis to determine whether you should refinance or not. The process is to calculate all costs and fees for the loan, calculate the monthly savings, determine the number of months of savings, and set the number of months on the new loan equal to the number of months remaining on the old loan so you are not extending the loan! If your IRR is greater than your risk-free rate, then refinance.

International Bonds. Bonds issued by international companies and sold internationally in various currencies.

International stocks and international mutual funds. These are stocks or mutual funds of companies based entirely outside the U.S. These can be of any size (small-cap, large-cap), any type (value, growth) and from any part of the world outside the US. 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.

Intestate. The process whereby the state essentially writes the will for a person because they did not prepare a will during their lifetime.

Investment advisor. A person or an organization that helps makes the day-to-day decisions regarding a portfolio's investments for investors.

Investment Assets. These assets include stocks, bonds, mutual funds that are invested for the future. These are also income-producing assets used to accumulate wealth to satisfy specific goals.

Investment Benchmarks. An investment benchmark is the standard by which to judge your asset performance. You never choose an asset without choosing an investment benchmark. Use your

investment benchmark to determine how well you are doing.

Investment Constraints. These are specific needs you have which will constrain how you will invest your portfolio.

Investment Guidelines. Your investment guidelines are the general road map on how you will be investing your assets over your life cycle. It integrates your personal goals and your financial goals into a complete financial perspective.

Investment Horizon. This is when will you sell the investment.

Investment Plan (also called and Investment Policy Statement). Your Investment Plan is the most important document you will prepare in regards to your investing activities. It sets the plan and framework on every investing activity. It states what you will do: what you will and will not invest in, how you will invest, why you will invest, what percentages you will invest, etc. In short, it is the key document that will impact your investment returns most for the rest of your future.

Investment risk. This is the risk of who takes responsibility for the investment outcome, the insurance company or the insured.

Investment vehicles. The investment vehicle is the tax-law defined framework that has specific tax advantages, i.e., 401k, 403b, Individual Retirement Account (IRA), SEP IRA, Roth IRA, Roth 401k, etc. Investment vehicles have different benefits, i.e., due to matching (free money), tax elimination, tax deferral, or just tax-efficient and wise investing. Investment vehicles are like shopping carts in the grocery store, they are the things you put your groceries, or financial assets, into.

Investment/financial assets. Investment or financial assets are the securities that are invested in by the investment vehicles, i.e., stocks, bonds, mutual funds, REITs, MMMFs, CDs, etc. They are like the groceries you put in your shopping cart, which is your investment vehicle.

IRA Rollover distribution (Be careful and don't touch the funds). You can roll over your distribution into an IRA. The benefits are you can defer taxes until you withdraw the funds, you can direct investment to different assets and asset classes, and you can continue to enjoy tax-deferred growth. The risks are that there is no guarantee that funds will last a lifetime and you must begin withdrawals at 70½ or 50% penalty is incurred.

Irrevocable Living Trust. A trust that cannot be changed by the owner once established, because the trust becomes another legal entity which owns all the assets contained in the trust and pays taxes on the assets and gains they produce. The assets are not subject to estate taxes since they are not part of your estate and assets in the trust do not pass through probate.

Issue. These are children.

Issuer. The corporation or government agency that issues the bond.

Itemized Deductions. These are allowable deductions (if you itemize) and include: charitable contributions (cash, in kind, and/or mileage), home mortgage interest, medical expenses (>10% AGI), un-reimbursed qualified job expenses (> 2% AGI), casualty and theft expenses (> 10% AGI), etc.

Jensen's Alpha. This is a risk-adjusted performance measure. This is the ratio of your portfolio return less CAPM determined portfolio return, or alpha = rp - [rf + ßp (rm – rf)] where ap = alpha for the portfolio, rp = average return on the portfolio, ßp = Weighted average Beta, rf = average risk free rate, and rm = average return on market index port. It is portfolio performance less expected portfolio performance from CAPM model.

Joint and Survivor Annuities (percent relates to the amount the spouse receives). You receive payment for as long as you live or for a certain guaranteed period, whichever is longer, and your spouse, after you die, receives that percent of your payment for as long as they live.

Joint Tenancy with Right of Survivorship (JTWROS). Ownership is shared equally and lifetime control is shared, income is shared between owners, testamentary control is absent, and then right of survivorship is key.

Jumbo loans. These are loans in excess of the conventional loan limits and the maximum eligible for purchase by the two Federal Agencies, Fannie Mae and Freddy Mac, of $424,000 in 2018 (some areas have higher amounts). Some lenders also use the term to refer to programs for even larger loans, e.g., loans in excess of $500,000.

Junk Bonds. Bonds with very low bond ratings, a

higher interest rate and default rate, and are almost always callable.

Keogh Plan. This is a small business retirement plan set up by a sole proprietor or partnership (not incorporated) which allows employers to make tax-deductible payments to retirement plans, similar to pension or profit-sharing plans. Plans can be either a defined benefit or defined contribution, but most commonly are DC profit sharing or money purchase plans. Contributions are tax deductible, earnings grow tax-deferred, and employers may borrow from the Plan

Large-cap (capitalization) stocks. Large caps are stocks with a market capitalization greater than roughly $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. These are generally mature corporations with a long track record of steady growth and dividends.

Lease cost: The total cost of a vehicle's lease.

Lease term: The number of months the vehicle is leased.

Lease: A contractual arrangement calling for the lessee (user) to pay the lessor (owner) for the use of an asset.

Leverage. The decision of using debt to invest. It is not recommended.

Liabilities. This is what you owe to others. Liabilities come in two major forms: current liabilities, liabilities that must be paid-off within the next year, and long-term liabilities, liabilities that extend beyond one year.

Liability Coverage. Liability is the financial responsibility one person has to another in a specific situation. Liability results from the failure of one person to exercise the necessary care to protect others from harm. Personal liability coverage protects the policyholder from the financial costs of legal liability or negligence. There are two major forms of liability insurance: the liability portions of homeowners and auto insurance and an umbrella liability coverage.

Life Annuities (guaranteed for the "certain" period). You receive benefits for as long as you live or for a certain guaranteed period, whichever is longer.

Life insurance. This is insurance that provides compensation to your beneficiaries should you die prematurely. It transfers the economic loss of death from an individual to an insurance company by way of a life insurance contract. It can help us take care of our own and extended families should we die.

Life-cycle funds. These are funds which change their allocation between stocks and bonds depending on investor age. As an investor ages, life cycle funds reduce their allocation to stocks and increase their allocation to bonds, more consistent with the goals and objectives of an older investor.

Lifetime transfers. Methods of transferring property including the sale or gifting of one asset to another.

Limit orders. These are orders to sell or buy a specific number of shares at a specific price or better. This is generally the best method in working with brokers.

Limited Partnership Basis. A process of teaching children about finance based on their age and consistent with their ability to learn.

Liquidity risk. Risk that investors will be unable to find a buyer or seller for a bond when they need to sell or buy.

Liquidity. This is the speed and ease with which an asset can be converted into cash.

Living Trust. A trust where assets are placed in the trust while you are still living. You can take them out and move them according to what you want to do before you die.

Living will. It is a legal document that details your end-of-life wishes for health care. It is used when you are still alive but unable to make health care decisions for yourself. A living will states your wishes regarding medical treatment in the event of a terminal illness or injury

Loads. Loads are sales charges to compensate the sales force for selling the fund. Loads directly reduce the amount of money invested by the amount of the load. Loads can either be front-end or back-end, depending on when the mutual fund company takes out the load or sales charge. Generally, research has found that the performance of load funds and no-load funds is identical. When the sales charges are included, no-load funds significantly outperform load funds. (Matthew R. Morley, "Should You Carry a Load? A Comprehensive Analysis of Load and No-Load Mutual Fund Out-of-Sample Performance,"

Journal of Banking and Finance, vol. 27, nu. 7 (2003), pp. 1245-71.)

Loan term. This is the duration of the loan. It can be 10, 15, 20 or 30 years depending on your goals and your cash flow situation.

Local income taxes. These are uncommon; but some larger cities, for example, New York City, impose such a tax.

Long-term bonds. Bonds with a maturity of greater than 10 years.

Long-term capital gains. These are capital gains where the Fund has owned the assets for more than a year (366 days). These are taxed at a rate dependent on your taxable income.

Long-term Debt Coverage ratio. This is your income available for living expenses divided by long-term debt payments. This ratio tells how long you could make monthly payments on your debt based on the amount of money you have available for living expenses (which is wages less taxes). The inverse of this ratio is the Debt Service ratio.

Loss Aversion. Often losses are given more weight in our minds than potential gains in any position. These weights are more than utility theory would suggest. We should give gains and losses equal weight in your analysis. It is the gains and losses of the overall portfolio that are important, not individual securities.

Low Income Filer. This is a single filer with provisional income below $25,000 or married filing jointly (MFJ) with income below $34,000. None of the benefits are taxable.

Lump Sum Benefit. A lump sum of $255 is available to the surviving spouse, nonresident spouse, or to children eligible for the monthly benefits (for 2018).

Lump Sum Distribution. This is taking the entire retirement account at retirement. You are responsible to ensure this amount lasts your entire life. The benefits are you can take the money out as you need it, and can invest/gift/use it elsewhere. The risks are that plans only allow distributions every 3 months, taxes are incurred immediately, and if you do not plan well, may not have sufficient money for retirement.

Lump-sum. You receive a single payment of all principal and interest at retirement that you are responsible to manage.

Maintenance margin. This is money you put up to buy on margin. If your maintenance margin falls below a specific level, you will be required to put up more money. If not, your position will be closed out.

Major Medical Insurance. This is major coverage of medical costs over and above the basic health insurance coverage. It covers medical costs beyond the basic plan. These normally require a co-payment and/or a deductible. There is a stop-loss provision, which limits the total out-of-pocket expenses incurred by the insured to a specific dollar amount and a life-time cap for the insurance company, which limits the total amount the insurance company will pay over the life of a policy.

Managed health care providers. These are insurance companies which provide pre-paid health care plans to employers and individuals. There are four main types of managed care: i. Health maintenance organizations (HMOs), Preferred provider organizations (PPOs), POS Plans (POS), and Exclusive Provider organization (EPOs). They pay for and provide health care services to policy holders and they provide the most efficient payment of bills. However, they limit choices to the doctors and hospitals that participate and they require policy holders to pay a monthly premium and share the cost of care.

Management fees. These are fee charged by the advisor to a fund generally on the basis of a percentage of average assets under management, i.e. 75 basis points or .75% a year.

Manager Style Drift. This is a check on the management style. Make sure the manager's investment style remains constant. Investment fund managers have no authority to change the asset class. If you purchase a small cap fund, the manager should purchase small cap shares. The fund's prospectus should clearly define the market size, company, and portfolio style tilt.

Margin accounts. These are accounts where you borrow from the brokerage firm to purchase financial assets. This is debt, and can amplify both gains and losses.

Margin call. This is a call by the broker to put up more money when your margin declines below a certain level. I recommend you do not buy on margin. It is using debt to invest and you can lose more than

your original investment doing this.

Marginal tax rate. This is your taxes on each additional dollar of earnings. If you made $1 more this year, at what rate would it be taxed.

Market capitalization. It 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. Market capitalization is used to weight companies in various benchmarks and to determine certain classes of companies, i.e. large-cap, mid-cap, small-cap, etc.

Market orders. These are orders to sell or buy a specific number of shares at the currently available or market price. Be careful as the market can move quickly and dramatically between when you place the order and order execution time.

Markup. This is the difference between the buying price and the calculated selling price.

Maturity date. The date when the bond expires and the loan must be paid back.

Maximum Family Benefit. When benefits are payable to more than one family member, a family maximum applies. This includes all benefits paid to the family. For disability, the family maximum is the lesser of 150% of the workers disability benefit or 85% of the AIME used to calculate the benefit, but is not less than the benefit paid to the worker. When the worker is living, and benefits exceed the family maximum, the worker's benefit is not adjusted; rather, the reduction is made in other beneficiaries' payments.

Mean Reversion. Prices tend to correct themselves as investors correct for overreaction. Long-term prices tend to revert to the mean.

Medicaid. Medicaid is a medical assistance program, operated jointly by the states and federal government, to provide health care coverage to low income, blind, or aged persons. Medicaid payments may be used to offset the premiums, deductibles, and co-payments incurred with Medicare. There is no guarantee that this plan will be around in its present form.

Medicare Benefits. Medicate hospital insurance (HI) portion of Medicare, also known as Part A, is largely funded by the 2.9% HI tax on earnings. Part A is compulsory. Individuals at least age 65 and eligible for Social Security retirement benefits on their own behalf are entitled to coverage under Medicare Part A. If the individual has applied for Social Security (SS) retirement benefits, no separate application is required.

- Medicare Part A is compulsory and covers all hospital related expenses, such as bed and board, operating room costs, and lab tests. Patient pays a deductible and coinsurance payment.
- Medicare Part B is voluntary, with a monthly charge. It covers doctors' fees and other outpatient treatment. Patient pays a premium, deductible, and 20% of approved charges.
- Medicare Part C (Medicare Advantage) provides three program alternatives: coordinated care plans, private fee-for-service Medicare, and health savings accounts (HSAs).

Medicare. This is a health care insurance program for elderly and disabled. Medicare insurance provides medical benefits to the disabled and to those 65 and older who are covered by Social Security. Its cost is covered through Social Security taxes. Individuals can get insurance through Medicare that would be prohibitively expensive through other channels, however, it doesn't cover all the costs and expenses and individuals must pay certain amounts. In addition, there are limitations to the coverage, such as out-of-hospital prescription drugs and limitations to the number of days in skilled nursing facilities. Medicare is divided into three parts: A, B, C.

Mental Accounts. Often investors keep mental accounts rather than viewing individual assets as part of a total portfolio. We do this to try to save ourselves from ourselves.

Mid-cap or mid-capitalization stocks. These are stocks with 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 similar to the small-cap asset class. For asset-allocation purposes, mid-caps are generally not considered a major asset class.

Middle Income Filer. This is a single with income from $25,000 to $34,000 and MFJ with income from $32,000 to $44,000. Up to 50% of social security benefits are taxable.

Minimum purchase amount. This is the minimum

amount the mutual fund company will allow you to purchase in their funds to begin investing.

Mission Statement. This can be your individual and family purpose and passion. It can also include other things such as family mottos, family mission statements, what you stand for, etc.

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

Monetary (or Current) Assets. This is cash or other assets that can be easily converted into cash. These may be also income-producing assets. They provide necessary liquidity in case of an emergency.

Money factor: A way of expressing interest rates, calculated by taking the APR and dividing it by 24.

Money Market Account or Money Market Deposit Account: A non-financial account that pays interest based on current interest rates in the money markets. They typically require a higher minimum balance to avoid monthly fees and typically have a higher rate of interest.

Money market mutual funds. Money market mutual funds are funds which invest the majority of their assets in short-term liquid financial instruments such as commercial paper and government treasury bills. Their goal is to obtain a higher return, after fees and expenses, than traditional bank savings or checking accounts.

Money Purchase Plans. These are defined contribution plans where the employer contributes a percentage of employee salary each year, not dependent on company profits. Employees do not contribute.

Monitor performance. The process of understanding and reviewing the performance of a portfolio. Unless you monitor performance, you will not know how you are doing in working toward accomplishing your objectives. You need to know how every asset you own is performing, and performing versus its benchmark, so you can determine how well you are moving toward your goals.

Month's Living Expenses Covered ratio. This is your monetary assets divided by your monthly living expenses. This ratio tells you how many months you could survive in the event of the loss of all current income. Your living expenses do not include charitable contributions, taxes or savings.

Mortality risk. This is the risk that the insured dies outside the contract period and is therefore not covered by insurance.

Mortgage-backed bonds. Bonds backed up by a pool of mortgages.

Mother's or Father's Benefit. The surviving spouse of a fully or currently insured worker is eligible to receive a benefit of 75% of the worker's PIA if they are caring for a child who is under age 16 or who was disabled before age 22 (subject to family maximum).

MSRP: The price the manufacturer hopes to get for the sale of a product.

Mutual fund returns. Mutual fund returns include distributions of dividends, capital gains, and interest, and any NAV appreciation. Your total return: (ending NAV–beginning NAV)+ distributions / beginning NAV. Mutual Fund after-tax returns is your return after all taxes are taken out. Mutual fund before-tax returns is your return before taxes.

Mutual fund share classes. These classes of shares vary depending on the loads and management fees paid. While there are differences in classes of shares among investment management companies which charge loads, they generally are:

Mutual fund supermarkets. Mutual fund supermarkets i.e., Fidelity Funds Network, Charles Schwab, or Jack White, allows you the benefits of the mutual fund company while you get access to a whole range of mutual fund companies (but not all of them). Mutual fund companies rebate part of their management fees back each month to the "mutual fund supermarkets" to have them included in their list of funds.

Mutual fund. It is a way of holding financial and real investments. It is an Investment company that pools money from investors to buy stocks, bonds, and other financial investments. Investors own a share of the fund proportionate to the amount of their investment divided by the total value of the fund.

Necessity. One of the reasons for going into debt. It is we truly cannot feed our families.

Needs Approach. This is an approach for determining the amount of life insurance that is required. It determines the total needs of the

beneficiaries which includes immediate, debt elimination, transitional, dependency, spousal life income, education, and retirement needs. It is the most detailed of the approaches.

Negative Amortization Mortgages (NegAm). These are mortgage loans in which scheduled monthly payments are insufficient to amortize, or pay off the loan. Interest expense that has been incurred, but not paid is added to the principal amount, which increases the amount of the debt. Some NegAm loans have a maximum negative amortization that is allowed. Once that limit is hit, rates adjust to make sure interest is sufficient to not exceed the maximum limit.

Net capitalized cost (also called **adjusted capitalized cost**): The final amount paid. Found by taking the capitalized cost and subtracting capitalized cost reduction.

Net worth or equity. This is the difference between your assets, the things you own of value, and your liabilities, what you owe to others.

New investor bias. New investors dilute the value of existing investor's shares. Since new money comes into the fund at Net Asset Value, and since this money must be invested (at roughly 0.5% on average in the U.S.), existing investors are subsidizing new investors coming into the fund

NMD (New Money / Donations) Addendum. This is a way to rebalance using either of the rebalancing methods. Rebalance as determined previously, but pay your charitable donations using appreciated assets, and use the money you would have spent on charity to purchase the "underweight" assets, so you do not have to sell and incur transactions costs or taxable events.

No-load mutual funds. Mutual funds that are sold without a sales charge and are redeemed without a charge as well.

No-Load Shares: These are shares sold without a commission or sales charge. Generally, these shares are distributed directly by the investment management company, instead of going through a sales channel. They may have higher management fees to compensate for the lack of a front- or back-end load.

Non-deductible IRA. Individuals may contribute to a non-deductible IRA. The benefits are that money is contributed after-tax, and investment earnings grow tax-deferred. No taxes are paid on the investment earnings until the earning are withdrawn at retirement. Accurate record keeping is required to pro-rate the nondeductible portion of any subsequent distribution.

Non-group Coverage Plans. These are health insurance plans which cover individuals on a case-by-case basis and are traditionally the most expensive type of coverage. They provide a custom insurance policy to the purchaser. They are expensive, usually 15% - 60% more expensive than a group policy and may require subscribers to pass a medical exam.

Non-probate transfers. These are "will substitutes," and include state law, right of survivorship, beneficiary designations, and gifts causa mortis.

Non-refundable credits. Non-refundable credits include child tax, child and dependent care, elderly and disabled, adoption, hope learning, and lifetime learning and are only good up to the amount of taxes owed.

OASDI – HI (Old Age, Survivors, and Disability Insurance and Hospital Insurance). This is payment for Social Security and Medicare taxes. The employee and employer each pay (assuming your Adjusted Gross Income (AGI) is less than $250,000: Social security tax (OASDI) of 6.20%, Medicare tax (HI) of 1.45%, for a total of 7.65% each. Self-employed individuals pay the whole 15.30%. OASDI-HI taxes are on taxable wages including wages, salaries, bonuses, commissions, value of employer provided meals/lodging, sick pay during first 6 months, employer paid group life insurance premiums in excess of $50,000, salary reduction from 401k, 403b, 457 plans, non-qualified deferred compensation no longer at risk, non-qualified stock options, vacation pay, and severance pay.

Open orders (GTC: good till canceled, GTD: good till date specified). These are orders which are good until filled or canceled. Be very careful with open or GTC/GTD orders. If you fail to cancel specific orders, you might have orders filled that you forgot to close out.

Open-end mutual funds. These are mutual funds that can be purchased and sold each day at the fund's Net Asset Value, which is the fund's assets less liabilities, divided by the number of shares outstanding.

Option Adjustable Rate Mortgages (Option

ARMs). This is an ARM where interest rate adjusts monthly, and payments annually, with "options" on the payment amount, and a minimum payment which may be less than the interest-only payment. The minimum payment option often results in a growing loan balance, termed negative amortization, which has a specific maximum for the loan. Once this maximum is reached, payments are automatically increased and the loan becomes fully amortizing after 5 or 10 years, regardless of increase in payment and must be repaid within the 30 year limit. These are not recommended.

Ordinary dividends. These are stock dividends earned from holding a stock an insufficient number of days within a specific period to be reported as qualified dividends. Ordinary dividends are taxed at a federal marginal or ordinary tax rate.

Organized Exchanges. These are areas used to facilitate trading of financial instruments.

Origination fees: These are the costs and profits made by the mortgage broker for originating the loan.

Overreaction. Many investors assign a probability to asset returns based on past theory. Appropriate reaction to a negative event is to update a prior probability to the most recent event. Overreaction is when they assign too high a value.

Over-the-Counter (OTC) Market. This is an electronic network of dealers used to execute trades without specialists or middle-men.

Ownership. This is the principle that everything we have is the Lord's, and we do not own the things we have and are. It is based on scripture and helps us to see our blessings as gifts on loan from a loving Father in Heaven.

Par value. The face value or amount returned to the holder of the bond at maturity.

Passive management. Passive management is the process of accepting average returns through purchasing index funds rather than trying to beat the market. It is much cheaper and more tax efficient.

Passive portfolio management. It is the process of buying a diversified portfolio which represents a broad market index (or benchmark) without any attempt to outperform the market or pick stocks. Since most active managers fail to outperform their benchmarks, especially after costs and taxes, investors have realized that if you can't beat them, join them, so they buy low-cost passive funds which meet their benchmarks consistently and minimize taxes.

Payday Loans. These are short-term loans of 1-2 weeks secured with a post-dated check which is "held" by the lender and then cashed later. These have very high interest rates and fees, APR > 720%. Typical users are those with jobs and checking accounts but who have been unable to manage their finances effectively.

Pell Grant. A type of government grant to help students attend college.

Percentages. We sometimes move in and out of asset classes and stocks instead of keeping specific asset class percentages relatively constant (within our minimum and maximum amounts from our Investment Plan). We get lower returns from increased trading costs and may have more risk than we want.

Percent-range-based rebalancing. This is the process of rebalance the portfolio every time actual holdings are +/-5% (or +/-10%) from target ratios. Rebalance whenever you are outside this range. It is easy to implement and wider ranges will reduce transactions costs (at the expense of higher tracking error).

Performance evaluation. It is the process of evaluating a portfolio's performance with the goal of understanding the key sources of return.

Periodic Payments distribution. With this distribution, you can plan for regular payments at regular intervals, and can ensure that payments are available for a specific period of time. However, there is no assurance of lifetime income, and your tax rate may be high due to the amount of money withdrawn.

Periodic-based rebalancing. This is the process of rebalancing where you specify a time period, i.e. bi-annually, annually, etc. After each time period, rebalance the portfolio back to your original asset allocation targets. It is the most simple of the methods, and longer periods have lower transactions and tax costs (but higher tracking error costs).

Permanent insurance. Permanent insurance is an insurance contract that is purchased for the entire life of the policy holder with premiums divided between death protection and savings. Provides insurance that cannot be cancelled, may be used for estate

retirement, and savings. It is complex, expensive, and not transparent, and unless premiums are paid, it can expire worthless. Please note that certain permanent products are not permanent, i.e. they can lose money.

Personal Financial Plan. This is a document that contains all critical areas of your personal financial life. It is your individual and personal roadmap for achieving your personal and family goals. It entails 6 steps: 1: Decide What You Want, 2: Evaluate Your Financial Health, 3: Define your Personal and Financial Goals, 4: Develop a Plan of Action, 5: Implement Your Plan, and 6: Revise Your Plan as Necessary.

Personal Property. These are depreciating tangible assets, such as boats, furniture, clothing, etc.

Personal Representative (Executor). This is the person who fulfills the requirements of the trust or will.

Perspective. Perspective is how we look at things. It is important because it impacts choice. We can take many different perspectives in our view of different aspects of our lives, with the best perspective being the perspective that last the longest—an eternal perspective.

Piggyback loans. These are two separate loans, one for 80% of the value of the home and one for 20%. The second loan has a higher interest rate due to its higher risk. The second loan is used to eliminate the need for PM Insurance. With a piggyback loan, PMI is not needed, but these are much harder to get now.

Point of Service Plans (POS). These plans have attributes of HMOs, PPOs, and indemnity plans. The point at which benefits are received determines the amounts of benefits paid. POS may include HMO, PPO, and indemnity type programs, and the POS may also have a gatekeeper.

Points. Points are fees for a loan. 1 Point is one percent or one hundred basis points of the loan. This money is pre-paid interest, money paid to the mortgage broker (not the lender). It is deducted from the loan proceeds (you still must pay it back), and is essentially another fee for helping you arrange the loan (minimize points). Lenders charge points to recover costs associated with lending, to increase their profit, and provide for negotiating flexibility. You will like have to pay origination points, but buy-down points (to reduce the interest rate on the loan) are purely optional.

Political or regulatory risk. Unanticipated changes in the tax or legal environment will have an impact on a company's bonds.

Portfolio attribution. It is the process of separating out portfolio returns into their related components, generally attributable to asset allocation, securities selection, industry, and currency.

Portfolio evaluation. The process of monitoring financial asset performance, comparing asset performance to the relevant benchmarks, and determining how well the fund is meeting its objectives.

Portfolio management. It is the development, construction, and management of a portfolio of financial assets to attain an investor's specific goals.

Portfolio rebalancing. It is the process of bringing portfolios back into given target asset allocation ratios. Changes in allocation occur due to changes in asset class performance and investor objectives or risk, or introduction of new capital or new asset classes.

Portfolio reporting. The process of reviewing portfolio performance with the necessary participants, i.e. your spouse or your investment advisor.

Potential Cap Gains Exposure. This is an estimate of the percent of a funds asset's that represent capital gains. If this is high, the probability is high that these may come to the investor as capital gains.

Pre-approval. Pre-approval is the process whereby lenders have pull your credit score, looked at your tax records and approve you for a specific amount of a loan. Get pre-approved for your loan by a number of lenders (with mortgage loans, you can have multiple loans requested within a 90 period and it's counted as one loan request). You can borrow up to this pre-approved amount without a problem. Remember however that you do not need to borrow that amount. I recommend you borrow less than that amount.

Preferred Provider Organizations (PPOs). PPOs are insurance plans which are essentially a cross between the traditional fee-for-service and an HMO. PPOs are organizations where in-plan provider's fees are covered, and out-of-plan providers results in higher fees. Insurers negotiate with a group of doctors and hospitals to provide care at reduced rates, while giving insurers the ability to go to non-plan doctors. PPOs provides health care at a discount to

fee-for-service plans. They provide a group of doctors which work at reduced costs to the participants, while assessing an additional fee if the participant uses a non-member doctor or center. PPOs are more expensive than HMOs and use of non-PPO providers results in higher out-of-pocket costs.

Prepayment Penalties. These are penalties enforced by the lender for prepaying a loan too soon. Prepayment penalties have a stated period of time, i.e., 1, 2, or 3 years the prepayment penalty is in effect, a maximum pay down percentage (MPP), i.e., 6% of the principal per year, and a prepayment penalty if you sell it before, i.e., 6 months interest. With a soft prepayment you cannot within the stated period of time without penalty, refinance at all, sell the loan to family members, or pay down more than your MPP each year. The only way to get out of a soft prepayment penalty is to sell the property to an unrelated party. With a hard prepayment, you cannot within the stated period of time without penalty refinance at all, sell the loan to anyone, or pay down more than your MPP each year. There is no way to get out of a hard prepayment penalty before the defined period without paying the penalty.

Prepayment. Prepayment is the process where you repay the loan early, either through paying off the loan or selling the house and the new buying paying off the old loan.

Pre-qualified. Pre-qualified is a process where lenders estimate your credit based on information you tell them. I recommend you get pre-approved, not pre-qualified.

Price. The price that the bond sells for.

Pride. A reason for going into debt. How we look to others is more important than how we look to God.

Primary and Secondary markets. Primary markets are markets for trading newly issued securities. Secondary markets are for trading already issued shares of stocks, bonds, and other securities. Secondary markets consist of organized exchanges and over-the-counter or electronic markets where existing shares are traded.

Primary Insurance Amount (PIA). Your PIA is the basic unit used to express the amount of a worker's benefit if they received benefits at their full retirement age (FRA). The calculation of PIA is based on the workers AIME, which is split into three segments and multiplied by specific percentages for each segment and summing the parts.

Primary markets. These are markets for trading newly issued securities.

Principles. These are doctrinally based guidelines for how we should live our lives. Whereas doctrines answer the 'why" questions, the principles are the "what" questions, i.e., what are the things and guideline we should be following and doing.

Priority of money. This is an educational tool to help individuals determine the order of which they should utilize investment vehicles to achieve their personal and family goals.

Private Alternative Loans. These unsubsidized loans are much more expensive than federal unsubsidized loans, interest starts immediately and accrues, and you must begin paying the loan back immediately. The student is the borrower. These have higher up-front fees and may require a cosigner. Read the fine print VERY CAREFULLY.

Private Health Care Plans. These are health care plans sold by private insurance companies to individuals and employers as part of a benefits package.

Private Mortgage Insurance. Insurance paid for by the borrower to ensure that the lender is made whole should the borrower default. If equity in the home is greater than 20%, PMI is not required for conventional loans or VA loans (but is required by FHA loans for the life of the loan).

Probate. Probate is the process of distributing an estate's assets after death. Probate is a matter of state law. It is the matter of administering the portion of the person's estate that is disposed of in either by will provisions, for those with a valid will, or by intestate succession, for those who die without a will.

Profit Sharing Plans. These are defined contribution plans where employer contributions vary year-to-year depending on firm profitability (it may be zero if the firm is not profitable in that year).

Psychological biases. These are views on how the brain works and affect our investment decision making process. Poor investment decisions caused by psychological biases affect your wealth, so we need to learn to recognize and avoid poor investment decisions which come from those psychological biases.

Q-TIP (Qualified Terminable Interest Property) Trust. A Q-TIP Trust is a testamentary trust which provides a means of passing income to the surviving spouse without turning over control of the assets. These trusts ensure that assets will be passed to your children upon the death of the surviving spouse.

Qualified dividends. These are stock dividends earned from holding a stock a minimum number of days within a specific period. Qualified dividends are taxed at a federal preferential tax rate depending on your marginal tax rate.

Qualified stock dividends. These are payment of cash to the Fund by the companies owned where the company owned the shares for a specific length of time. These are taxed at a preferential rate depending on your taxable income.

Real estate and property taxes. These are taxes imposed annually or semi-annually on assets owned.

Real Goals. These are goals you really want to accomplish, and are willing to work hard and seek Heavenly Father's help in accomplishing them.

Realtor or Real Estate Broker. This is a person supposedly trained in the process of selling and buying real estate. You want a realtor that know the market in the area you are looking at. Remember that realtors are paid by the seller, so remember that in your associations. Sellers divide the sales commission (usually 6-8%) between the listing realtor and the buying realtor.

Redemption. The process of redeeming a callable bond before its maturity date.

Refinance. The process of getting another mortgage loan on your home and repaying the old loan with a goal to reducing your interest and other costs overall.

Refundable Credits. These are credits paid to the taxpayer even if the amount of the credits exceeds the tax liability.

Required minimum distributions. For tax deferred retirement plans, the government requires that a certain percentage of assets must begin by April 1st of the year following age 70½. The distribution is the account balance on Dec. 31 of the previous year (age 69) divided by the life expectancy from the table below. There is a 50% penalty on minimum distributions not taken.

Required Minimum Distributions. This is a legal requirement of many tax-deferred retirement vehicles which require savers to distribute a specific amount each year after age 69 of total plan assets. It is calculated by dividing the total amount in accounts by a specified number given.

Residual value: Expected value of a vehicle at term end. Often used as purchase price after a lease has ended.

Retirement Benefits. Retirement benefits can either be reduced or increased depending on your PIA, your FRA and the date when benefits begin. You can begin receiving benefits as early as age 62. Benefits that begin 3 years before FRA will be reduced by a maximum of 20% (or 5/9% of 1% per month for each month benefits begin before FRA or 6.67% per year). Additional reductions of 5% per year are effective when FRA exceeds age 65.

Retirement Payout Options. These are the types of annuity distribution payouts available at retirement. Investors and spouses jointly determine the types of payments at retirement.

Retirement plans. These are income-producing assets, such as pensions, IRAs, 401K, Roths, SEPs. etc. by you or employer used to accumulate wealth for retirement.

Retirement vehicles. These are a specific type of investment vehicles which are related to retirement. These include qualified retirement plans such as both traditional and Roth 401k, 403b, and 457 plans; Individual retirement plans such as Roth and traditional IRAs; and small business plans such as SEPs, Simple, and Keogh plans.

Retirement vehicles. These are investment vehicles to help you save for retirement. These include for private businesses: 401-k, Roth 401-k plans; non-profit tax-exempt businesses: 403-b/Roth 403-b plans; State and municipalities: 457 plans; Individual retirement accounts: IRA/Roth IRA; and small business plans: SEP IRA, SIMPLE IRA;

Retirement/Annuitization Stage (of retirement). This stage begins when you retire. It is your plan on how your assets will be distributed at retirement. Your goal should be to have sufficient assets for your lifetime to enable you and your spouse to live like you want in retirement.

Retirement/Annuitization strategies. These are strategies to use while you are in the retirement stage. They might include: calculate a minimum acceptable level of retirement income, and annuitize that

amount; take out on a specific percentage of assets each year in retirement, etc.

Revenue bonds. Bonds backed by the revenues of a specific project.

Reverse Mortgages. These are mortgage loans whose proceeds are made available against the homeowner's equity. Financial institutions in essence purchase the home and allow the seller the option to stay in the home until they die. Once they die, the home is sold and the loan repaid, generally with the proceeds. These 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.

Revocable Living Trust. It is the most common type of living trust. It is a trust which allows for unlimited control by the trust's owner, because the owner retains title to all the assets in the trust. They do not pass through probate. They provide greater ease and privacy of distribution upon death.

Risk of Downgrading. Should a bond's rating be downgraded, the seller would need to reduce the price of the bond (resulting in a lower yield to the seller and a higher yield to the buyer) to make up for the increased risk.

Risk pooling. It is the process where individuals transfer or share their risks with others to reduce catastrophic losses from health problems, accidents, lawsuits, etc.

Risk. Risk is the possibility of having a return different from what was expected, whether it is losing all your money, losing principle, or not achieving a specific rate of return. There are many different types of risk including: inflation, business, interest rate, financial, market, political and regulatory, exchange rate, call, and liquidity risk.

Risk-adjusted Performance. It is the process of determining performance after adjusting for the risk of the portfolio.

Rollover IRA: A traditional IRA set up to receive a distribution from a qualified retirement plan.

Roth Conversion. This is the process of converting a traditional individual retirement account to a Roth account.

Roth IRA. This is an individual retirement account which provides no deduction for contributions but provides that all earnings and capital gains are tax free upon withdrawal after retirement. You are actually investing more with a Roth, since your investments are after-tax, and contributions can be withdrawn tax/penalty free. Earnings grow tax-free if the Roth IRA is in place for at least 5 years, and you are 59½ years old.

Savings Bonds: Bonds issued by the US government with tax advantages to encourage savings.

Savings Ratio. This is your income for savings divided by your income available for living expenses. This ratio tells you what proportion of your after-tax income is being saved.

Scholarships. Money given to promising students because of their shown abilities in specific areas. There are many scholarships available, but you have to find and apply for them individually.

Seasoned new issues. These are new shares being issued by a company that is already publicly traded.

Secondary markets. These are markets for trading already issued securities. Secondary markets trade previously owned shares of stocks, bonds, and other securities. Secondary markets consist of organized exchanges and over-the-counter or electronic markets where existing shares are traded.

Secured Credit Card: Similar to a standard credit card, but is tied to a checking or savings account. The card cannot be used once the money in the account is gone, until more funds are added. Useful for building credit.

Secured loans. Secured loans are guaranteed by a specific asset, i.e. a home or a car, and typically have lower interest rates.

Securities markets or organized exchanges. These are areas used to facilitate trading of financial instruments.

Securities markets. Securities markets are where securities, i.e., financial assets, are traded. The two different types of securities markets are primary and secondary markets.

Seeking Solace (abdicating responsibility). Sometimes we follow newspaper/newsletter advice which we know has been shown to under-perform. We prefer to take other's advice rather than doing our own homework. That way if the performance goes bad, we can blame others (we don't have to take responsibility).

SEP-IRA. The Simplified Employee Pension (SEP-IRA) is an Individual Retirement Account which allows a small business employer to contribute to the retirement of the employees. Employer contributes the same percentage to all employees, and no required annual contribution. Contributions are tax deductible, earnings grow tax-deferred, and employees own the plans.

Series EE and Series I Bonds. US savings bonds with the special tax advantage that earnings on the bonds are tax-free if used for paying tuition and fees

Sharpe Index. This is a risk-adjusted performance measure. It is the ratio of your "excess return" divided by your portfolio standard deviation, i.e., your (rp – rf)/sp where rp = Average return on the portfolio, rf = your riskfree rate, and sp = Standard deviation of portfolio return. The Sharpe Index is the portfolio risk premium divided by portfolio risk as measured by standard deviation.

Shortfall. This is the difference between what you have now saved for retirement and what you think you need for retirement.

Short-sell. A short-sell is where a lender allows a property to be sold for less than the amount owed on a mortgage and takes a loss. A short sell allows the borrower to avoid foreclosure, which involves hefty fees for the bank and poorer credit outcome for the borrower, and the lender to make "less" of a loss on the property and to not enter foreclosure. A short sell does not necessarily release the borrower from the obligation to pay the remaining balance of the loan.

Short-term bonds. Bonds with maturity usually a year or less.

Short-term capital gains. These are capital gains where the Fund has owned the assets for less than 366 days. These are taxed at your Federal and state "ordinary" or "Marginal Tax Rate (MTR)"

SIMPLE 401k. This is a small business qualified retirement plan that provides some matching funds by the employer. Employees can have no other qualified plan, and may contribute up to the specific amount each year. Contributions are tax deferred and grow tax-free, and there is a penalty for early withdrawal. The employer is "required" to either contribute at least 2% or to match employee contributions, usually 1-3%

SIMPLE IRA. This is one of the SIMPLE retirement plans where Employees can participate. Contributions are tax deductible, it is easy to set up and administer (compared with a traditional 401(k)). A small business qualified retirement plan that provides some matching funds by the employer.

SIMPLE Plans. These are Savings Incentive Match Plans (SIMPLE) that provides matching funds by the employer. It can be established as an IRA or as part of a 401k plan. Employees can have no other qualified plan, and can contribute up to 100% of compensation to a maximum limit each year. The employer is "required" to either contribute at least 2% or to match employee contributions, usually 1-3%.

Single payment (or balloon) loans. These are loans that are repaid in only one payment, including interest. These are generally short-term lending of one year or less, sometimes called bridge or interim loans, often used until permanent financing can be arranged. These may be secured or unsecured.

Sinking fund. Money set aside annually to pay off the bonds at maturity.

Small-cap or small capitalization stocks. Small-cap 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.

Smart Card: Similar to a debit card, but rather than being connected to a certain bank account, they magnetically store a certain amount of money linked to the card itself.

SMARTER Goals. SMARTER is an acronym for helping you as you strive to set effective goals. It is: S = specific, M = measurable, A = assignable, R = realistic, T = time-bound, E = evaluated, and R = reassessed.

Social Security or FICA. Social security is a government provided retirement, survivor, and disability benefits. Franklin D Roosevelt signed the Social Security Act in 1935 to Aid the displaced and out of work. Social Security is a pass-through account, which means that FICA taxes being paid by current workers provided the money for benefit payments to current retirees.

Sole ownership. Ownership where ownership and control is absolute in one individual. Income belongs to sole owner and testamentary control is absolute.

Special Joint and Survivor Annuity (if there is a death in the marriage the benefit decreases). You receive payment for as long as you live or for a certain guaranteed period, whichever is longer, and your spouse, after you die, receives a percentage of that payment for as long as they live.

Spousal IRA. A Spousal IRA is an IRA contribution for a non-earning spouse. If one spouse is an active participant, the non-earning spouse can contribute to a Spousal IRA. Limits are the same as the traditional and Roth IRA.

Spouses benefit. A fully insured worker's spouse age 65 (FRA) is eligible to receive a retirement benefit of 50% of the worker's PIA subject to the family maximum. This benefit is reduced by 25/36% of 1% for each of the first 36 months that the spouse is under FRA (25% for 3 years). Once the FRA > 65, a reduction of 5/12 of 1% is imposed for each month beyond 36 months the spouse is under the FRA. The reduction of benefit from early retirement will not affect the amount of the spouses benefit. Disability benefits for spouses are 50% of the worker's PIA, reduced if the spouse is under FRA, subject to a family maximum amount.

Spreadsheet budgeting method. Using a computer and spreadsheets, determine your gross salary and take home each month after taxes and other deductions. Determine spending by categories (rows) and dates (columns), and budget for each category. As bills come in, input the spending on each date (column) and row (category).

Sprinkling Trust. A Sprinkling Trust is a testamentary trust that distributes assets on a needs basis rather than according to some preset plan to a designated group of beneficiaries.

Standard Family trust. This is a testamentary trusts which hold the assets of the first spouse to die until the second spouse dies. The spouse has access to income from the trust, or the trust principal, if necessary. They reduce the estate of the second spouse so that the estate taxes can be reduced.

State taxes. Most states impose an income tax; however, some, like Texas and Nevada do not. Alaska actually pays you to live in that state

Status Quo Bias. Sometimes individuals prefer the status quo over a new, more preferable position. There is an aversion to change, even if the change is for the better.

Stepped Up Basis. This is the process of the value of an asset being stepped up, or changed from the original value when purchased, to the current value when the person dies and it is transferred to heirs.

Stewardship. This is the principle that we are stewards over all that the Lord has, is, or will share with us. This view helps us realize the things we have are a gift and we should take care of them.

Stock Bonus Plan. These are defined contribution plans where employer contributions are made with employer shares of stock. Employee stock ownership plans (ESOPs) and leveraged ESOPs (LESOPs) are the most common.

Stock dividends. Stock dividends are dividends received from a company from the ownership of the company shares. Stock dividends are of two types, qualified or ordinary/not qualified. A qualified dividend is a dividend paid by a U.S. corporation where the investor held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (see Teaching Tool 32). An ordinary dividend is a dividend that is not qualified, i.e., you have not held the stock for a long enough time period to get the Federal preferential tax rate.

Stock Market Secrets. These are supposed short-cuts or secrets that only the professionals know, but they will share them with you for a price. Don't get taken.

Stock mutual funds. These are stock mutual funds are funds which invest a majority of their assets in common stocks of listed companies. These funds generally have a specific objective, i.e. "large-cap," "small-cap", "value," "growth," etc. which relates to the types of stocks the mutual fund invests in.

Stockbroker. A stockbroker is a person who is employed by and solicits business for a commission house or merchant.

Stop (or stop-loss) orders. These are orders to sell a specific number of shares if the stock price falls below a certain price or buy a specific number of shares if the stock price rises above a certain price. These are used to set prices to safeguard against major fluctuations.

Student Loans. These are loans with low, federally subsidized interest rates used for higher education. Examples include Federal Direct (S) and PLUS Direct (P) available through the school; Stafford (S)

and PLUS loans (P) available through lenders. Some are tax-advantaged and have lower than market rates. Payment on Federal Direct and Stafford loans deferred for 6 months after graduation.

Style analysis. It is another way of obtaining abnormal returns is by analyzing the investment style pf the portfolio. You can decompose returns by attributing allocation to style, and style tilts and rotation are important active portfolio strategies.

Subordinated bond. Bond that will be paid after the other loan obligations of the issuer are paid.

Subsidized Loans. Loans where another party pays the interest while the student is in school. Interest begins 6 months after the student graduates or drops below half-time enrollment.

Subsidized University Loans. These are loans offered by the university to students attending school.

Successor Trustee. This is the person to succeed the trustee should the trustee not be able to manage the trust.

Supplemental medical insurance. The SMI portion of the Medicare program (Part B) is financed by premiums paid by participants and by federal government funding. Participation in Part B is voluntary.

Survivor Benefits. Deceased worker must had had fully insured status; other survivor benefit (mother's or fathers' child's lump sum) will be paid to eligible survivors of a fully or currently insured worker

Target Benefit Plan. These are defined contribution plans that establish a required contribution level to meet a specific target level of benefits at retirement.

Tax Considerations. These are how taxes will impact your investment decisions, including your tax position, specifically your marginal and average tax rate; and how tax-free investments may fit into your plan, i.e. municipal versus corporate bonds.

Tax Cost Ratio. This is the percent of nominal Fund return attributable to taxes, assuming the fund is taxed at the highest rate. If a fund had an 8.0% return, and the tax cost ratio was 2.0%, the fund took home (1 + return) * (1 – tax cost ratio) -1 or (1.08*.98)-1 or 6.00%.

Tax Efficiency. Invest in taxable funds with an eye to obtaining high returns while keeping taxes low. Taxes reduce the amount of money you can use for your personal and family goals. Watch the historical impact of taxes, for it will likely continue. Remember it is not what you earn, but what you keep after taxes that makes you wealthy.

Tax Freedom Day. This is the day you stop working for the government and begin working for yourself.

Tax Tables. These are tables to help you calculate how much taxes you owe.

Taxable accounts. There are investment vehicles without tax advantages.

Taxable bonds. Taxable bonds include U.S. Treasuries, corporate bonds and agency issues (bonds issued by U.S. government agencies, like Ginnie Mae).

Taxable Estate. This is equal to the gross value of your estate, less estimated funeral and administrative expenses, debts, liabilities, taxes and any marital or charitable deductions.

Tax-adjusted Return. This is your return after taxes

Tax-advantaged money. This is the process of using investment vehicles that have specific advantages. There are two types: Tax deferred and tax-eliminated vehicles.

Tax-deferred money. This money has the ability to be invested before-tax, with principle and earnings taxed only at retirement (IRA, SEP IRA, etc.). This money converts long-term capital gains into short-term income for tax purposes.

Tax-efficient and wise investments. This is money that is invested tax-efficiently and wisely, consistent with the principles of successful investing discussed earlier.

Tax-eliminated money. This money can be used at retirement (or for education) without penalty and without taxes, i.e., a Roth IRA/410k/403b for retirement, and 529 Funds and Education IRA for education. You pay the taxes upfront, and then pay no taxes on earnings or capital gains when you take it out at retirement.

Taxes (automobile) (also called government costs). It is the tax on the usage and interest in a lease. It is calculated as (Usage + Interest) times your tax rate.

Taxes on Distributions. These are taxes on your distributions which must be taken into account to get the true return of your portfolio but which are not noted on your monthly reports.

Taxes on mutual funds. Mutual funds are pass through vehicles, which means that taxes are not paid at the Fund level but are passed through to the individual shareholders who must pay the taxes. Mutual fund taxes are mainly capital gains, stock dividends and interest/coupon payments. They are handled the exact same way as the taxes for stocks and bonds discussed earlier.

Taxes. These generally are your largest single annual expense. These may include personal, income, business, transportation and other taxes. Taxes can further be divided into Federal taxes, or taxes we pay the Federal government; State taxes, or taxes we pay the state government, and local taxes, which are taxes we pay the local government.

Tax-free bonds. 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.

Teaser Rates: Very low introductory interest rates used to attract new customers to a certain credit card. They increase soon after the card is in the user's hands.

Temporal goals. These are goals that relate to the temporal measures of success. It could be money, title, fame, positions at work or in industry, include influence, rank or power, or assets, investments, or possessions.

Tenancy by the entirety. Ownership is shared equally and limited to spouses, lifetime control is shared by both spouses, consent from both is required to sell, income is shared between owners, testamentary control is absent, and the right of survivorship is key.

Tenancy in Common. Ownership is shared, with each owning an undivided fractional interest that may be unequal, lifetime control is unlimited, income is shared between owners in relation to fractional interest, and testamentary control is unlimited.

Term Insurance. Term insurance is insurance protection for the insured over a specific term or time period. They may be renewable or non-renewable policies. It is the least expensive form of insurance and the death benefit coverage is only for a specific term.

Term or Bond Maturity. The maturity of the bond.

Testamentary transfers. Methods by which property is transferred at death.

Testamentary Trust. The process where assets are placed in trust after you die. The trust is created after probate according to your will.

Thrift /Savings Plans (TSP). These are defined contribution plans where the employer matches a percentage of employee contributions to a specific amount (i.e., free money). This program is for employees of federal civil service.

Total Costs Analysis. This is a form of loan analysis that does not take into account the time value of money, but is simple to calculate. To do this, calculate your total new costs and fees from the loan until it is paid off, your total current monthly principal and interest costs remaining without refinancing, your total refinance monthly principal and interest costs. If you will be paying less overall, think about it, if it is equal or less, it likely does not make finance sense.

Total expense ratio. This is the total percentage of assets that are spent each year to manage the fund including management fee, overhead costs, and 12b-1 fees.

Tracking Error. This is the return on the fund less the return on the benchmark. This tracking error should be small versus your benchmark. Tracking error is the historical difference between the return of a fund (i.e. a mutual fund) and its specific market/sector benchmark or index. The smaller the tracking error, the better the performance of the Index fund relative to the benchmark. However, you won't complain if the tracking error is positive (i.e., your fund had higher returns than the index or benchmark).

Traditional IRA. An individual retirement account in which an individual can contribute up to a specific amount annually which is tax-deferred. Eligibility and amounts depend on the contributor's income level and whether they have other retirement plans. The contribution is tax deductible and earnings grow tax-deferred.

Transaction costs. These are costs of the fund buying and selling securities, which are not included in other costs. Mutual funds which turn over the portfolio often, i.e. buy and sell a lot, will have higher transactions costs. A good proxy for this is the turnover ratio.

Treasury Bills. A short-term debt obligation issued

at a discount and redeemed at face value upon maturity in 3, 6, or 12 months.

Treasury Bonds. A long-term debt obligation issued at or near par and interest is paid semiannually.

Treasury Notes. An intermediate-term debt obligation issued at or near par and interest paid semiannually.

Treynor Measure. This is a risk-adjusted performance measure. This is similar to Sharpe but it uses the portfolio beta instead of the portfolio standard deviation, or (rp – rf)/ ßp where rp = average return on the portfolio, rf = average risk free rate, and ßp = weighted average b for portfolio. It is the portfolio risk premium divided by portfolio risk as measured by beta.

Trust Grantor. The person who created the trust.

Trustee. The person who will manage the trust.

Trusts. A trust is a legal contract. When you create a trust you are simply creating another legal entity. Trusts avoid probate and are more difficult to challenge than wills. They may reduce estate taxes, allow for professional management, provide for confidentiality, can be used to provide for children with special needs, can be used to hold money until a child reaches maturity, and can assure that children from a previous marriage will receive some inheritance in the future.

Turnover ratio. This is a measure of trading activity during the period divided by the fund's average net assets. A turnover ratio of 50% means half the fund was bought and sold during the period. Turnover costs money and incurs taxes.

Turnover. This is the amount of the portfolio that is bought and sold during a specific period. Keep turnover low, as turnover is a proxy for fund expenses and taxes. The costs associated with turnover are hard to quantify and may not be disclosed in the prospectus. These costs include commissions, bid-ask spreads, and market impact.

Types of Mutual funds. The types of mutual funds generally follow the major asset classes, i.e., money market, stock, and bond mutual funds.

Underwriting. Underwriting is the process whereby the borrower fulfills the requirement of the lender and the lender funds the loan. It also includes the lender selling the loan and the loan being syndicated and sold to investors.

Un-invested Cash. This is the amount of cash in the portfolio. High cash levels in the portfolio are drags on performance so keep un-invested cash low.

Unique Needs. Unique needs are special needs that may impact your investing decisions.

Unlimited Marital Deduction. There is no limit on the value of an estate that can be passed tax-free to a U.S. citizen spouse. This does not apply to non-U.S. citizen spouses. The tax-free maximum gift per year to non-citizen spouses is specified.

Unsecured corporate debts. Bonds not secured by collateral, and pay a higher return.

Unsecured loans. Unsecured loans require no collateral, are generally offered to only borrowers with excellent credit histories, and have higher rates of interest – 12% to 28% (and higher) annually.

Unsubsidized Federal Loans. These are loans for both grads and undergrads where the student responsible for interest during school, repayment begins six months after student graduates, discontinues, or drops below half-time enrollment for a continuous 6 months. The interest is not subsidized.

Upfront costs. These are cost due at the signing of the loan which include closing costs and points, down payment (3-20 percent of the loan amount), and other closing costs including points (3-7 percent).

Upgrade. A situation where a bond rating company improves the bond rating of a bond due generally to an improving financial condition.

Upper Income Filer. These are singles with income above $34,000 and MFJ with income above $44,000. 85% of Social Security benefits are taxable.

US Savings EE Bonds. Savings bonds issued by the US government that pay a fixed rate of interest with is reset every 6 months.

US Savings I bonds. Bonds issued by the U.S. government, and tax deferred until maturity. They are not marketable, but can be redeemed from local banks. Bonds sold at face value, with interest paid at maturity, with the interest rate set to inflation with a fixed component.

Usage (automobile) (also called depreciation). This is the amount of the value of the vehicle that is used over the lease life. It is calculated at the Net capitalized cost – residual value.

VA Loans. These are Veterans Administration (VA)

Guaranteed Loans. These loans are issued by others and guaranteed by the Veterans Administration. They are only for ex-servicemen and women as well as those on active duty. Loans may be for 100% of the home value.

Value stocks. These are inexpensive (in terms of low PE and low P/BV ratios), companies that have potential for good long-term return through both appreciation and dividends.

Values Statement. These are the values you will live by to help you accomplish your vision and mission.

Variable or Adjustable Rate Mortgages (ARMs). These are mortgage loans with a rate of interest that is pegged to a specific index that changes periodically, plus a margin that is set for the life of the loan. Generally the interest rate is lower compared to a fixed rate loan, as the borrower assumes more of the interest rate risk. The may have a fixed rate for a certain period of time, then afterwards adjust on a periodic basis.

Variable-rate loans. Have an interest rate that is tied to a specific index (e.g., prime rate, 6-month Treasury bill rate) plus some margin or spread, i.e. 5%). Can adjust on different intervals such as monthly, semi-annually, or annually, with a lifetime adjustment cap. Normally have a lower initial interest rate because the borrower assumes the interest rate risk and the lender won't lose money if overall interest rates increase

Vesting period. This is the period required before the promised benefits are considered yours.

Vision Statement. This is your vision of what it is you want to become. It is seeing or visualizing with your mind's eye what you will be in the future.

Widow(er)'s Benefits. A benefit of up to 100% of the deceased, fully insured PIA will be paid to the surviving spouse who is at least age 60 and who was married to the worker for 9 months. The surviving spouse is generally eligible if he or she is not remarried and is not entitled to retirement benefits (due to his or her covered employment) of at least the amount of the deceased workers PIA. A widowers benefits terminates at death or at eligibility for an equal or greater retirement benefit.

Will. A legal declaration by which a person provides for the disposition for their property and other assets at death.

Winning by Losing. Sometimes we actively trade stocks instead of buying index funds or ETFs which we know are lower cost and take a lot less time to invest. We know index funds generally outperform the actively managed funds, but we try to invest actively anyway.

Workers' Compensation. Workers compensation is state insurance program that insures against work-related accidents and illness. Workers' Compensation provides insurance to workers injured on the job, regardless of whether they have other health insurance or not. It only covers work-related accidents and illnesses, and coverage is determined by state law and varies state by state.

www.charitynavigator.org. a website on information about various charities which file Form 990 with the IRS. However, they do not include religious organizations listed as "church or convention or association of churches" which are exempt from filing Form 990.

Yankee Bonds. Bonds issued by international companies and sold in the U.S. in U.S. dollars.

Yield to Maturity. This is the true yield received if the bond is held to maturity, which assumes that all interest payments can be reinvested at the same rate as the bond itself.

Yield. The annual interest on a bond divided by its price.

Zero-coupon bonds. A discount bond which pays no interest until maturity.

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