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### Financial Planning for High School Students

Evan Weissman

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# Financial Planning for High School Students

Evan Weissman

A beginners guide to the basics of Financial Planning

First Edition



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## Financial Planning for High School Students

### *Abstract*

The global financial crisis of the early 21<sup>st</sup> century has taught us many things about human nature, our societal goals and the finance industry overall. Perhaps the most surprising finding, however, has been the observance of financial illiteracy among the general public. The combination of greed and ignorance towards financial responsibility has played an important role in the collapse of our financial system.

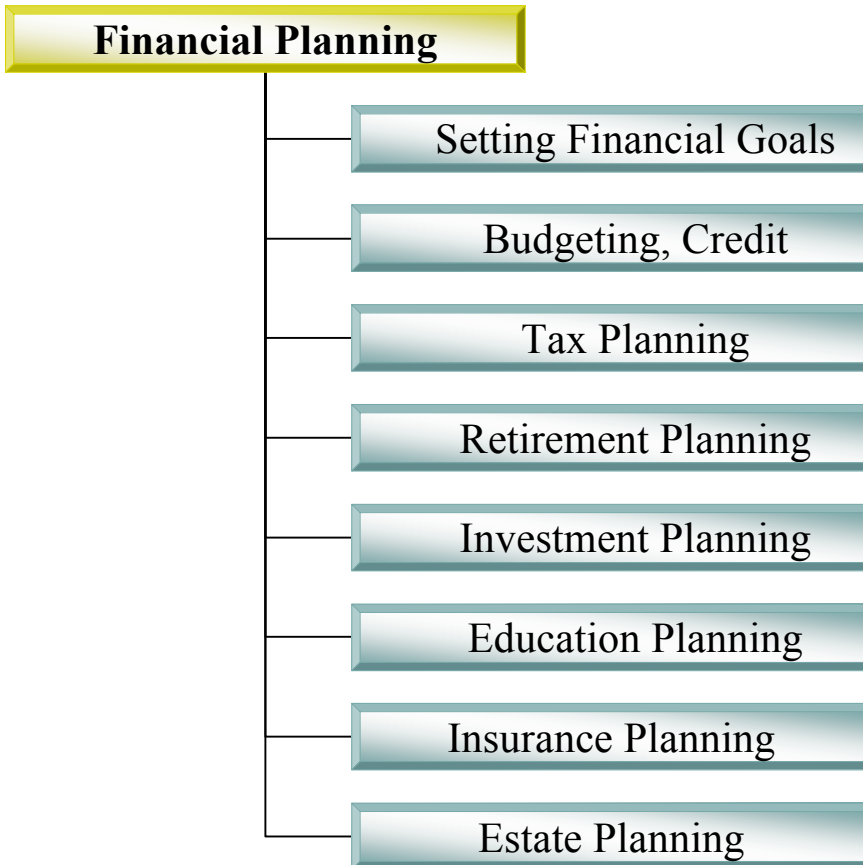
The financial illiteracy of our society has been an epidemic in our country for some time. Financial planning is a topic that has been rarely taught in high schools. This has led to an influx of adults who lack fundamental knowledge of how to manage their finances. In an attempt to combat this ever-growing trend in our society, *Financial Planning for High School Students* was conceived. Currently, there is nothing on the market that can be used as an educational tool to teach basic financial planning to high school students.

The text is a beginner's guide to the basics of financial planning. It is written in a concise and organized fashion to enable easy comprehension. Large sets of information have been condensed into helpful graphs and diagrams that are both visually appealing and informative. The text is divided into three sections based on age: *Strategies for Young Adults, Adults and Old Age*. This format helps to explain how the financial plan evolves as an individual progresses through life. Some major topics covered are: *Budgeting, Credit Planning, Taxes, Investing, Insurance Planning and Estate Planning*. Exposure to the basic concepts of financial planning should help address the issue of financial illiteracy and prevent another terrible global economic disaster.

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# Introduction



While many of the topics discussed in this book can, and in many instances should, be outsourced to professionals, it is important to gain a general understanding of each in order to properly evaluate your financial situation and plan for the future.

## Section 1: Strategies for Young Adults





## Section 1 Overview

### Chapters:

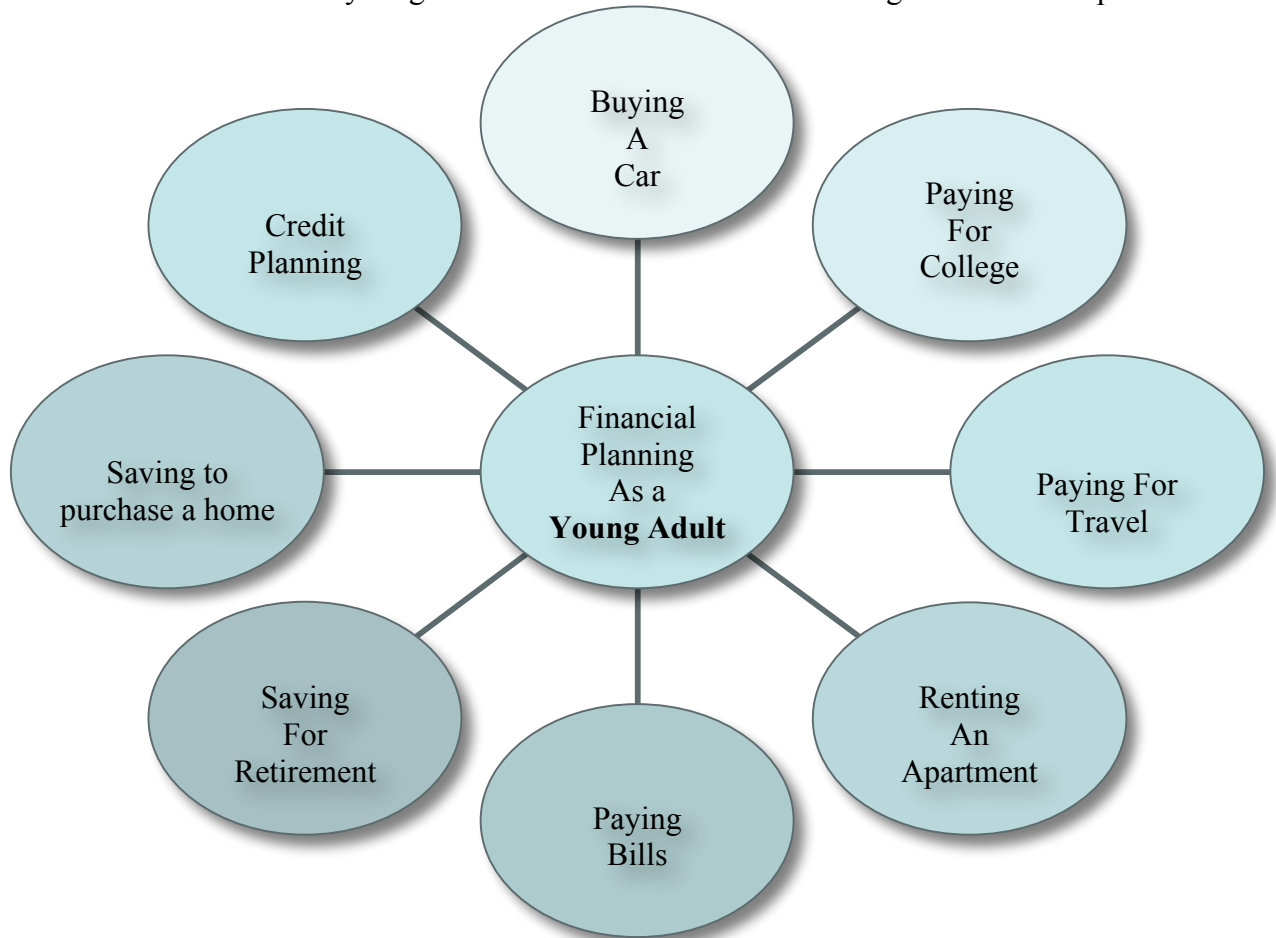
- 1.1 Financial Goal Setting
- 1.2 The First Big Purchase
- 1.3 Budgeting
- 1.4 Controlling Debt and Building Credit
- 1.5 Paying with Plastic



Section Goals- To learn how to begin the financial planning process as a young adult and gain the ability to make educated financial decisions early in life.

## Chapter 1.1: Financial Goal Setting

Financial goal setting is perhaps the most important aspect of the financial plan. It is about assessing where you are at the current point in your life, deciding where you want to be in the future, and taking the necessary financial steps to achieve your goals. This is why it is important to begin this process as a young adult and carry it on throughout your life. Remember your financial plan should evolve as you grow older and must be modified for changes in: income, marital status, children, interests, expectations, etc. Below is a diagram showing a few financial considerations a young adult should make when considering their financial plan:



These are only suggestions of possible things to consider; every individual will have their own unique financial situation. However, remember that it is never too early to plan for things such as retirement or buying a house. In financial planning, it is always beneficial to begin saving for the future as soon as possible. Early saving can greatly increase your funds down the road. Below are several basic rules to consider when setting financial goals:

### **Basic Rules for Financial Goal Setting:**

1. Be specific
2. Be realistic
3. Label the goal as either short, medium or long term
4. Set a date for completion
5. Think about how you can obtain this goal and plan to budget accordingly

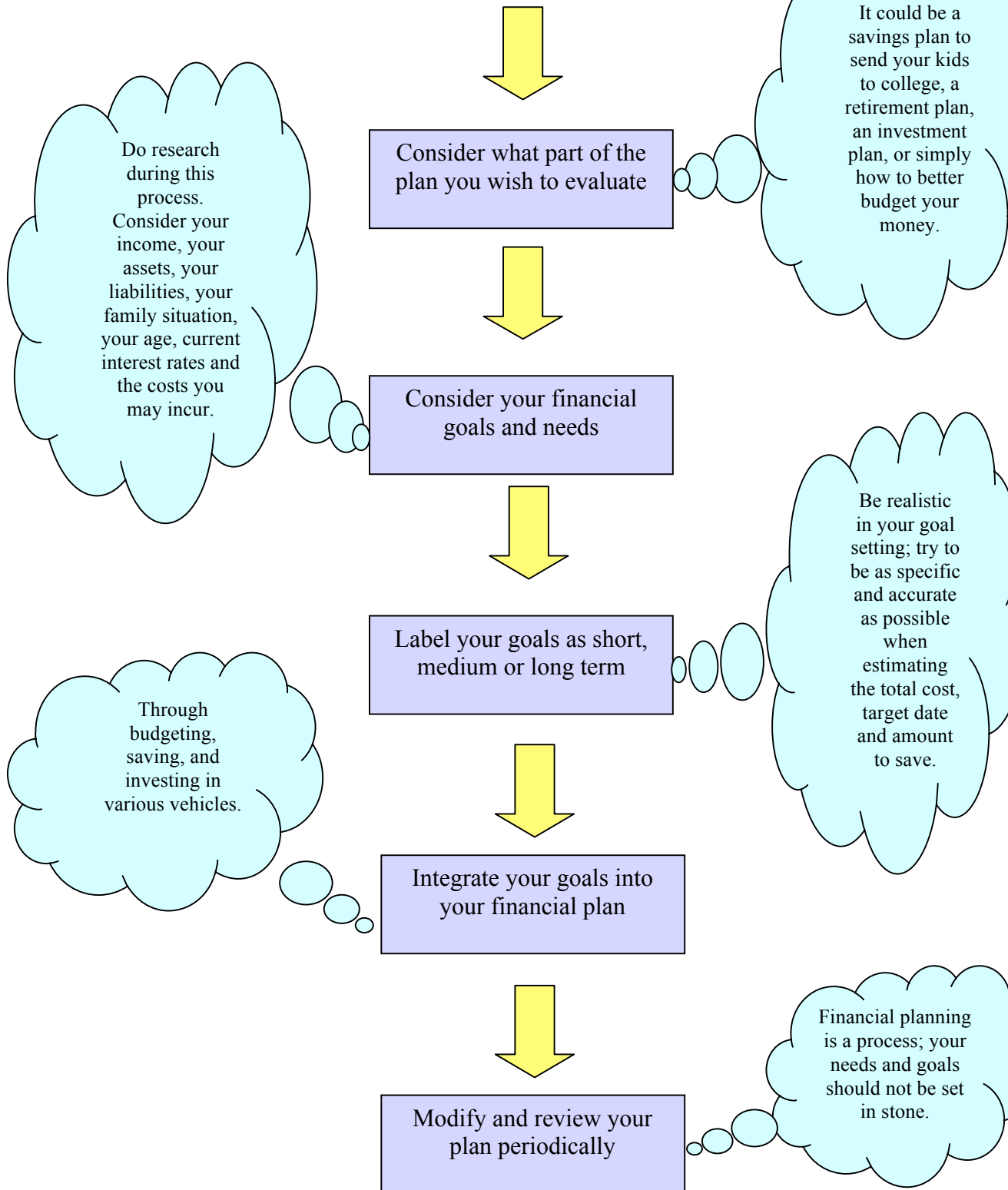
As you learn more about this process and how to budget properly, keep in mind that you must prioritize your goals and address them on a rational basis. Do not let your future plans slip away because of your short-term impulse purchases and spending.

In addition to these basic rules, there are also several steps that help incorporate these goals into your financial plan. This can be done in many different ways. A general set of rules has been provided in diagram form on the following page.



Financial Planning is an ongoing process that requires patience, discipline and good planning. Keep your goals realistic and be sure to conduct the proper research when evaluating your financial situation.

## Steps in Creating Financial Goals



This diagram is very general and should be used for basic financial goal setting and when learning about the financial planning process. If you were to pursue personal financial planning as a career, you will learn exactly how to analyze an individual's financial situation by using their financial statements and the various options that are available to achieve financial goals. Much of this is done through different financial ratios and research by talking to the client. A more detailed, complete financial process is listed below; however, to understand basic financial goal setting the previous diagram is suitable.

**1. Establish the Scope of the Activity-**

This defines the part of the financial plan that the financial planner must analyze. This influences the options that are available for suggestion to the client.

**2. Gather Data and Identify Goals-**

The financial planner must acquire many different types of data from the client. This is done by analyzing the client's financial situation and interviewing them about their assets, risk tolerance, health, lifestyle, goals, etc. This can be a lengthy process and is perhaps the most important step in creating a sound financial plan.

A large amount of trust must exist between the client and the financial planner in order for this process to work correctly. The client must trust that the planner is working in their best interest and the planner must trust that the client is providing accurate information. This is what makes financial planning such a personal business.

**3. Compile and Analyze the Data-**

After collecting the data from the client, the financial planner then prepares several financial statements (balance sheet, statement of cash flows, etc). This simply makes the data easier to analyze and provides an overall picture of the client's financial situation. From here, the planner is able to get a better idea of how to help the client.

**4. Develop Solutions and Present the Plan-**

This is when the planner uses his expert knowledge to evaluate the situation and choose possibilities for the client. The client's goals are considered, and based on their financial position the planner will suggest several options for the future. This is important because in financial planning there are often several ways to achieve the same goal and presenting options to the client gives them a better understanding of how to plan for the future. This is also important because the financial planner needs to refer back to the client and get permission in order to carry out the proposed plan.

**5. Implement-**

After the plan has been decided upon, the discipline requirement of personal finance kicks in. You can plan all you want, but until you are disciplined enough to take action and save, nothing will get accomplished. If you are serious about your finances and your future success, you must stick to your financial plan and constantly be aware of your financial position.

**6. Monitor and Review Periodically-**

This is a very important part of the financial plan that many people forget. Your financial situation will change over time and you must continually update your plan to keep it current with your changing goals and family situation. The more accurately this is done, the better it will reflect your financial needs and ambitions.<sup>1</sup>

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<sup>1</sup> (Altfest, 2007, pg. 6)

## Chapter 1.2: The First Big Purchase

As a young adult, one of the most important financial considerations you may have is planning to purchase a large ticket item. This item could be as complex and expensive as a car or an apartment; or as simple and cheap as a new television or an item of clothing. There are some basic financial devices to be aware of when saving for these items. The first of these are interest rates.

**Interest Rates** can be explained as the price you pay to borrow money or the amount you charge others for lending it. They are determined by both the Federal Reserve (through the federal funds rate) and the markets overall. While it is important to have a general understanding of how interest rates are determined, it is more important that you remember to compare these rates when considering investments and large purchases. Below is a chart that should help with decisions about interest rates.

<b>If you are:</b>	<b>You want to look for:</b>	<b>Because:</b>
Borrowing (such as taking out a loan from a bank)	The <b>Lowest</b> interest rate possible	You are responsible for paying the bank back over time.
Lending (such as depositing money into a bank account)	The <b>Highest</b> interest rate possible	The borrower (bank) is responsible for paying you back over time (interest).

Interest rates impact just about every financial transaction that an individual makes and they can make the difference between getting a good deal and getting ripped off, depending on the situation. We will speak more about interest rates later in the book and you will further understand their importance.

### An Interest Rate Example...



Although a low premium (monthly payment) may be very attractive when financing your first car, you should actually look for a low interest rate and term period (amount of time before the car is paid off). This is just one of the many ways people are confused when financing large ticket items.

The second financial device to be knowledgeable about when saving to make a big purchase is compounding. When talking about compounding, you are often referring to some kind of savings account. Unlike most checking accounts, savings accounts earn interest and over time this can make a big difference.

The original amount of money that is placed into the savings account is called the **principal** and **compounding** is the device that allows this amount to grow as time passes. Compounding not only allows you to earn interest on your principal but interest on your interest as well. This may sound confusing but it is easier to understand by using an equation:

1. Year one:

Principal at the beginning: \$1,000

Interest Rate: 5%

$$\begin{aligned}\text{Principal at the end of the year} &= \$1,000 \times (1 + \text{Interest rate}) \\ &= \$1,000 \times (1 + .05) \\ &= \$1,000 \times 1.05 \\ &= \$1,050\end{aligned}$$

The previous equation displays the basic formula for calculating the effect of interest on principal for one **period** (the amount of time the money must stay in the account in order to earn interest; in this case the period was one year). At the beginning of the period you put \$1,000 in the bank, and by the end you have \$1,050 because you earned 5% interest in that time.

This may not seem like a large amount, but observe what happens when you are able to leave the money in the bank for multiple periods:

2. Year two:

Principal at the beginning: \$1,050

Interest Rate: 5%

$$\begin{aligned}\text{Principal at the end of Year 2} &= \$1,050 \times (1 + \text{Interest rate}) \\ &= \$1,050 \times (1 + .05) \\ &= \$1,050 \times 1.05 \\ &= \$1,102.50\end{aligned}$$

Notice in this equation very little has changed from Year 1 (period one). The amount of time the money stays in the bank is the same (one year), the interest rate is the same (5%) and the basic formula is the same. However, instead of earning \$50 like in Year 1, we earned \$52.50 because we started with \$1,050 as the principal for the beginning of the year and we earned interest on our interest.<sup>2</sup>

## A Little More...

Instead of calculating the interest each period as we did in the last example, you can use a slightly more complex equation to calculate the result all in one step:

Principal at the beginning of Year 1: \$1,000

Interest Rate: 5%

$$\begin{aligned}\text{Principal at the end of Year 2} &= \$1,000 \times (1 + \text{Interest rate}) \times (1 + \text{Interest rate}) \\ &= \$1,000 \times (1.05) \times (1.05) \\ &= \$1,000 \times (1.05)^2 \\ &= \$1,102.50\end{aligned}$$

Observe the line in red. Just as we used an exponent to shorten the line above and calculate the principal at the end of Year 2, we can use the same concept to calculate the principal at the end of any number of years.

Try and calculate the principal at the end of year 10....

<sup>2</sup> (Altfest, 2007, pg. 23)

Take a look at the *With Compound Interest* side of the table below; imagine you decide to invest \$5,000 in year 0. You are able to get 10% in interest every year (which is very aggressive but possible). So you put \$5,000 into the account (which can be a savings account, a certificate of deposit, an annuity, etc.) and you never make another payment into the account. You simply put in the initial \$5,000 and you let the money grow:

With Compound Interest			Without Compound Interest		
Year	Interest Earned	Balance	Year	Interest Earned	Balance
0	0	\$5,000	0	0	\$5,000
1	\$500.0	\$5,500.0	1	500	\$5,500.0
2	\$550.0	\$6,050.0	2	500	\$6,000.0
3	\$605.0	\$6,655.0	3	500	\$6,500.0
4	\$665.5	\$7,320.5	4	500	\$7,000.0
5	\$732.1	\$8,052.6	5	500	\$7,500.0
6	\$805.3	\$8,857.8	6	500	\$8,000.0
7	\$885.8	\$9,743.6	7	500	\$8,500.0
8	\$974.4	\$10,717.9	8	500	\$9,000.0
9	\$1,071.8	\$11,789.7	9	500	\$9,500.0
10	\$1,179.0	\$12,968.7	10	500	\$10,000.0
11	\$1,296.9	\$14,265.6	11	500	\$10,500.0
12	\$1,426.6	\$15,692.1	12	500	\$11,000.0
13	\$1,569.2	\$17,261.4	13	500	\$11,500.0
14	\$1,726.1	\$18,987.5	14	500	\$12,000.0
15	\$1,898.7	\$20,886.2	15	500	\$12,500.0
16	\$2,088.6	\$22,974.9	16	500	\$13,000.0
17	\$2,297.5	\$25,272.4	17	500	\$13,500.0
18	\$2,527.2	\$27,799.6	18	500	\$14,000.0
19	\$2,780.0	\$30,579.5	19	500	\$14,500.0
20	\$3,058.0	\$33,637.5	20	500	\$15,000.0

As you can see, in only 20 years you have accumulated \$33,637.50 and you have earned over \$3,000 in interest! You can check this amount with the formula we discussed earlier. While these returns are not typical of everyday investment, they are entirely possible and illustrate the power of compound interest. If the above results are attainable in only 20 years, imagine the possibilities for 40 years or even a greater interest rate. You can play around with the calculation from before to test how the different inputs change the results.

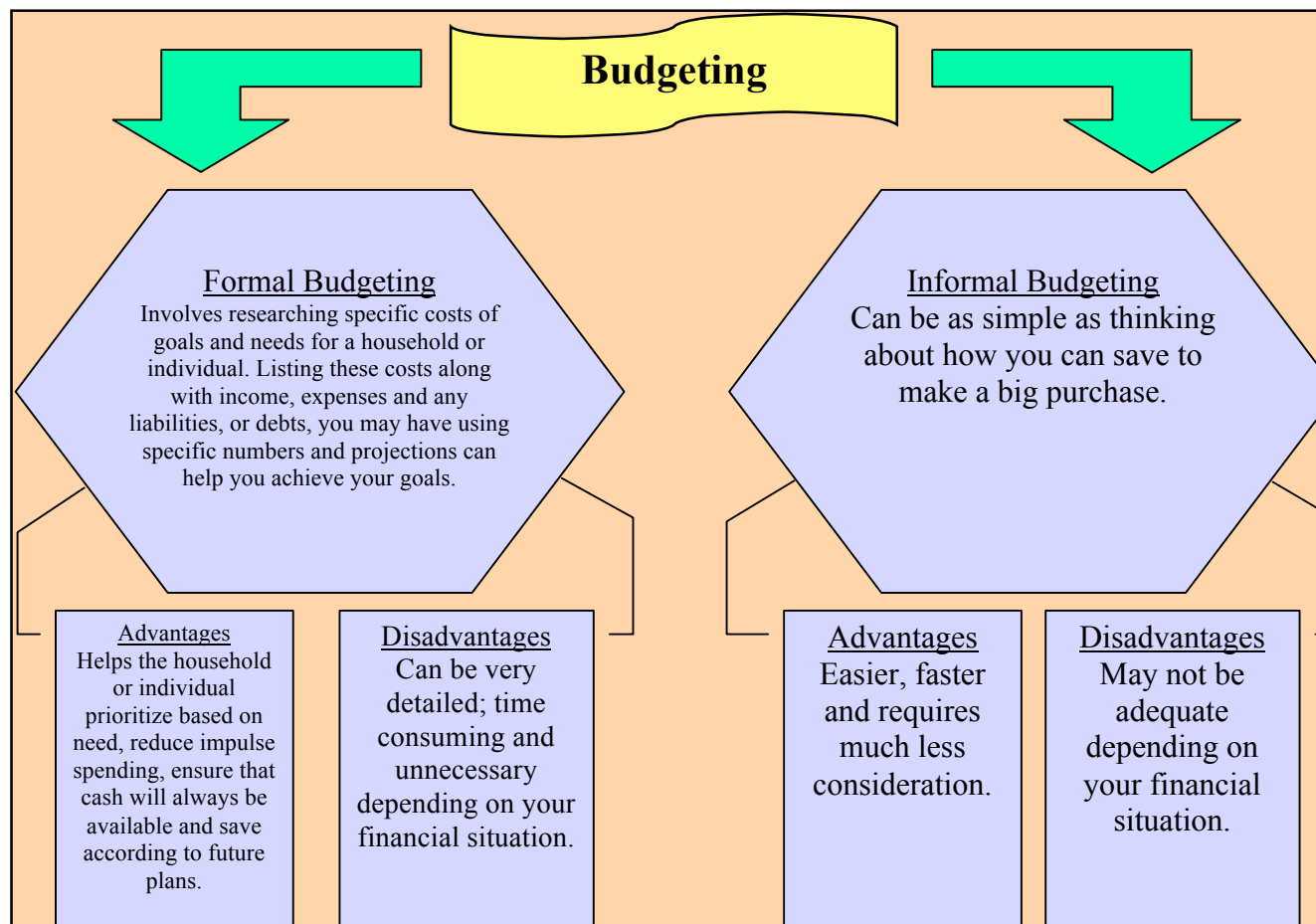
Now compare this to the right side of the table labeled *Without Compound Interest*. As you can see, you have accumulated \$15,000, which is a lot of money, but not even half the amount accumulated with compound interest. This is because you were never earning interest on interest; you were simply receiving a 10% rate of return on the initial investment of \$5,000 (notice the stable interest earned results).

Now that you have learned about interest rates and the power of compound interest, you are almost ready to make that first big purchase. The following sections in this chapter (Budgeting, Credit/Debit Planning and Credit Cards) are very important for young adults to be aware of and will complete your knowledge of how to plan for the purchase of a big-ticket item.



## Chapter 1.3: Budgeting

Now that you have learned how to make the most of your savings for a large purchase by using interest rates and compounding, it is time to actually start saving. In other words, it's time to start budgeting. Budgeting is an important part of Financial Planning that is often overlooked. In general, "Budgeting is a process of intentionally planning your spending so you live within your income and save for important financial goals".<sup>3</sup> Although, it may not be necessary in all circumstances, it is very helpful in planning to alleviate debt, purchasing a big-ticket item or controlling poor spending habits. If you budget correctly, it can help you with every part of the financial plan and also with your persistence in following your plan. There are two basic forms of budgeting that many of us are subconsciously aware of:



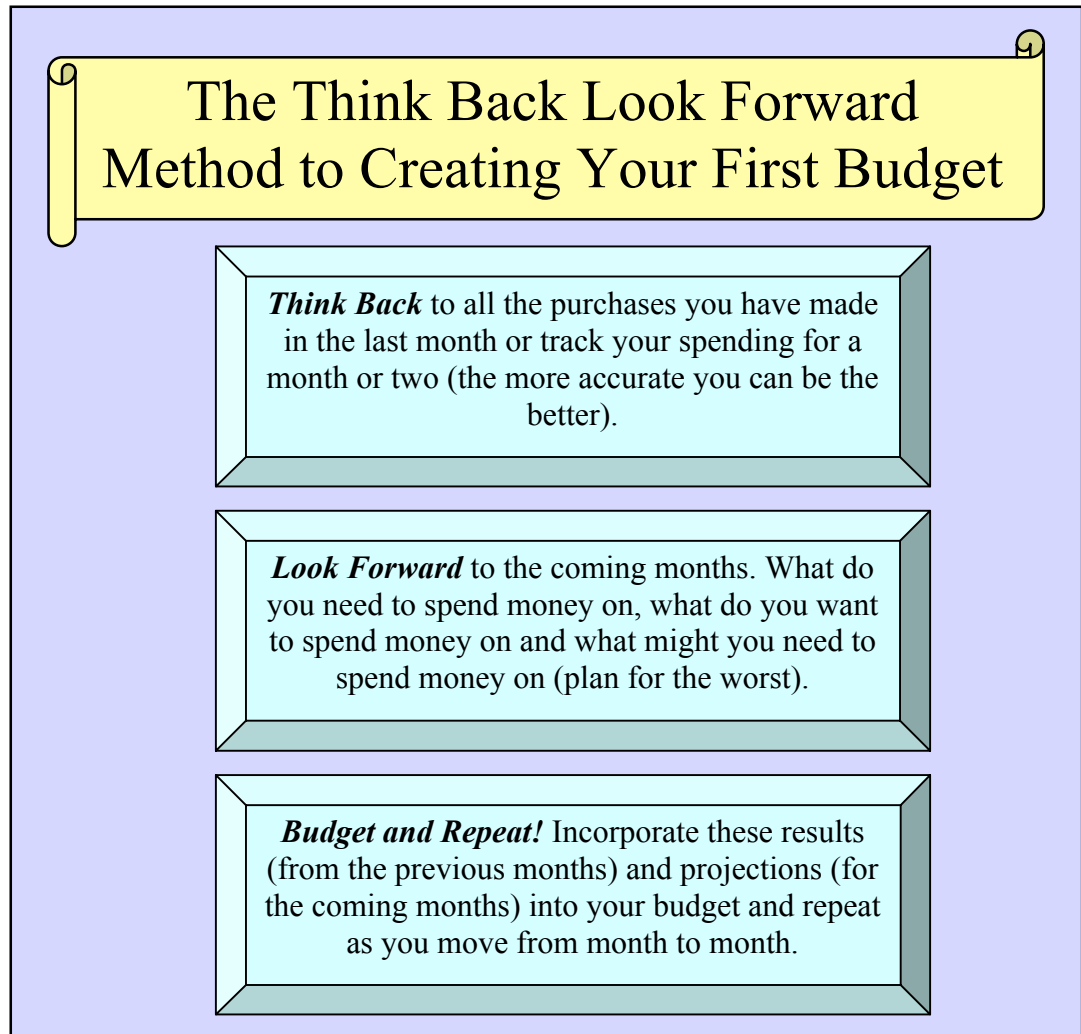
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<sup>3</sup> (Little, *Personal Finance Desk Reference*, pg. 36)

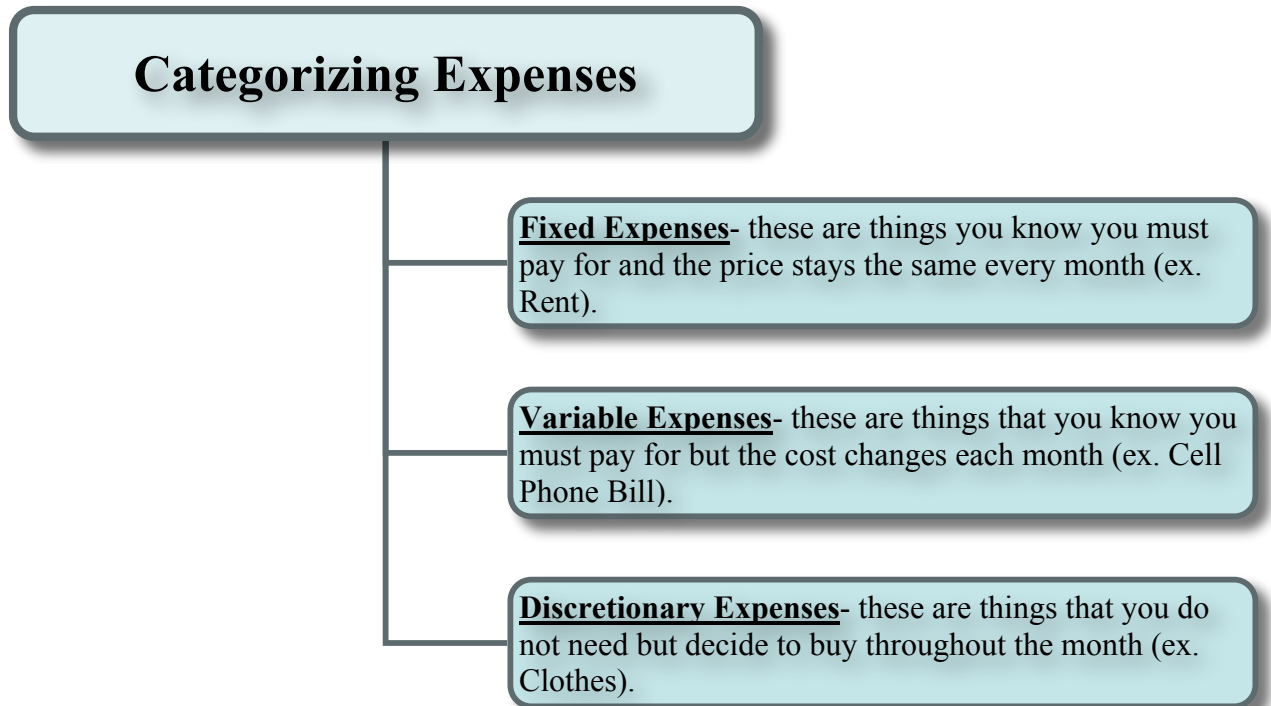
<sup>4</sup> (Altfest, 2007, pg. 122)

Although Formal Budgeting may not be necessary depending on your level of financial responsibility, it is an excellent way to get your spending habits under control and save for your long-term goals. It is also a good habit to get into as a young adult because the more you practice it, the easier, faster and more effective it will become.


Formal Budgeting can be done in many different ways. There are a countless number of budgeting books and worksheets available to help you organize your budget. However, there are several general budgeting concepts that exist which you should be knowledgeable about when taking this course. A helpful method when forming your first budget is illustrated below:



In general, budgeting is simply keeping track of your cash inflows and outflows. This is done by categorizing expenses and income while attempting to project (make a well-planned estimate about) what will happen to them in the future. The more accurate you can be with your projections, the more helpful your budget will be to you. The key to budgeting effectively is breaking down your cash flows into categories. We will start with expenses because they often get people into trouble if done incorrectly:



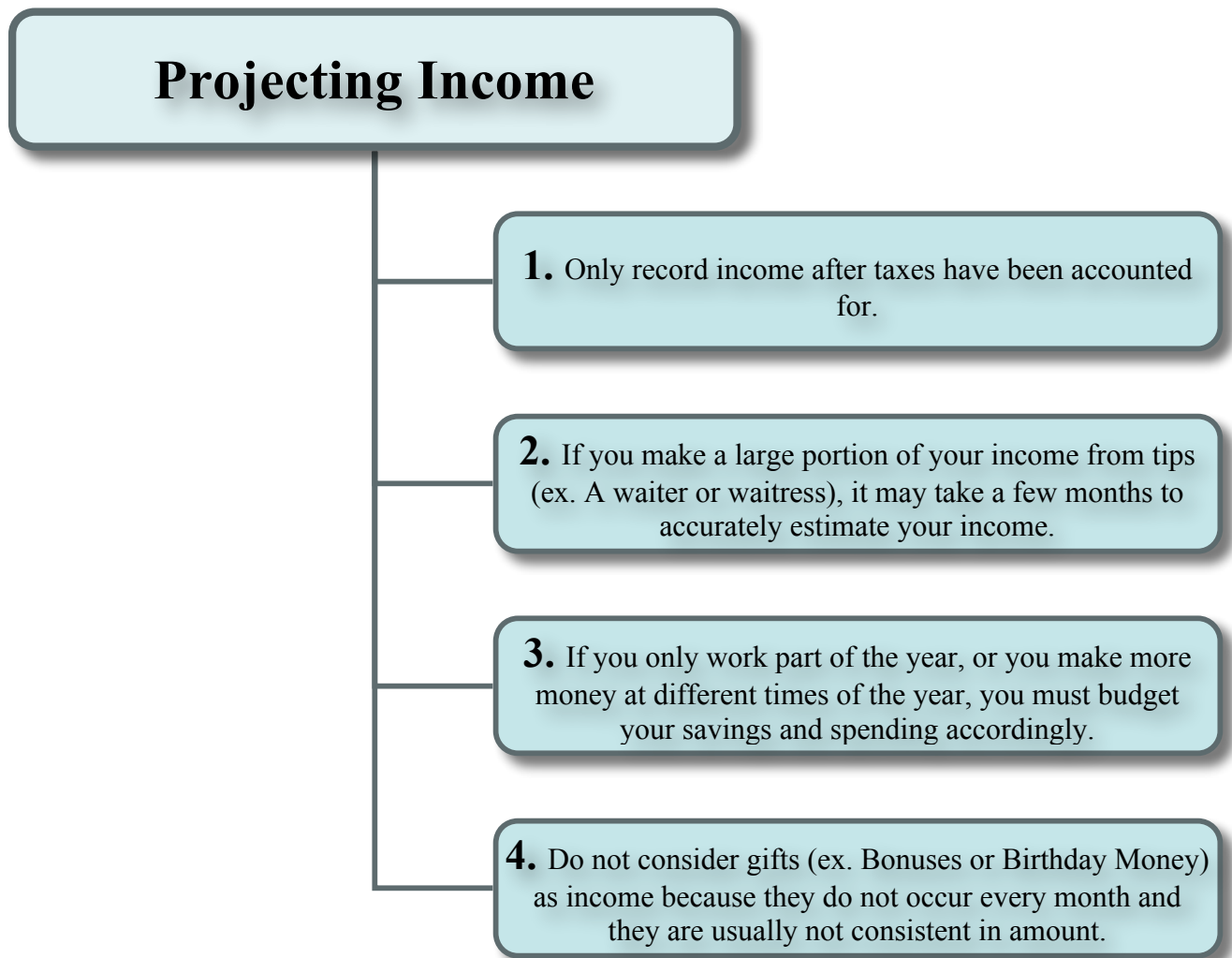
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In many cases financial planning is about planning for the worst and hoping for the best. Be conservative about your budget, anticipate that you will spend more than you think and make less money than you expect. If this is done correctly, and you are able to control your discretionary spending, you will have a surplus of money to be invested towards your long-term financial goals.

<sup>5</sup> (Little, *Personal Finance At Your Fingertips*, pg. 27)

After you are able to categorize your expenses, it is time to move on to your income. Projecting your income could be a very easy task or a very difficult one, depending on fluctuations in your work schedule from month to month. If you are paid regularly (ex. Every week or twice a month) and your work schedule stays the same each month, it will be easy to estimate how much you should make in the coming months. However, if you get paid every other week or your work schedule tends to fluctuate, it may take more practice to project your income for the future. Here are some simple tips on how to accurately estimate your income:



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<sup>6</sup> (Little, *Personal Finance Desk Reference*, pg. 45)

After you can effectively categorize your expenses and project your income, you can then begin to plan your budget. Ideally, you want to take a portion of your income before you plan for the month and put it towards your financial goals. This concept is called **paying yourself first**. You should also take another small portion of your income for the month and put it into an **emergency fund**. This is a cash reserve that is put aside and used only in emergencies, such as losing your job (going to the movies is *not* an example of an emergency). These two portions of your income do not have to be large, but they should be taken out every month.<sup>7</sup>

After this is done, you want to budget so that you have enough money left over, after considering your long term financial goals and your emergency fund, to cover your projected expenses. This may be difficult at first, but if this process is taken seriously you will be surprised at how much you can accomplish by saving a small amount each month through budgeting. Remember, budgeting is the easy part; it is sticking to your budget that can be tricky!

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<sup>7</sup> (Little, *Personal Finance At Your Fingertips*, pg. 22 and 39)

## Chapter 1.4: Controlling Debt and Building Credit

### Controlling Debt

Before we begin, consider the title of this section, *Controlling Debt and Building Credit*; and note that it was chosen for a very specific and important reason. The words *Controlling Debt* were used because many individuals view debt as something that is purely negative; and because of this they avoid incurring (taking on) any debt at all. As you read through this section and learn how to control your debt rather than avoid it, think about how debt can be both positive and negative. We will begin by talking about the different types of debt and then move on to building credit from this debt.

In general, an individual incurs **debt** to finance the purchase of an item. This may sound very complex, but it is actually very simple. The individual receives the item (whether it be clothing, a car, a house, a hamburger, etc.) immediately, and pays for the purchase later on plus interest (through a credit card, a loan, a payment plan, etc.). Debt allows us to pay for things we want and need, which may be difficult to save enough cash to pay for directly. A good example of this is a college education. You may not have enough money to pay for a college education immediately; however, debt allows you to go to college now and pay for it later, when you will be making more money.

Debt gives us the ability to purchase things we want and need immediately. This can be both a good thing and a bad thing, as mentioned before. It is very important that you learn the difference between good debt and bad debt as a young adult. A college education is an example of **good debt** because it raises your standard of living in the long run. Anything that you can benefit from over a long period of time (usually decades) can be considered good debt. On the other hand, **bad debt** is incurred when purchases are made that do not add long-term value to your life. These purchases (clothes, mp3 players, video games, jewelry, etc.) may bring happiness to your life in the short-run, but they do not offer the long-term value or benefit that a college education would.<sup>8</sup>



While Credit cards are the most popular way of incurring debt, they are not the only way. Debt is incurred with any type of loan whether it be to pay off a car, a house, or something simpler, such as an article of clothing. All debt is not created equal, you want to try and avoid bad debt and incur as much good debt as possible, as long as you can afford to make the payments! Defaulting (not being able to pay), is always bad, whether it is on good debt or bad debt.

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<sup>8</sup> (Little, *Personal Finance Desk Reference*, pg. 364-5)

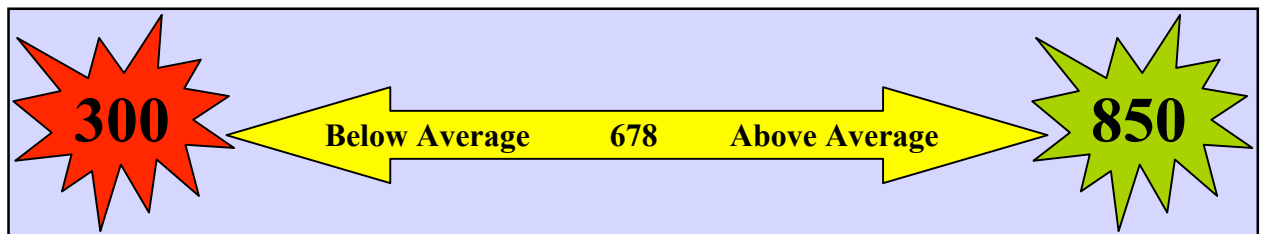
## Building Credit

The amount, and type, of debt an individual has can be used to build credit. Like debt, an individual can have good credit and bad credit. It all depends on a very important number called your FICO Credit Score. It is crucial that you understand what a credit score is and the factors that affect your credit score as a young adult because it can have a significant impact on your life.



### What is a FICO Score?

This refers to an individual's Fair Isaac Corporation credit score, or simply just credit score. A **credit score** is important in evaluating how financially responsible an individual is. It tells lenders, employers, and others how risky you are from a financial perspective. You have probably seen commercials that mention credit scores and how to check them. The Fair Isaac Corporation calculates credit scores for everyone that range from 300 to 850. The higher your score, the more likely you are to receive financing opportunities (the ability to pay off purchases over time), loans, home mortgages or even jobs.

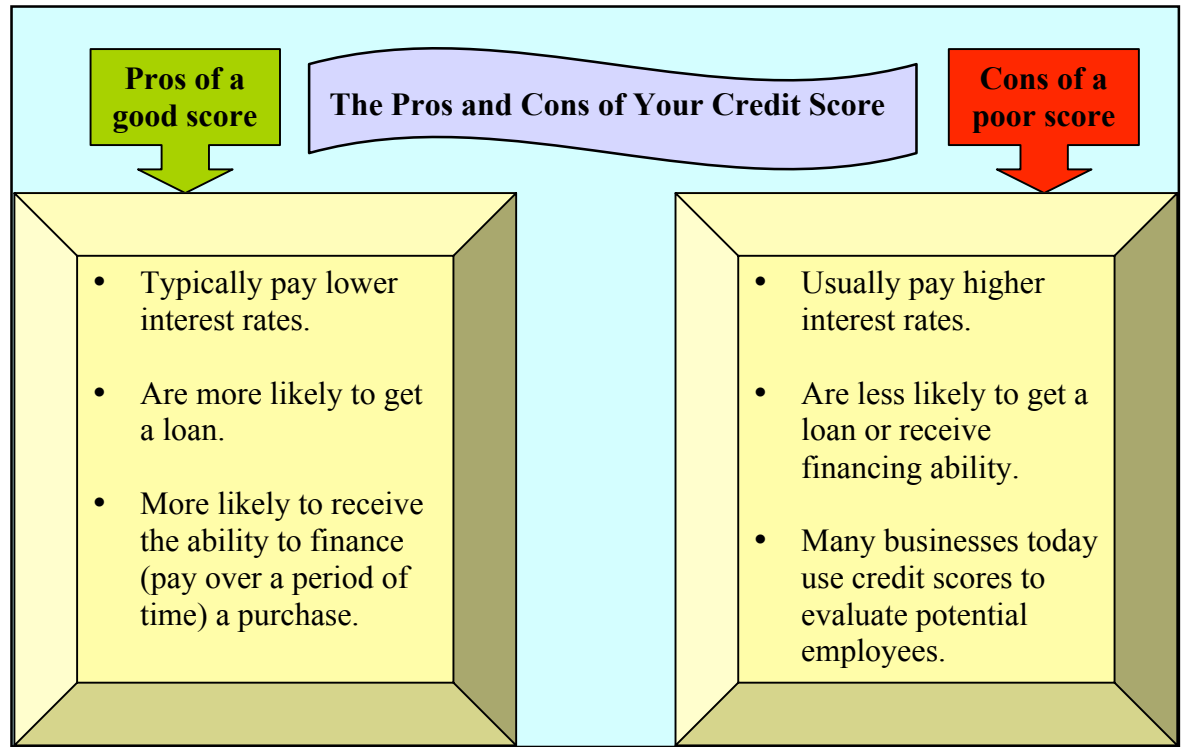


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This gives credit card companies, banks, car salesmen, future employers and other establishments an idea of your borrowing habits and allows them to better calculate the risk of lending you money. Today, credit scores are evaluated very frequently and they are more important than ever. This is why you must learn what impacts your credit score, and some steps you can take to make it better. The higher your credit score, the more financial opportunities you will have throughout your life. Positive and negative examples of having a good and poor credit score can be found in the model on the following page:

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<sup>9</sup> (Franklin, 2007, *Debt*)

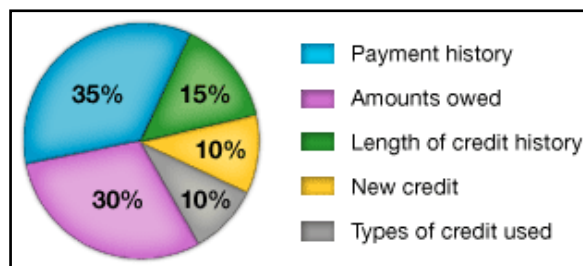


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## What Goes Into a Credit Score?

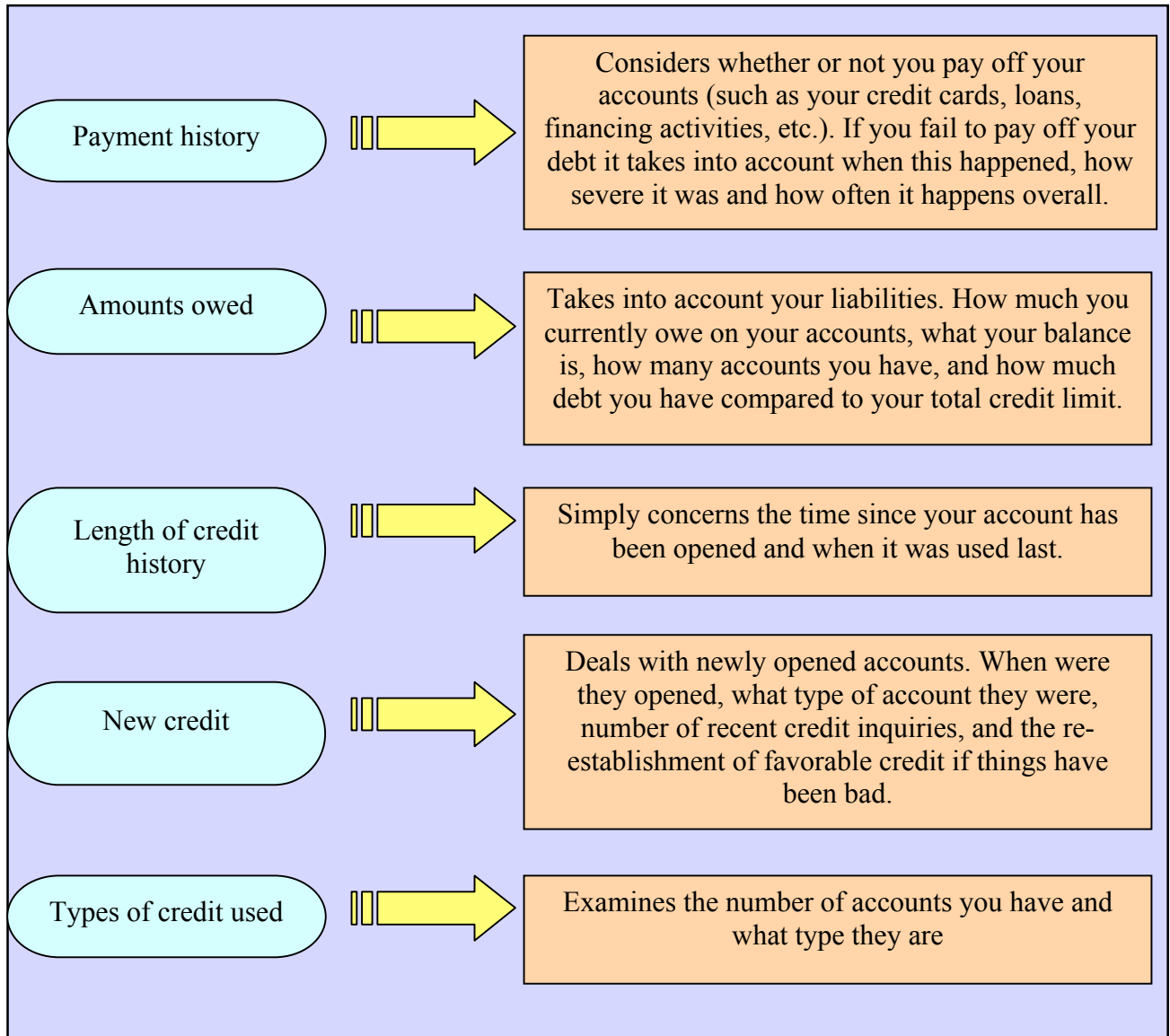
Credit scores can be confusing because there are many things that one would think impact the score that actually do not; and also many things that are believed to be unimportant that actually alter the score severely. As we discussed before, debt is very important to your credit score. While it is not the only factor that makes up an individual's credit score, it is one of the more controllable. The FICO credit score is calculated the following way:



<sup>10</sup> (Franklin, 2007, *Debt*)



Below is a model that explains what each factor is in more detail and how you can improve your overall score:



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Some of these factors may sound a little strange, but they have been tested to calculate how financially risky an individual tends to behave. You should keep this model in mind when considering your credit situation. An additional table is provided on the following page explaining some other things that impact your credit score that may have been overlooked:

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<sup>11</sup> (myFICO.com, 2001-2009)

Past Credit History	The most heavily weighted item. No amounts-past-due disputes, charge-offs, bankruptcy to obtain high scores. In other words, it is not good enough to pay off your debt; you must repay it on time to receive a high score.
Married	Higher score
Two wage earners	Higher score
Age	Being young or old gives you a lower score
Children	Higher score
Job	The more skilled the job, the more stable it is, the higher the score.
Years at job	The longer, the higher the score
Having account book requesting loan	Higher score
Years at current residence	The longer, the higher the score
Years at previous residence	The longer, the higher the score
Current Debt Obligations	The lower the amount, the higher the score
Favorable credit history	
-At bank granting loan	-Very favorable for score
-At any bank	-Favorable for score

You must remember that when dealing with credit you have to think of it in terms of the person giving you the credit. This is especially true when first establishing your credit (your first credit card in college or high school). When first establishing, you do not necessarily want to pay everything off on time. It is good to pay more than the minimum payment but less than the full amount once or twice and incur the interest in the next month in order to show financial responsibility. In fact, if you pay the full amount on time every month, you are what is called a 'deadbeat' and this may not help your credit score at all. It is very important that this concept is not confused with paying your minimum payment. You should always cover your minimum payment every month in order to keep your credit score from dropping, and in many situations it may not be good to incur a large amount of interest depending on your financial situation .<sup>12</sup>

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<sup>12</sup> (Franklin, 2007, *Debt*)

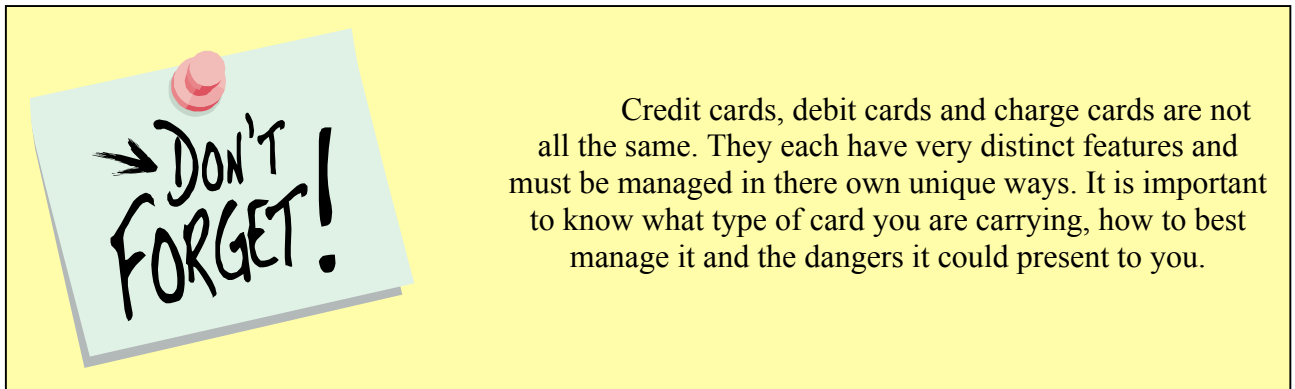
## Chapter 1.5: Paying with Plastic

Although credit cards were spoken about briefly at the end of the previous section, they are so important to young adults that it is beneficial to go over them in more detail. Many young adults have gotten into trouble by not understanding the conditions of credit cards, or using them irresponsibly.

Picture this disturbing credit card scenario: You are an entering freshman at a well-known university. You are excited to learn material that interests you and plan for your future career and life. You arrive at school, and all the incoming freshmen are out on the quad enjoying what is left of the summer before the upper class students arrive at campus.

During this exciting opening weekend convention you learn about a company that can do you laundry for you, a club sports team that you can join, and a credit card that you can open to earn points to travel during spring break. You take advantage of all of these options and on that credit card you charge one meal. However, you were caught up in the rush of opening weekend; and for one reason or another you do not remember that meal that you charged at 2:00 AM. You go on to be a successful college student who never uses the card again.

You are now a senior and looking forward to pursue your dreams only to realize that you are unable to get a job, buy a car or get a loan because of your horrendous credit score, not to mention the severe amount of debt you will have as a result of not paying for your purchase. Although it may sound farfetched, high school and college students very often find themselves in similar situations because they are unable to manage their credit cards properly. It is important to learn the functions of a credit card, the terms that credit companies' use, and how to properly manage your credit purchases. We will begin with the credit card and then move on to debit and charge cards.



### Credit Cards

The best way to think of credit cards is to look at them as a short-term loan. You are able to purchase an item now, but you must pay off the purchase, plus interest, later on. They work on a concept called **revolving credit**. You are given a limit and as you charge and pay off your balance, the credit replenishes itself automatically. The limit that the credit card issuers allow you to charge up to is called your **credit limit** (this could be any amount, but it is usually under \$5,000 if you are just starting out). Your credit score and your spending history determine your

credit limit. You can ask for an increase on your credit limit by contacting the company; however, you may not always receive this privilege. If you charge more than your credit limit you may be charged a fee depending on how far over the limit you are; or they may not allow the charge to go through at all.<sup>13</sup>

## Usage

Credit card companies make using a credit card extremely easy on purpose in order to make a profit. From the consumer's perspective, you make a purchase with a credit card and pay it off over time in addition to interest charges. These days, many credit cards can be set up online to make these transactions even easier.

This may sound like simple concept, but it is extremely easy to get into trouble. The credit card company gives you what is called a **minimum payment**. This is the very minimum you must pay for the current month's bill (this is usually lower than 5% of the total). This is what can get young adults confused. Many people think that it is acceptable to pay the minimum payment each month; however, this is exactly what the credit card companies want you to think. Because the minimum payment is such a small fraction of the total bill, the interest charges pile up from month to month and you end up paying much more than you intended to for your purchase.<sup>14</sup> "You'll never pay off your credit card debt if you keep charging on your card and make only the minimum monthly payments. Interest continues to pile up on your outstanding debt. Paying only the minimum monthly payments could lead to your carrying high-interest debt on your card for decades (not just months or years!)"<sup>15</sup>

You want to pay as much as you possibly can (if not the entire balance) each month so that you do not have to pay more in interest charges. Now, I know earlier I said, when you are first establishing your credit, you do not necessarily want to pay the entire balance off on time. It is good to pay more than the minimum payment but less than the full amount once or twice and incur the interest in the next month in order to show financial responsibility. This is still true as long as it is done responsibly, not because you are unable to the full amount, but because you are trying to build your credit. This should also only be done once or twice when you are just starting out in order to build credit, not repeatedly throughout your life.



Remember; do ***not*** confuse this concept with paying your minimum balance. You always want to cover your minimum balance so that you do not get hit with fees and hurt your credit score. This should only be done once or twice when you are first building credit.

<sup>13</sup> (Little, *Personal Finance At Your Fingertips*, 77)

<sup>14</sup> (Little, *Personal Finance Desk Reference*, 377)

<sup>15</sup> (Tyson, 2006, 45)

## Shopping for a Credit Card

When you are shopping for a credit card there are a few things to remember. The first is that you should look for the card with the lowest interest rate (or **APR**, Annual Percentage Rate). This is because the rate controls how much you will be charged on your balance from month to month, the higher the rate, the more you will be charged on your balance. Remember that banks and other institutions issue credit cards not Visa or MasterCard. Therefore, they control the interest rates. So if you get a rate from one bank on a Visa card, do not think that this will be the same rate on any other Visa card. While it may be close, it really depends on the bank that is issuing the card to you.<sup>16</sup>

The second thing you should keep in mind when shopping for a credit card is how the issuer calculates the interest charges. This may sound like the same thing as in the last paragraph but it is actually very different. This refers to the way in which the issuer calculates the interest rather than the interest rate itself. This is easy to understand when you observe the two different methods:

### How they do it...

1. **Single Monthly Cycle**- In this method, the issuer considers your average daily balance (the average amount that you have yet to pay off) over a single month. If you make a payment but do not pay the entire balance, the remainder is carried over to the following month and is used to calculate the interest charge for that month (the balance x APR).
2. **Double Monthly Cycle**- In this method the issuer considers your average daily balance through two months instead of just one. This means that the issuer does not recognize a payment until the amount is entirely paid off. So if you only pay off part of your balance, the total amount (instead of just the unpaid amount as in the previous method) is carried over into the second month and is used to calculate the interest. Since they are using the total amount in the second month, there will be a larger interest charge.

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This may be difficult to understand at first, please consider the following example:

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<sup>16</sup> (Little, *Personal Finance Desk Reference*, 372)

<sup>17</sup> (Little, *Personal Finance Desk Reference*, 376)

You buy a bike for \$100 on your credit card and your monthly interest rate is 10% (which is a very high monthly rate for the purpose of this example). The first month you pay off \$75 (carrying over a \$25 balance from one month to the next) and the following month you pay off the remaining balance.

1. Using the Single Monthly Cycle- You would only have to pay \$2.50 ( $\$25 \times 10\%$ ) in interest for the second month. Making your balance in the second month \$27.50.
2. Using the Double Monthly Cycle- You would have to pay \$10.00 ( $\$100 \times 10\%$ ) in interest in the second month, making your balance \$35.00

This may seem like an insignificant difference, but consider this example over a long period of time and with much a much larger purchase. As you can see, a credit card that calculates the interest using the single monthly cycle is more beneficial to you. You should consider many different options and evaluate the different fees and systems that each card offers. Many people get into trouble by charging a small amount each week on family dinners or entertainment and not repaying the debt. It may help to get a card that can be managed online to ensure you can access your information easily. The most important tip is to stay on top of it, and not get behind in your payments.<sup>18</sup>

## Debit Cards

Once you understand credit cards, it is easier to see the differences between them and debit cards. Debit cards are especially good for young adults because they provide all the conveniences and ease of payment of credit cards, but you do not have to worry about getting into debt or interest charges. This is because they are similar to writing a check. When you make a purchase with a debit card the money is transferred out of your account immediately (within a few business days), rather than having to pay for the purchase at the end of the month as with a credit card. This is beneficial because you do not have to worry about paying a bill at the end of the month and it is harder to spend more than you have.



This sounds like the perfect scenario; however, you must be careful and monitor how much money you have in your account as to not get hit with an **overdraft fee** (a fee charged when you spend more than what you have in your account). These can be very dangerous because you often do not get notified and are not even aware that anything is wrong...so you continue to spend.

<sup>18</sup> (Franklin, 2007, *Credit Planning*)

## Charge Cards

The final piece of plastic you should know about is the charge card. While the terms *charge card* and *credit card* are often used interchangeably, they are actually very different cards. The largest difference between the two is that charge cards do not allow you a line of credit. In other words, when the bill comes at the end of the month you are expected to pay the total amount. Because there is no unpaid balance being carried over from one month to the next, charge cards do not charge interest.<sup>19</sup>

Another difference between a charge card and a credit card is that charge cards usually charge annual fees. These fees may be worth it when you move on to adulthood because they often come with many perks for businessmen and reward schemes. However, for a young adult, these fees (which can often be very expensive) are usually not worth it.<sup>20</sup>

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<sup>19</sup> (Little, *Personal Finance Desk Reference*, 383)

<sup>20</sup> (Little, *Personal Finance Desk Reference*, 383)

## Section 2: Strategies for Adults

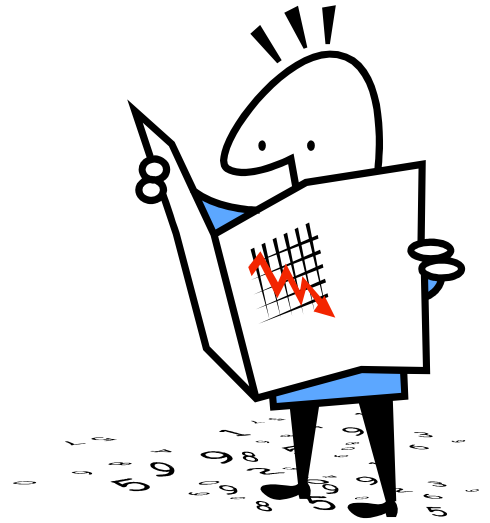




## Section 2 Overview

### Chapters:

- 2.1 Taxes
- 2.2 Investing
- 2.3 Education Planning
- 2.4 Owning a Home



Section Goals- To understand the financial responsibilities of an adult during the mid-life period and how to prepare for the transition into old age.



## Before We Begin

This chapter deals with the financial responsibilities of adults during the pre-retirement period. I have placed *Retirement Planning* and *Insurance Planning* in *Section 3- Strategies for Old Age* because this is when those strategies typically get put to use. However, the reader should note that adulthood is the time to begin planning for retirement and insurance matters!

### Chapter 2.1: Taxes

You may have heard the phrase, “The only things you can count on in life are death and taxes”. As you transition into adulthood and gain more financial responsibility, it may seem as if taxes are an everyday occurrence. In fact, the average American family gives up about a third of their income to tax each year.<sup>21</sup> Every facet of the financial plan has tax implications that must be managed in order to save money. However, with the complex nature of the tax code, it may be difficult to understand and take advantage of the rules. This is why many individuals count on **CPAs** (Certified Public Accountants) to manage their taxes for them. Having a good CPA working to manage your taxes can save you an incredible amount of time and money during tax season. Despite this, it is also beneficial for the average person to learn about the tax code and how their taxes are calculated in order to better understand where their money is going and why. Before we get started, you should note that the information presented in this chapter deals with federal taxation; you must also consider other forms of taxation (such as state and local taxes) when analyzing your tax situation. In most cases, individuals file their taxes using the IRS **Form 1040**. Observe the federal tax brackets for a single individual below:

If taxable income is over--	But not over--	The tax is:
\$0	\$7,550	10% of every dollar over \$0
\$7,550	\$30,650	\$755 plus 15% of the amount over 7,550
\$30,650	\$74,200	\$4,220.00 plus 25% of the amount over 30,650
\$74,200	\$154,800	\$15,107.50 plus 28% of the amount over 74,200
\$154,800	\$336,550	\$37,675.50 plus 33% of the amount over 154,800
\$336,550	no limit	\$97,653.00 plus 35% of the amount over 336,550

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<sup>21</sup> (Franklin, 2007, *Tax Planning*)

<sup>22</sup> (Internal Revenue Service, 2008, *Federal Tax Rates*)

At first, this table can be very confusing; but it is actually quite simple. It is used, along with Form 1040 to calculate the amount owed in taxes each year. The first \$7,550 you make during the year will be taxed at 10%. The next \$23,100 (\$30,650 - \$7,550) you make will be taxed at 15%. This includes everything you make over \$7,550 (because that has already been taxed) and under \$30,650 (because that is taxed at a higher rate. For every dollar you make over \$30,650 but under \$74,200, you will have to pay a 25% tax on; and so on and so forth. This may be a difficult scenario to work out in your head, but try to understand the following example:

Assume you are a single person who has made \$100,000 in taxable income in the past year:

1. The first \$7,550 will be taxed at 10%
  - $\$7,550 \times 10\% = \$755$
2. The next \$23,100 (\$30,650 - \$7,550) will be taxed at 15%
  - $\$23,100 \times 15\% = \$3,465$
3. The next \$43,550 (\$74,200 - \$30,650) will be taxed at 25%
  - $\$43,550 \times 25\% = \$10,887.50$
4. And the final \$25,800 (\$100,000 - \$74,200) will be taxed at 28%
  - $\$25,800 \times 28\% = \$7,224$
5. To find the total amount, you must add all the results together
  - $\$755 + \$3,465 + \$10,887.50 + \$7,224 = \mathbf{\$22,331.50}$

This means that you will be paying \$22,331.50 in taxes at the end of the year. The more you make, the more you will have to pay in taxes because the higher your **marginal tax bracket** will be. The marginal tax bracket is the highest rate your money is taxed on. In other words, it is the rate at which your last dollar is taxed on. In the previous example your marginal tax rate was 28% because this is the highest bracket you reached. The more you make, the higher your **average tax bracket** will be as well. Your average tax bracket is the overall average rate that you are paying in taxes. This can be found by dividing the total amount you paid in taxes by your taxable income (Average Tax Rate = Total Paid in Taxes / Taxable Income). In the previous example, your average tax rate was .223 or 22.3%. This was the overall average rate that you were taxed ( $22,331.50 / 100,000 = .223$ ).

## A Little More...

You can calculate how much you will have to pay in taxes from the previous example much faster using the information from the tax bracket table:

You are still a single person who has made \$100,000 in taxable income the past year:

➤ \$15,107.50 plus 28% of the amount over \$74,200 (this was found in the tax bracket table)

1. Since you made \$25,800 over \$74,200 (\$100,000 – \$74,200):

- $\$25,800 \times 28\% = \$7,224$

- $\$15,107.50 + \$7,224 = \mathbf{\$22,331.50}$

When calculating this way, be sure to choose the correct line in the tax bracket table or else you will not get the correct result. I retrieved the above information from line four because your income was \$100,000 which falls between \$74,200 and \$154,800.

Try and calculate how much you will pay in taxes if you make \$200,000....

As complicated as the last example may have been for you to understand, taxes would be a piece of cake if they were this easy. Unfortunately, they are much more complex. In fact, they are so complex that entire college courses are devoted to understanding and taking advantage of the tax code. For the remainder of the chapter, I will attempt to explain some other basic tax principles that you should be aware of as a financially responsible individual.

You may have observed in the previous examples I have used the term taxable income. This is very important because it takes a large amount of work to arrive at this taxable figure. In general, tax planning is focused on lowering your **taxable income**, or the money that you must pay taxes on, as much as possible. In general, this is done through adjustments, deductions, exemptions and credits. Let us take a look at this process a little more closely.

## Adjustments

Adjustments are the first step to minimizing your taxable income. You start with your **gross income**, or the total amount you earned before taxes, and you add or subtract your adjustments to calculate your **adjusted gross income (AGI)**.<sup>23</sup> You must add in any interest, money you have made through investments (stocks, bonds, etc.) and money you have made in other places (winning the lottery, gifts, etc.). However, it is more beneficial to lower your AGI by subtracting adjustments. You are able to subtract in several instances; observe the following examples:

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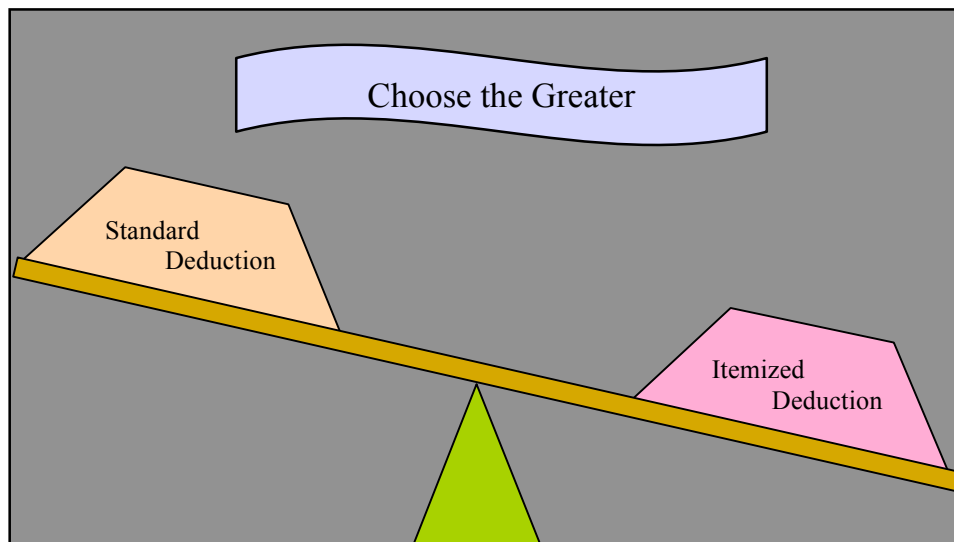
<sup>23</sup> (Franklin, 2007, *Tax Planning*)

## Beneficial Adjustments

- Any money you have paid into a retirement account
  - Any alimony paid
- Half of what you paid due to self-employment taxes
- Any penalties you may have paid for taking money out of savings too early

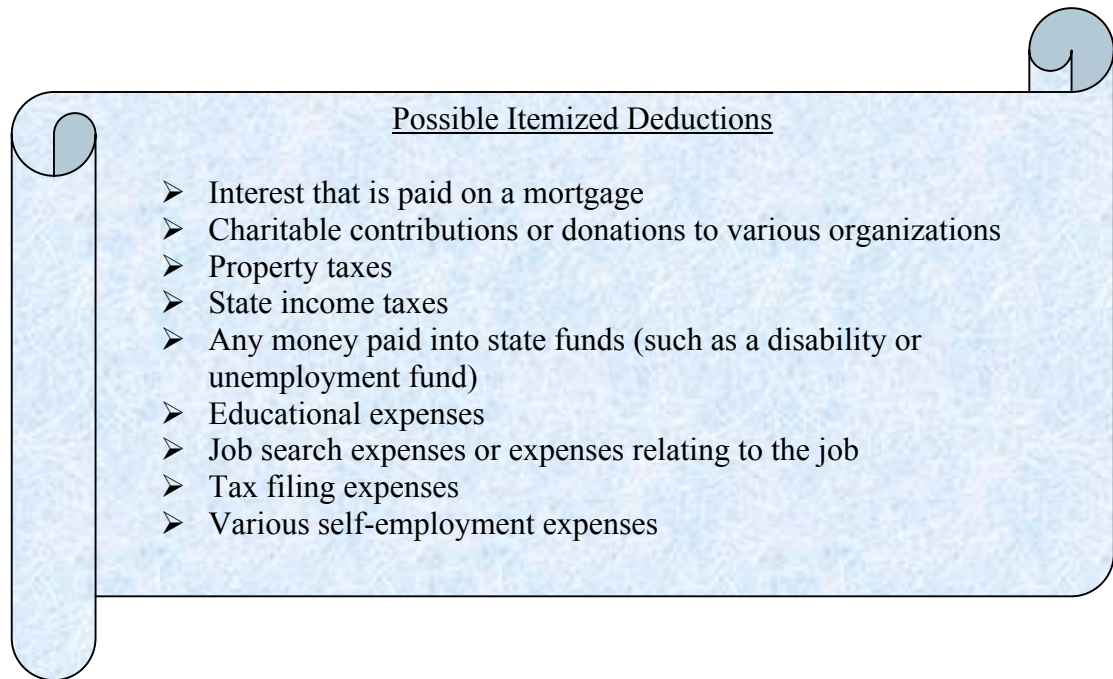
## Deductions

The next step in reducing your taxable income is through deductions. They can be slightly more complex than adjustments; however, they generally serve the same purpose. The trick with deductions is that you must choose between the **standard deduction**, which is a set amount based on your financial position that is determined by the government, and **itemized deductions**, which involves calculating your deductions based on certain expenses throughout the year. In general, you want to “write off”, or list, as many deductions as possible when itemizing in order to lower your taxes. The government allows you to choose between the standard deduction and itemizing your deductions. This can be done by calculating your itemized deductions. If this amount is greater than the standard deduction, it is to your benefit to itemize your deductions. However, if the standard deduction is greater (which will be true for individuals who do not have many itemized deductions to write off), it is to your benefit to claim the standard deduction.<sup>24</sup>



<sup>24</sup> (Little, *Personal Finance Desk Reference*, 587)

Now that you understand how to choose between the standard deduction and itemizing your deductions, it is time to consider what expenses fall under the itemization category. The framework used to itemize deductions when filing taxes under Form 1040 is called the **Schedule A**. You may be surprised to learn that there are actually a great number of expenses that can be listed as itemized deductions. The largest of these for homeowners is usually the throughout the year. This and some others are listed in the diagram below:



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It is important to verify that these deductions are applicable to you through research and professional assistance. However, it is clear to see how you may be able to benefit by itemizing your deductions rather than taking the standard deduction, depending on your financial situation.

## Exemptions

Exemptions are possibly the most straightforward step in the tax filing process. Exemptions take into consideration the number of people who rely on the income earned by the individual filing taxes. Because these people rely, or depend on the income earner, they are called **dependents**. They can be any member of the household or relative who depends on the income for over 50% of their living costs and earns less than a certain amount of income. This also refers to any children (under age 19) or full-time students (under age 24). Like the standard deduction, exemptions are a fixed amount set by the government based on the number of dependents. The more dependents that are claimed, the greater the exemption and therefore the lower your taxes will be.<sup>26</sup>

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<sup>25</sup> (Tyson, 2006, 135-138)

<sup>26</sup> (Altfest, 2007, 405)

## Credits

Credits are slightly different than adjustments, deductions or exemptions because they can be a more powerful way to reduce taxes. This is because credits are actually a dollar for dollar reduction after you have calculated the amount owed (after you have considered your marginal tax rate).<sup>27</sup> This is explained more thoroughly in the example below:

### The Power of Credits

Assume you have an adjustment, deduction or exemption worth \$1,000 off your taxes and you have made \$30,000 in income before adjustments.

You would subtract the \$1,000 (giving you \$29,000 in taxable income) before calculating your tax rate and computing the taxes owed:

- $\$755 + [15\% \times (\$29,000 - \$7,550)] = \mathbf{\$3,972.50 \text{ owed}}$

However, with credits, you subtract the credit after computing the taxes owed making the savings dollar for dollar. Let's assume you have the same \$1,000 reduction in the form of a credit:

- $\$755 + [15\% \times (\$30,000 - \$7,550)] = \$4,122.50$
- $\$4,122.50 - \$1,000 = \mathbf{\$3,122.50 \text{ owed}}$

As you can see credits can be pretty powerful opportunities to save on taxes. Knowing this, you should also be knowledgeable of some popular credits to take advantage of. These include: credits for expenses related to child or dependent care, education, child tax, adoption, or earned income credits.<sup>28</sup>

<sup>27</sup> (Altfest, 2007, 406)

<sup>28</sup> (Franklin, 2007, *Tax Planning*)

## Chapter 2.2: Investing

Investing is a very important piece of the financial plan. It is the vehicle that allows your money to grow and gives you the ability to reach your financial goals. Good investment decisions can expedite the financial planning process, allowing you to reach your goals more quickly and efficiently. However, investing poorly could cause you to lose everything, which could be detrimental to you and your family. This is why the investment industry is so large and those working in it are paid so handsomely.

An **investment** is, "...any vehicle into which funds can be placed with the expectation that it will generate positive income and /or preserve or increase its value".<sup>29</sup> There are a countless number of different investments that are available to you as a financially responsible individual. It is important to consider all available options in order to find the investment that is right for you.



Some investments can get so complex that they may be considered unsafe for the uninformed individual. In addition to this, you must also be mindful of possible investment scams that are out there. This is why there are so many professional analysts who are willing to help the average investor in exchange for a fee. If you are ever unsure of an investment, it is very important that you seek the help of a professional, or at least an investment savvy friend who you trust.

There are many things to consider when deciding between investments. Simply throwing money into the stock market with the hope of it appreciating in value is not the best investment plan. The average investor must understand that there are many other options that should be considered in addition to the stock market when putting together an investment portfolio. An investment **portfolio** refers to a number of investments that an individual holds (or has decided to invest in). This portfolio must be carefully put together; perhaps the most common mistake made by the average investor is the lack of proper diversification. **Diversification** involves spreading your money into a number of different investments in an attempt to increase your returns or decrease your chances of a loss.<sup>30</sup> The idea is, if you spread your money into a number of different investment vehicles, you will be safer if one of those vehicles fails. If you put all your money into one place and it turns out to be a poor investment, you will be in serious danger of losing everything.

Now that we have established it is safer to spread your money into several different investments rather than putting it all in one vehicle, let's go over the components of an investment vehicle. Investments have certain attributes that make one different from another. It is important that investors understand how changes in these attributes change the overall investment. The following box explains several elements that all investments contain:

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<sup>29</sup> (Gitman and Joehnk, *Fundamentals of Investing*, 3)

<sup>30</sup> (Gitman and Joehnk, *Fundamentals of Investing*, 14)





## Parts of an Investment

1. **Risk**- All investments contain some level of risk. This refers to the chance that you could lose the money put into the investment. Some investments can be very risky (or contain a high level of risk), which means that you have a greater chance of losing the money you put in, compared to other investment options. However, some investments contain very low levels of risk, which correlates to a low probability of loss (or less of a chance that you will lose the money you put in, compared to other investments). It is often hard to calculate risk, which can make investing difficult for the average individual.
2. **Return**- Investments also contain some amount of return. This is the additional money received or lost after the investment ends or is terminated. In other words, it is the income you receive while holding the investment, plus what is received from the sale of the investment (called the **capital gain**). Ideally investors want a large positive return (more money received than was initially put in). However, very often returns can be small or negative.
3. **Price**- Most investments have a price that you must pay in order to undertake the investment. This could be the price of a share of stock, the price of a bond, the minimum amount that must be put into a certain investment account, etc.
4. **Time**- Investments are typically measured over a period of time. An investment could be completed in less than a day or as long as several decades. Long-term investments are usually held over several years while short-term investments are less than one year. Some investments, such as common stock, allow the buyer to control when the investment is terminated. However, other investments require an investment over a fixed time period. It is very important to know and understand these restrictions before making the investment.

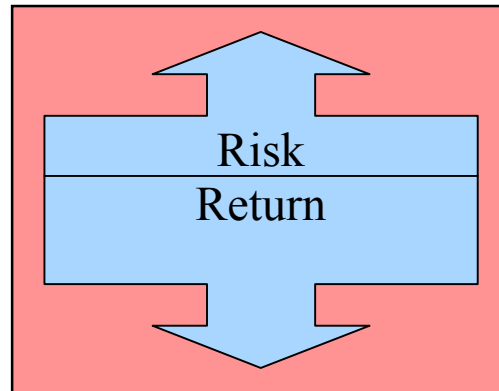
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Each of these individual parts often impacts the others. In general, there are certain tradeoffs or relationships that the investor should be aware of before considering any investment. The first relationship is between risk and return. In general, the riskier an investment is, the greater the potential return. Similarly, if an investment is less risky, there is a smaller potential return. In other words, these parts are positively correlated; they both move in the same

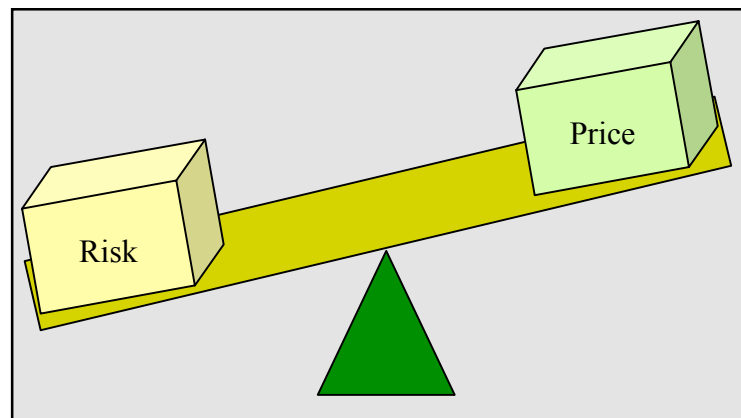
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<sup>31</sup> (Franklin, 2007, *Investing*)

direction.<sup>32</sup> This can be thought of as two parts of a single arrow that can move up or down, as displayed in the following visual:



The next relationship is a tradeoff between risk and price. In general, as an investment increases in risk compared to other investments, it decreases in price compared to other investments as well. In contrast, as an investment decreases in risk compared to other investments, it increases in price compared to other investments as well. This can be described as a negative correlation between price and risk. In other words, price and risk move in opposite directions.<sup>33</sup> They can be thought of as two boxes on a see-saw as displayed in the following visual:



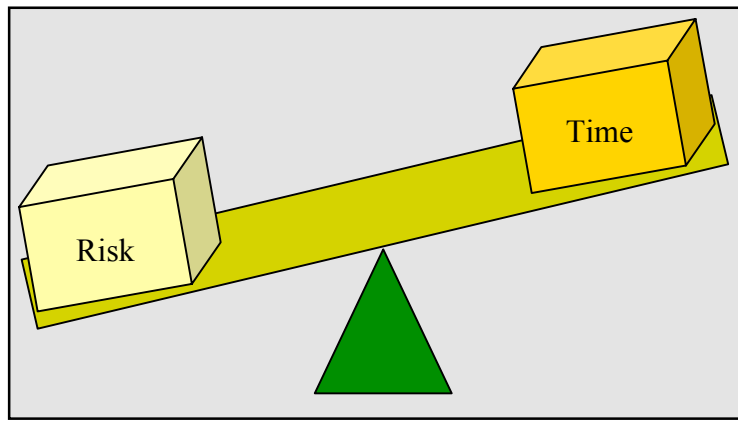
The next relationship is very similar to the previous tradeoff relationship; however, it is between risk and time. In general, as the time period of an investment increases (it becomes more long-term), the risk of the investment declines. The more short-term the investment, the riskier it becomes as well. As in the last example, this is described as a negative correlation between time and risk; time and risk move in opposite directions.<sup>34</sup> This relationship can also be conceptualized as two boxes on a see-saw:

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<sup>32</sup> (Little, *Personal Finance Desk Reference*, 447)

<sup>33</sup> (Little, *Personal Finance Desk Reference*, 449)

<sup>34</sup> (Little, *Personal Finance Desk Reference*, 444)



Now that you understand the parts of an investment and the relationships between these parts, you can begin to consider which investment is right for you.



During your research, it is important to consider age, risk tolerance (or the amount of risk you wish to endure) and financial position (how much money you have in savings, how much income you make, where you expect to be several years from now, etc.). These factors are unique to every individual and are very important to think about when researching investment options.

When researching investments, you will quickly realize that there are an infinite number of possible options. We will now discuss several popular options that may be available to you as a financially responsible individual.



## Certificates of Deposit (CDs)

Certificates of deposit or CDs can be considered safe, short-term investments. They are special accounts that are set up by banks to give you a higher return on your money in exchange for locking it up with them for a longer period of time.<sup>35</sup> These accounts have predetermined time periods and offer predetermined rates of return. It is very easy to get a list of different CD options from a bank displaying all possible time frames and interest rates. They can even calculate how much your money will grow to by the end of the time period (although, you should be able to do this after reading *Chapter 1.2- The First Big Purchase*).

There are several important things to know about CDs before investing in one. The first, as said before, is that they are issued for predetermined time periods and offer predetermined interest rates. This is important because once you decide to invest in a CD there is often a penalty if you remove your money from the account before the scheduled time period ends. This time period could be as short as a few months or as long as several years. The second feature of CDs

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<sup>35</sup> (Little, *Personal Finance Desk Reference*, 206)

you must understand before investing is the concept of a minimum CD balance. Some accounts require a minimum investment in order to purchase them. This may limit your choices of which accounts you are eligible to pick from. The third thing that you must be aware of, regards the safety of the CD. Before investing in the CD, be sure to check if the account is covered by the **Federal Deposit Insurance Corporation (FDIC)**. If the CD or bank you wish to invest in, is not insured by the FDIC, you do not want to invest in it. The FDIC generally covers all CDs by reputable banks. In other words, if there is a bank failure and the bank that sold you your CD must go out of business, you will get your money back if the account is covered by the FDIC.<sup>36</sup> The final thing you must be aware of is the renewal terms of the account. These CDs often automatically renew after their time period is completed. This can be troublesome for an unaware investor who does not wish to renew the account upon completion.



## Treasury Bills (T-Bills)

Treasury bills are another form of a low risk, short-term, investment. They are issued by the U.S. Treasury to cover federal debts and obligations. This means that the only way they can be considered risky is if the federal government is in jeopardy and unable to pay them back, which is highly unlikely. They are also exempt from state and local taxes.<sup>37</sup>

They are bought on a **Secondary Market** or a place where instruments can be traded after they have been issued by an original entity (in this case the U.S. Treasury).<sup>38</sup> They have what is called a **Face Value**. This is the price that the U.S. Treasury will pay for the bill when it matures. This maturity date is specified in advance, giving the bill a fixed time period. After being issued, the bills are sold on the secondary market at a **Discount**. This is a price that is lower than the face value. Investors buy the bills at this discounted price and collect the face value upon maturity. The interest rate, or rate of return, can be calculated by the spread between the discounted price and the face value price collected at maturity. They differ from U.S. bonds because their maturity periods are less than three years.<sup>39</sup>



## Treasury Bonds

Treasury bonds are similar to T-Bills because they are also issued and backed by the U.S. Government. They provide a long-term, low risk investment that many individuals are attracted to. They can be bought for specific amounts and maturity periods that exceed 10 years. They also

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<sup>36</sup> (Little, *Personal Finance Desk Reference*, 199)

<sup>37</sup> (Little, *Personal Finance At Your Fingertips*, 305)

<sup>38</sup> (Gitman and Joehnk, *Fundamentals of Investing*, 40)

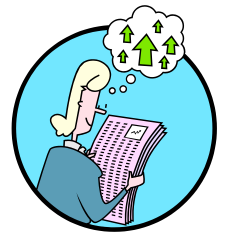
<sup>39</sup> (Little, *Personal Finance At Your Fingertips*, 307)

pay a specific interest rate semiannually. This can be beneficial for investors who desire a small portion of income during their investment time period. T-Bills and Treasury Bonds are very low risk compared to other investments. This means that they also offer lower returns compared to other investments because of the relationship between risk and return that was discussed before.<sup>40</sup>



## Corporate Bonds

Corporate bonds are bonds that are issued by corporations to fund projects and other debt. They differ in risk compared to corporate bonds because the federal government does not back them. This means that they can be considerably more risky. However, as we learned before, this also means that they can offer a greater return. For investors wishing to gain a better understanding of the risk involved in a certain corporate bond, ratings agencies rate each bonds risk compared to the others. This is very important when deciding between several different corporate bonds. However, it is also important to remember that the risks involved with corporate bonds will always be greater than with Treasury Bonds. This is because the companies that issue the bonds have a much higher chance of bankruptcy. There are several different types of corporate bonds that vary in structure and risk. Each type offers a different opportunity to the investor and each type should be considered as a potential investment.<sup>41</sup>



## Common Stock

When you buy common stock, you are effectively purchasing a **share** of a company. This share represents partial ownership of that company. This means that if there are one million shares of common stock available to buy, and you purchase one share, you own one millionth (1/1,000,000) of the company. These shares can be purchased through several exchanges such as the **NYSE** (New York Stock Exchange) or the **NASDAQ** (National Association of Securities Dealers Automated Quotations). You pay per share and the prices can usually be found in the newspaper or online.<sup>42</sup>

Once the share of stock is purchased, the investor decides when to sell it. This means that the share can be held for any period of time (as long as the company is still in existence). Some companies pay dividends to shareholders. A **dividend** is typically a small amount of money given to each shareholder based on how many shares they currently own. This is done by

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<sup>40</sup> (Little, *Personal Finance At Your Fingertips*, 309)

<sup>41</sup> (Little, *Personal Finance At Your Fingertips*, 309)

<sup>42</sup> (Gitman and Joehnk, *Fundamentals of Investing*, 9-10)

companies to entice future investment and thank current investors for owning their shares. In addition to this, money can be made, or lost, through the sale of the stock (capital gain or loss).<sup>43</sup>

It is important to note that even though common stock is the most popular investment vehicle today; it is particularly more risky than any of the previous investments we have discussed.<sup>44</sup> This is because the share prices have what is called a **market value**. This means that they go up or down based on what investors are willing to pay for them.<sup>45</sup> For instance, assume you buy one share of stock in a company called *Evan's Computers*. You purchase this share on Monday for \$10.00. This means that at that time, you own part of *Evan's Computers* that is worth \$10 if you wanted to immediately resell it. Let's assume that on Tuesday it is discovered that 50% of customers who bought computers from *Evan's Computers* are reporting problems with them. This announcement would cause the market value of a share of *Evan's Computers* stock to drop. This is because the company is not performing well and investors are not willing to pay as much for shares in a dysfunctional company. Let's say that this incident causes the price-per-share of *Evan's Computers*' common stock to drop to \$5.00. This means that the share of stock you bought on Monday for \$10.00 is now worth \$5.00 on Tuesday if you wanted to immediately sell it. This is a very general example of how the prices for shares of common stock can drop. These share prices can also rise based on information about the company or future plans of the company. In reality these movements happen continually throughout the day. This explains how purchasing a share of stock in a company can be a risky investment. After considering this, it is important to evaluate the size and reputation of the company, as well as the company's future goals and direction.



## Mutual Funds

Mutual funds can be a great way to diversify your investment. As we have discussed before, diversification can help to decrease the risks of overall losses or increase the chance of overall gains because money is spread into several different investments. A mutual fund is a company that acquires money from individual investors and puts it towards a diverse portfolio of investments (whether it be stocks, bonds, or any other form of investment). Because these mutual funds pool money from many small investors, they are able to invest in larger vehicles and diversify more than the average investor can. They are also managed by professionals, who decide the best use of the money at any given time. This means that the individual investor is free to think about other things besides constantly monitoring his investment.

However, mutual funds do come with some drawbacks. There are typically additional fees that investors must pay in exchange for the professional management. The individual investor also does not have the ability to choose which investments the fund should make. The fund manager makes all the investment decisions. Finally, even though shares in mutual funds are sold just like common stock shares, they may be more expensive or have other requirements

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<sup>43</sup> (Gitman and Joehnk, *Fundamentals of Investing*, 9-10)

<sup>44</sup> (Gitman and Joehnk, *Fundamentals of Investing*, 9-10)

<sup>45</sup> (Altfest, 2007, 5)

of purchase. Each mutual fund company typically offers a variety of different funds that range in risk and potential reward (such as high growth, long-term growth, etc.). Like common stock, it is important to evaluate the size and reputation of the company as well as the fees involved and past performance of the fund.

Believe it or not, there are an infinite number of variations to the investments we have discussed. In addition to this, there are many other investment options other than the ones mentioned in this chapter. The investment world can be a cold and ruthless place for the uninformed novice. This is why it must again be stressed that any prospective investor does substantial research and seek the proper outside guidance from trusted individuals.

## Chapter 2.3: Education Planning

As you grow older you continually gain more and more financial responsibilities. As we mentioned in Chapter 1.1, your financial plan should evolve much like your life evolves. You must consider changes in income, marital status, children, etc. You will find that many of your financial responsibilities as an adult are done out of love for your family and friends. Education planning falls under this category. It is done out of love for your children and a genuine respect for their educational goals.

With the increasing costs of higher education (college, graduate school, etc.) and the complexity of the many savings plans, education planning may seem like a daunting task. However, with a little research, it is easy to find a plan that best suits your needs and ambitions. In general, you want to save for education by choosing an option that both minimizes taxes and allows your money to grow over time. With financial aid, loans, and the various savings plans available, there is no shortage of options for you to consider. Before you make a rash decision, consider the following steps:

### **Education Planning:**

1. Establish your goals
2. Calculate the cost
3. Project the potential for financial aid
4. Estimate the total cost you will pay
5. Determine the optimal savings structure
6. Establish the investment policy
7. Estimate the required annual funding

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## Establishing Your Goals and Calculating the Cost

The most important thing to remember when establishing your goals and calculating approximately what it will cost you is that, ideally you want your child to be able to choose a school without having to worry about how expensive it is. This is why it is important to start early (usually years before your child is even close to attending college) and do as much research as possible. Four years of private university college costs around \$135,000 on average (2006); there are more expensive schools and state schools, which cost much less.<sup>47</sup> However, you want to research specific schools to get a better idea and also consider that the price will probably go up by the time your child is ready to attend.

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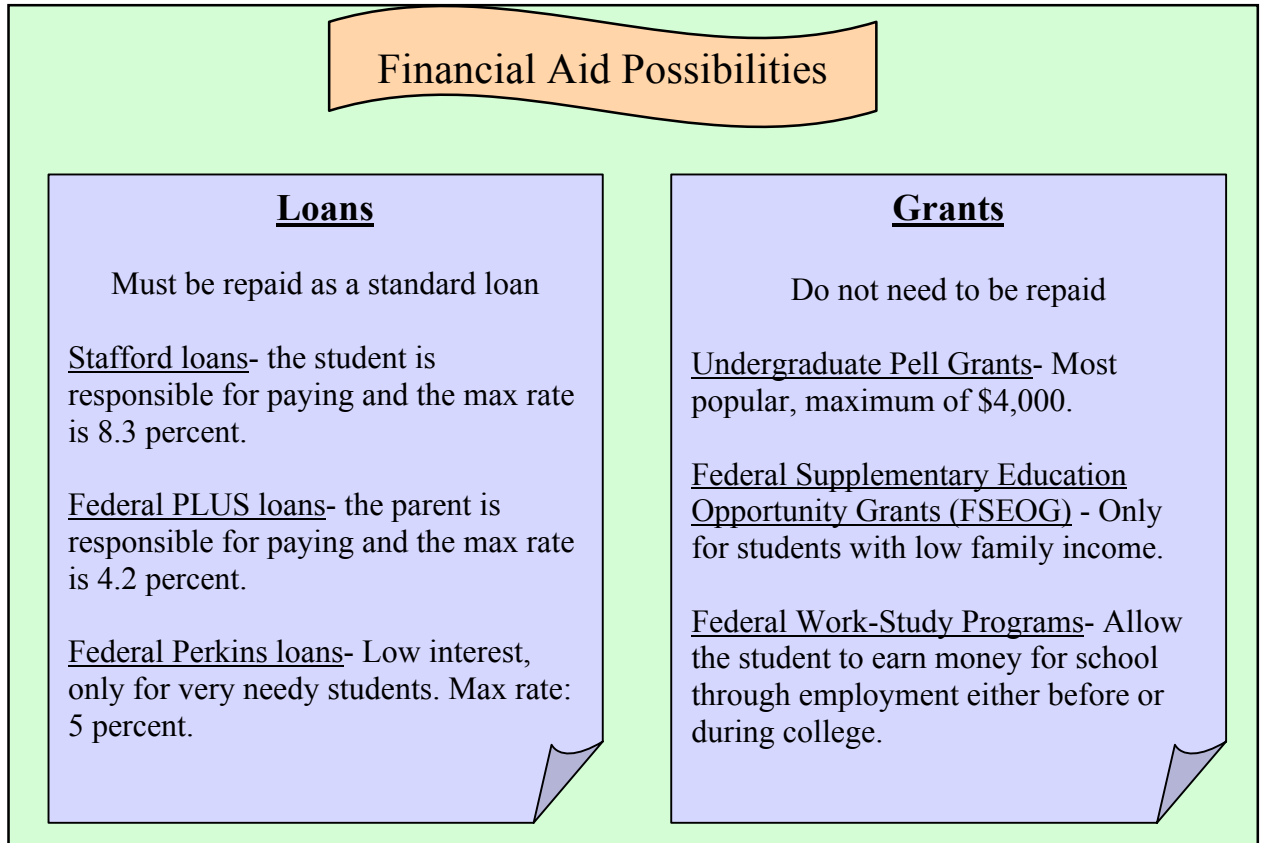
<sup>46</sup> (Altfest, 2007, 352)

<sup>47</sup> (Tyson, 2006, 259)



## Project the Potential for Financial Aid

Financial aid can be very helpful in paying for a collegiate education. However, it is not given to everyone. You must fill out a free application that analyzes your financial situation (income, assets, etc.); if you are considered financially strong, you will not be given financial aid because you will not need it (according to their analysis). However, if you qualify, you have the ability to receive grants and or loans.<sup>48</sup> Observe the following model to get a better idea of what financial aid offers you:




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It may sound difficult to make financial aid decisions when your child is so young and college is so far away. However, the earlier you start, the more you will have saved and the more ready you will be when the time comes. The loans provided through financial aid are often a better alternative to standard student loans through some other financial institution.


<sup>48</sup> (Tyson, 2006, 254)

<sup>49</sup> (Altfest, 2007, 354)



Remember to apply for other forms of funding, such as scholarships, when the time comes. Even after financial aid and other scholarships, there is usually a large remaining balance that must be paid. From here, you must decide how much of this balance you wish to pay and exactly how to save.

After you have projected approximately how much financial aid you are eligible to receive, you want to begin thinking of the total cost that you will pay. This is done by gathering the information from your previous college cost research, factoring in your financial aid results, and deciding whether or not to pay the remaining balance in full. Perhaps you will pay half or 75% of your child's education, giving them the responsibility of paying the rest through a work-study program or something similar. This can be an excellent way to teach them responsibility and the cost of a good education. On the other hand, if you are able to pay the total cost in full, and you value your child having more time for school rather than working, you may want to pay the total. Either way, you are making the decision to invest in your child's future success, which will be beneficial down the road.<sup>50</sup>



Don't make the mistake of underestimating the total cost. Remember that college prices are constantly rising. You must consider any changes in your financial situation that would impact your savings plan. Remember, plan for the worst and hope for the best.

## Determine the Optimal Savings Structure

The next step is to determine exactly how you are going to save. Like with financial aid, there are a variety of options for you to consider. Generally, you should be concerned with how your money will grow, whether or not there are any restrictions on how you can use the money and any tax ramifications that could occur. We will evaluate several savings structures so that you can determine the best option for you. This first of these being **Section 529 Plans**, which are displayed on the following page:

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<sup>50</sup> (Tyson, 2006, 258)

## Section 529 Plans

\$55,000 can be put into the account immediately to fund the first 5 years

Each provider can place \$11,000 into the account per year after that

Money grows tax free and can accumulate to more than \$200,000

Money used for education expenses can be taken out without getting taxed

You cannot control how the money is invested. It is usually managed by an investment provider

Contributions must be in cash

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Section 529 plans are offered through the state and can be very attractive. There is a prepaid plan, which allows you to buy credits for college at today's prices; and a general savings plan in which your money is invested in different mutual funds.<sup>52</sup> However, they may reduce the amount of financial aid received, which could be potentially unfavorable.<sup>53</sup>

The second type of plan is called a **Coverdell Education Savings Account**. This is a similar type of plan as the Section 529; however, there are some income limitations to be aware of. This means that if you make over a certain amount of money, you may not be able to contribute the full amount each year. The criteria of Coverdell Accounts are displayed in chart form on the following page:

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<sup>51</sup> (Tyson, 2006, 256-7)

<sup>52</sup> (Little, *Personal Finance Desk Reference*, 723)

<sup>53</sup> (Tyson, 2006, 256)

## Coverdell Accounts

\$2,000 per child can be contributed each year

You must make less than \$190,000 (or \$95,000 as a single filer) per year to make the full contribution

If you make \$190,000-\$220,000 (or \$95,000-\$110,000) per year you can make a smaller contribution

Your money grows and can be withdrawn tax-free as long as it is used for qualified education expenses

These accounts are set up with after-tax dollars

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As you can see, Coverdell Accounts may or may not be a beneficial option for you depending on your income level. Both Coverdell Accounts and 529 Plans have their positives and negatives and choosing between them really depends on your own unique financial position. Other options are available for education planning such as, regular investment accounts, retirement accounts and insurance options; however, they are not specifically intended to fund education like Coverdell Accounts, 529 Plans, loans or Financial Aid.<sup>55</sup>

<sup>54</sup> (Little, *Personal Finance At Your Fingertips*, 207)

<sup>55</sup> (Altfest, 2007, 356)

## Chapter 2.4: Owning a Home

For many years, the prototypical American dream has been to own a home. Although purchasing a home may sound like a difficult process, it is actually very simple if you can afford the home you intend to buy. This simple concept however, has gotten our country into a very difficult economic situation called the housing crisis (or sub-prime mortgage crisis). To even begin to understand what led to the housing crises of the early 21<sup>st</sup> century, we must first understand how an individual purchases a home.



### Mortgages

There are several things you should know before you decide to purchase a home. The first is that homes are expensive. A home will probably be the single most expensive purchase you make in your entire life. This means that it is highly unlikely you will have enough money to pay for your home at one time. This is where a mortgage comes into play.

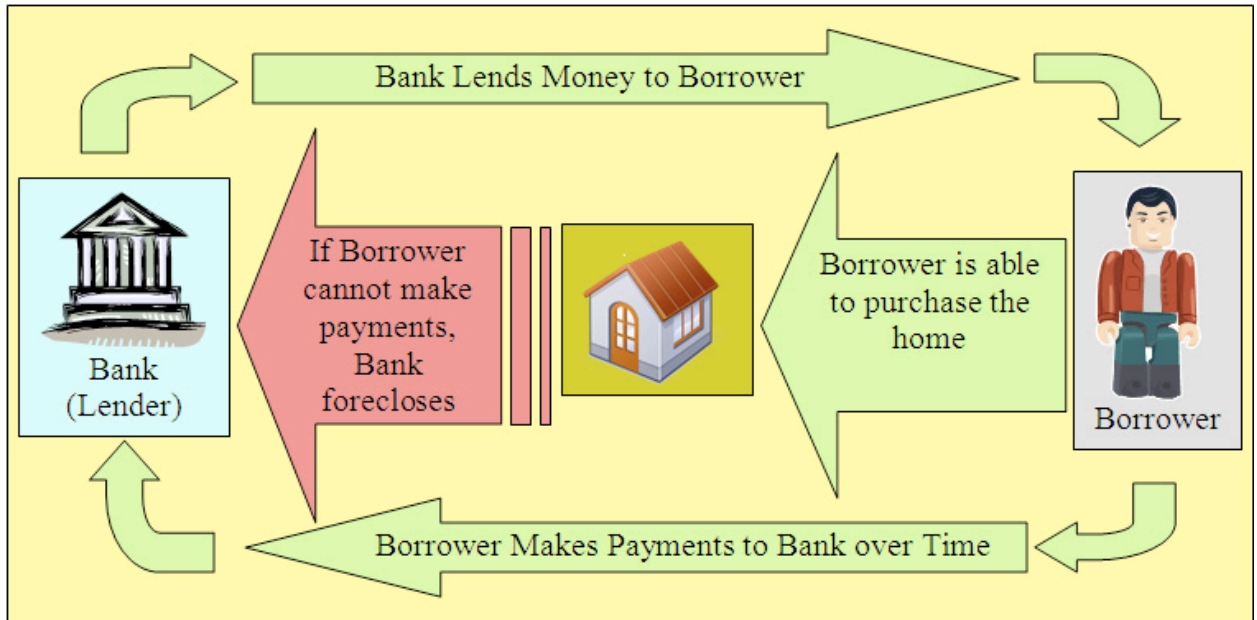
A mortgage is essentially a loan from a bank, where the borrower (homeowner) is given money by the lender (bank). In general, the actual transaction is made up of three parts; they are listed in the following chart:

### Three Main Parts of a Mortgage Transaction

- 1. Down Payment-** This is the money that the borrower will need to pay up front in order to buy the home. It is usually a percentage of the total price of the home.
- 2. Principal-** This is the amount of money that the lender lends to the borrower after the down payment has been made. This must be repaid by the borrower over time.
- 3. Interest-** This is the additional rate the bank (lender) charges in exchange for giving the loan. It is a percentage that must be paid back over time in addition to the principal. As we mentioned earlier, if you are borrowing you want this rate to be as low as possible.

Up to this point, a mortgage seems almost identical to a traditional loan; however, there is one distinct difference from a traditional loan arrangement and a mortgage. The difference is something called **collateral**. Because purchasing a home requires such a large amount of money, the bank uses the house as collateral on the loan. This means that if the borrower is not able to

pay the loan payments (amount that is paid back to the bank each month on the loan), the bank can repossess the house, called **foreclosure**. Please observe the following diagram:



Collateral is important because it makes it safer for the bank to lend. For example, let's assume that the bank gives you \$400,000 in the form of a 15 year mortgage to buy a home. You must pay a certain amount back to the bank each month plus interest on the loan. Let's now assume that for whatever reason you are unable to pay your mortgage payments each month. Because of the collateral, the bank does not come up \$400,000 short on the loan. They simply repossess your home and sell it to cover the cost of the loan.

When it all works correctly: the bank lends money to the borrower, the borrower is able to purchase the home, and the borrower pays the money back to the bank each month including interest. In the end, the bank makes money from the loan (interest) and the borrower is able to purchase the home and pay it off over time. The borrower makes mortgage payments to the bank each month for the duration of the loan (usually 15 or 30 years). It is important to understand the basic elements of these payments. The money that is paid to the bank each month either goes to paying off the actual value of the home (the principal), or it goes to paying off the interest on the overall loan. This split between interest and principal actually changes throughout the duration of the mortgage. If we consider the above example (15 year, \$400,000 mortgage) at an interest rate of 6%, we can observe how the payments are split between interest and principal. Please observe the following chart displaying this relationship for a 15 year, \$400,000 mortgage at 6%:

Parts of Yearly Payment					
Year	Interest		Principal		Total Yearly Payment
1	\$23,538.46	+	\$16,966.67	=	\$40,505.13
2	\$22,491.99	+	\$18,013.14	=	\$40,505.13
3	\$21,380.98	+	\$19,124.15	=	\$40,505.13
4	\$20,201.44	+	\$20,303.68	=	\$40,505.13
5	\$18,949.16	+	\$21,555.97	=	\$40,505.13
6	\$17,619.63	+	\$22,885.49	=	\$40,505.13
7	\$16,208.11	+	\$24,297.02	=	\$40,505.13
8	\$14,709.52	+	\$25,795.61	=	\$40,505.13
9	\$13,118.50	+	\$27,386.63	=	\$40,505.13
10	\$11,429.35	+	\$29,075.77	=	\$40,505.13
11	\$9,636.02	+	\$30,869.10	=	\$40,505.13
12	\$7,732.09	+	\$32,773.04	=	\$40,505.13
13	\$5,710.72	+	\$34,794.41	=	\$40,505.13
14	\$3,564.67	+	\$36,940.45	=	\$40,505.13
15	\$1,286.27	+	\$39,218.86	=	\$40,505.13

56

As you can see, the total amount of money that is paid each year (Total Yearly Payment) by the borrower is the same. However, the split between interest and principal is different every year. This split changes every time you make a monthly payment, even though the total amount that is paid each month is the same. This is because each month the borrower pays off a little more principal, which reduces the interest charge (Principal X Monthly Interest Rate) slowly over time.

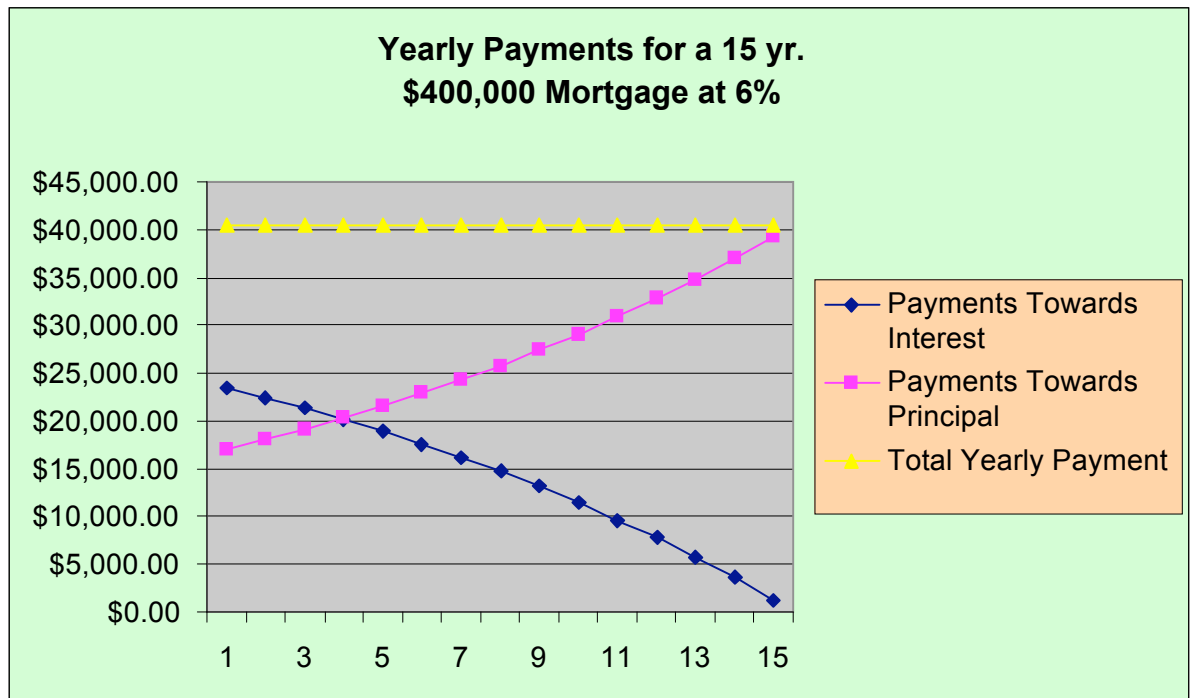
More simply, at the beginning of the loan, the majority of your monthly payments will go towards interest; however, by the end of the loan, the majority of your payments will go towards paying off principal. This is displayed in the table above; notice in Year 1 you are paying \$23,538.46 towards interest and only \$16,966.67 towards principal. However, by Year 15, you pay only \$1,286.27 towards interest and \$39,218.86 towards principal.



Remember, the total amount that is paid to the bank each year (or each month) by the borrower is the same. The only thing that changes is the split between interest and principal, or where exactly your money is going. Understanding this concept allows you to better comprehend how mortgage payments are calculated and the overall relationship between lender and borrower.

<sup>56</sup> (Similar to: Altfest, 2007, 147)

To better visualize this concept, the payments for the above mortgage are displayed as a graph:



This makes it very easy to see how the split between interest and principal changes over time, while the total payment stays the same at just over \$40,000. As you can see, by Year 5 you are paying more in principal each year (and also each month) than in interest. This is important because this is when you start to increasingly build **equity** in your home. Equity is, "...the difference between an asset's value and what you owe on the asset".<sup>57</sup> In this case, the asset would be your home, and what you owe would be the amount of the loan that is not yet paid off (Asset Value – Debt = Equity). In other words, if you decide to sell your home at any point, the money left over after you sell it and pay off the debt to the bank is your equity.<sup>58</sup>

Because more of your money is going towards paying off principal after Year 4, and house prices typically increase over time, your equity builds gradually each year (you will have more money left over each year if the house should be sold and the debt to the bank is paid off). This is why individuals often wait several years before selling their home.

<sup>57</sup> (Little, *Personal Finance at Your Fingertips*, 73)

<sup>58</sup> (Gitman and Joehnk, *Personal Financial Planning*, 248)





## A Little More about Interest Rates...

Interest rates are very important in mortgage situations. We saw how powerful they can be in *Chapter 2- The First Big Purchase*. However, they are especially powerful for mortgage loans because the principal is very high (houses are expensive) and the loan is for such a long period of time (usually 15 or 30 years). Because of this, interest rates deserve some extra attention when discussing mortgages.

When thinking about mortgages, it is helpful to think of the interest rate as the amount that the bank is charging the borrower in exchange for the ability to pay the loan off over time. The higher the rate, the more the bank is charging the borrower and the more interest he will pay over time in addition to the price of the house. This is why if you are borrowing (taking out a mortgage), you want the interest rate to be as low as possible.

This concept may sound easy; however, it is unfortunately not as simple as searching for the lowest interest rate possible. There are several different types of mortgages available and some are more complicated than others. Some of these have gotten borrowers into a lot of trouble in the past. For example, an **Adjustable Rate Mortgage** is a mortgage where the interest rate is free to move up and down. This can be extremely dangerous; they typically lure borrowers in with very low introductory rates that rise dramatically over time. This is why if you are looking to obtain a loan, you should always get a **Fixed Rate Mortgage**, or a mortgage where the interest rate is fixed throughout the duration of the loan.



## A Summary of the Sub-prime Mortgage Crisis

Now that you have a basic idea of how mortgages work, you can begin to understand what caused the sub-prime mortgage crisis of the early 21<sup>st</sup> century. We will begin by reviewing the basic concepts of a mortgage. In general, a bank lends money to a borrower to buy a house in the form of a mortgage loan. The borrower pays back this loan with interest over time. If the borrower cannot pay back the loan, the bank repossesses the house and sells it to cover the cost of the loan. These mortgage loans generally take the form of either a fixed rate mortgage (where the interest rate is fixed over time) or a variable rate mortgage (the interest rate is free to move up or down over time). Finally, in general, borrowers want to search for the lowest interest rate possible to get on their mortgage.

These aspects of a mortgage are crucial in understanding what caused the crisis that severely threatened the US economy. Over the years, the rules and regulations that have governed the finance industry have changed, allowing for more complicated investment options. These changes have allowed banks to use mortgages as investments that can be sold to other banks or investors. The commercial banks that receive monthly mortgage payments from borrowers can sell these mortgages on to investment banks. **Investment banks** are specific banks, or branches of large financial institutions, that specialize in major financial transactions.<sup>59</sup> The investment banks buy mortgages from commercial banks and bundle them together. These mortgage bundles are then sold to other investors or other investment banks. This greed fueled, quick profit mentality led to one of the most devastating economic disasters in our country's history.

This mentality was not only present in the highest levels of structured finance (such as the banks and specialized investors we have discussed); it was also evident in many average homeowners. Many potential homebuyers unfortunately did not understand the components of a mortgage or what exactly to look for when acquiring one. Specifically, many individuals were enticed by the low monthly payments of adjustable rate mortgages. They did not understand that the interest rates on adjustable rate mortgages are free to move over time; and when interest rates went up, they were unable to pay their monthly payments. This caused many Americans to default on their mortgages. In addition to this, banks were being very lenient as to who they gave loans to. Driven by greed, they extended credit to (gave mortgages to) risky borrowers who would otherwise be unfit to repay a mortgage loan. This increased the default rates and exacerbated the issue.

Another important contributor to the crises was the decline in housing prices. In the past, housing prices followed an overall steady upward trend. This created a "housing bubble" that our society grew to depend upon. This means that the prices of homes rose so dramatically for such a long period of time that they became overvalued (homebuyers were not willing to pay the high prices that were being asked). Finally, this bubble "popped" and home prices began declining.

Before we explain how these issues combined to form the "perfect storm" that was the sub-prime mortgage crisis, take a moment to review the causes that we have discussed in the following summary diagram:

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<sup>59</sup> (Gitman and Joehnk, *Fundamentals of Investing*, 38)

## General Causes of the Sub-prime Mortgage Crisis

1. The Buying and Selling of Mortgages by Investment Banks and Specialized Investors.
2. Homebuyers Defaulting on their Mortgages Because of:
  - a. Adjustable Rate Mortgages- Interest Rate Increases
  - b. Banks extending loans to risky borrowers
3. Real-Estate Bubble Popping Causing a Decline in Housing Prices.

### ...The Perfect Storm

These factors simultaneously combined to form the perfect storm that was the U.S. housing (sub-prime) crisis. Default rates by homeowners who were unable to pay their mortgages increased, forcing the commercial banks to foreclose on the homes. However, because housing prices were falling, the banks could not sell the homes for prices high enough to cover the costs of the loan. This caused the commercial banks to incur huge losses. They loaned out tremendous sums of money to homebuyers who were unable to pay. However, these losses did not stop at the commercial banks. Because these banks were allowed to bundle these mortgages together and sell them on to investment banks, hedge funds and other specialized investors, the losses were felt throughout the entire finance industry all over the world. This created uncertainty in the markets (because investors did not know what these assets were actually worth) and caused a global economic recession.

## Section 3: Strategies for Old Age



## Section 3 Overview

### Chapters:

- 3.1 Retirement Planning
- 3.2 Life Insurance
- 3.3 Estate Planning




Section Goal- To gain a better understanding of how to secure and control one's money during old age and after death.

## Chapter 3.1: Retirement Planning

In many instances, retirement planning is the driver of the financial plan. Everyone has unique retirement needs and goals that must be addressed in their retirement plan. Individuals want to save periodically throughout their lives in order to accumulate enough money to live comfortably off of when they decide to retire. In general, retirement planning is investing money throughout life with the hope of living off these funds during old age (when retirement is desired). This allows the individual to stop working and enjoy their golden years as they see fit.

As simple as this concept sounds, there are several things that can go wrong with this process. Three of the most common mistakes are shown in the danger box below:

	<p>Common mistakes that people make when attempting to save for retirement:</p> <ol style="list-style-type: none"><li>1. They do not start early enough in life.</li><li>2. They do not put away enough money.</li><li>3. They are not aggressive enough with their investments.</li><li>4. They underestimate how much they will need during retirement.</li></ol>
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### Starting Early

Throughout this text, we have seen the incredible power compounding can make when saving or investing (to review, please see Chapter 1.2). Saving for retirement is by far the most important example of this concept. If you are able to start early in life, your money will be given more time to grow and you will be rewarded when you finally retire. Please observe the table on the following page:

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<sup>60</sup> (Gitman and Joehnk, *Personal Financial Planning*, 597)

Starting at Age 21			Starting at Age 31		
Age	Contribution	Amount Saved	Age	Contribution	Amount Saved
21	\$5,000	\$5,400	21	\$0.00	\$0.00
22	\$5,000	\$11,232	22	\$0.00	\$0.00
23	\$5,000	\$17,531	23	\$0.00	\$0.00
24	\$5,000	\$24,333	24	\$0.00	\$0.00
25	\$5,000	\$31,680	25	\$0.00	\$0.00
26	\$5,000	\$39,614	26	\$0.00	\$0.00
27	\$5,000	\$48,183	27	\$0.00	\$0.00
28	\$5,000	\$57,438	28	\$0.00	\$0.00
29	\$5,000	\$67,433	29	\$0.00	\$0.00
30	\$5,000	\$78,227	30	\$0.00	\$0.00
31	\$5,000	\$89,886	31	\$5,000	\$5,400
32	\$5,000	\$102,476	32	\$5,000	\$11,232
33	\$5,000	\$116,075	33	\$5,000	\$17,531
34	\$5,000	\$130,761	34	\$5,000	\$24,333
35	\$5,000	\$146,621	35	\$5,000	\$31,680
36	\$5,000	\$163,751	36	\$5,000	\$39,614
37	\$5,000	\$182,251	37	\$5,000	\$48,183
38	\$5,000	\$202,231	38	\$5,000	\$57,438
39	\$5,000	\$223,810	39	\$5,000	\$67,433
40	\$5,000	\$247,115	40	\$5,000	\$78,227
41	\$5,000	\$272,284	41	\$5,000	\$89,886
42	\$5,000	\$299,466	42	\$5,000	\$102,476
43	\$5,000	\$328,824	43	\$5,000	\$116,075
44	\$5,000	\$360,530	44	\$5,000	\$130,761
45	\$5,000	\$394,772	45	\$5,000	\$146,621
46	\$5,000	\$431,754	46	\$5,000	\$163,751
47	\$5,000	\$471,694	47	\$5,000	\$182,251
48	\$5,000	\$514,830	48	\$5,000	\$202,231
49	\$5,000	\$561,416	49	\$5,000	\$223,810
50	\$5,000	\$611,729	50	\$5,000	\$247,115
51	\$5,000	\$666,068	51	\$5,000	\$272,284
52	\$5,000	\$724,753	52	\$5,000	\$299,466
53	\$5,000	\$788,133	53	\$5,000	\$328,824
54	\$5,000	\$856,584	54	\$5,000	\$360,530
55	\$5,000	\$930,511	55	\$5,000	\$394,772
56	\$5,000	\$1,010,352	56	\$5,000	\$431,754
57	\$5,000	\$1,096,580	57	\$5,000	\$471,694
58	\$5,000	\$1,189,706	58	\$5,000	\$514,830
59	\$5,000	\$1,290,283	59	\$5,000	\$561,416
60	\$5,000	\$1,398,905	60	\$5,000	\$611,729
61	\$5,000	\$1,516,218	61	\$5,000	\$666,068
62	\$5,000	\$1,642,915	62	\$5,000	\$724,753
63	\$5,000	\$1,779,748	63	\$5,000	\$788,133
64	\$5,000	\$1,927,528	64	\$5,000	\$856,584
65	\$5,000	\$2,087,130	65	\$5,000	\$930,511
<b>Total Retirement Savings:</b>		<b>\$2,087,130</b>	<b>Total Retirement Savings:</b>		<b>\$930,511</b>

The table assumes that you put \$5,000 away at the beginning of each year and you are able to earn an 8% return on your investments. As you can see, starting early makes a huge difference in retirement planning. If you started at age 21, you would have accumulated \$2,087,130 in total retirement savings by year 65. However, if you decided wait and start at age 31, you would have only accumulated \$930,511 by age 65. This is a difference of over \$1 million in only 10 years! Clearly, you want to begin to save for retirement as soon as you get your first full time job. At this point, you do not need to have a full retirement plan, you simply should be putting money away and allowing it to grow; you will be rewarded in the long run.



## How much is enough?

The second common mistake people make when saving for retirement is not putting away enough money. This is also related to the fourth mistake of underestimating how much is needed during retirement. In order to have a sufficient amount of funds for use during retirement, you must attempt to estimate how much retirement income you need and have a diligent savings plan that you can stick to. As a general guideline, you want to save at least 10% of your income before taxes each year prior to retirement.<sup>61</sup> The keys to this process are to make conservative estimates for the future and to stick to your savings plan.

First, you must consider the probable conditions of your retirement. At what age do you expect to retire and about how long do you expect to live? This is done by analyzing your own personal goals and contemplating the expected lifespan of an individual. Remember, you must be conservative in your estimates, plan to need retirement funds for longer than you expect to live. This will ensure that you have enough in savings to cover your expenses for the duration of your life. Plan for the worst and hope for the best. Once these questions have been answered, you will be able to figure out how long you have until retirement and about how many years you will need of retirement funds.

The next step is to estimate how much income you will need each year throughout retirement. You want to have enough money to maintain your lifestyle during retirement. This can be a difficult process because it requires you to project your needs 30 to 50 years into the future. Remember, seeking professional assistance is always an option if things get too difficult for you.

In order to better estimate how much you will need in the future, it is helpful to think about how much you would need if you decided to retire today. You must consider your personal lifestyle and calculate how much you spend per year plus any retirement spending goals you may have (traveling once a year for example). Don't forget, some expenses will increase when you stop working and others may decrease (think about transportation costs, healthcare costs, dining out, and purchases made during the year). Also, you must consider expenses that increase every year (such as utilities, taxes, etc.). It is likely that many expenses will increase along with inflation each year. **Inflation** is the increase in price for a given good or service or the growth of

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<sup>61</sup> (Little, *Personal Finance At Your Fingertips*, 331)



overall costs in the economy over time.<sup>62</sup> At times inflation is very high (prices are increasing very fast), and at times inflation can be low (prices are not increasing rapidly). This can make it difficult to account for; the average inflation rate is about 3% per year<sup>63</sup>; however, you must be conservative and plan for above average conditions both before and after your expected retirement age. In general, if you are a financial independent person, you can estimate needing about 80% of your current income to cover your living expenses during retirement.<sup>64</sup>

## Retirement Plans

Once you calculate how many years you have until retirement, about how many years you will need retirement funds for, and about how much you will need each year, you can begin to construct your savings plan. There are many different structured plans, called **pensions**, which can be used when saving for retirement. Some pension plans are funded solely by the individual, and others, the employer and the individual together. Choosing between these options involves careful consideration and insight about your personal financial situation. We will begin by discussing the most popular employer-sponsored retirement program, the 401(k).



### The 401(k)

The most well known employer-sponsored retirement program is the **401(k)**. They allow you to make pre-tax (money that comes directly out of your paycheck before taxes) contributions into a variety of different investment vehicles. Although every plan is different, most allow you to invest a percentage of your salary up to a maximum dollar amount. These contributions are placed in investment vehicles and are allowed to grow in a **tax-deferred** environment (you pay normal income tax on the withdrawn funds during retirement). It is important to follow the responsible investment practices that we have discussed in the investing chapter. Younger investors should take more risks (growth stock and mutual fund rather than bonds). As retirement draws near, funds should be slowly shifted towards more conservative investments such as bonds and savings accounts.

In some fortunate cases, employers will match all, or a percentage of, your contributions.<sup>65</sup> This structure is called a **defined contribution** (when an employer guarantees a contribution, but not a return on the contribution or a retirement benefit). Although they are becoming scarce, some employers offer **defined benefit** plans. This means that the employer

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<sup>62</sup> (Altfest, 2007, *Glossary*)

<sup>63</sup> (Little, *Personal Finance At Your Fingertips*, 328)

<sup>64</sup> (Little, *Personal Finance At Your Fingertips*, 327)

<sup>65</sup> (Little, *Personal Finance Desk Reference*, 620-623)

will actually guarantee the end benefit, despite good or bad performance of the investments. These structures make the 401(k) plans a very attractive retirement option.



Some 401(k) plans enable the employee to borrow from the plan and pay the money back over time. This is generally a bad idea. It can lead to double taxation (because you use after-tax funds to repay the loan and you must pay taxes again when you receive the money during retirement). In addition, you are inhibiting growth for that period of time.

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## The Roth 401(k)

The **Roth 401(k)** is practically identical in structure to the traditional 401(k). The only aspect that sets it apart is that it is funded using after-tax dollars. In other words, the individual is taxed now rather than when they withdrawal the funds in retirement. This means that the income received during retirement is tax-free. Choosing between the Roth 401(k) and the traditional 401(k) can be a little tricky. The key is trying to guess when you will be in a lower tax bracket. If you believe that you are in a lower tax bracket now, as apposed to during retirement, the Roth 401(k) is right for you. However, if you believe that you are in a high tax bracket at the current time and you think that it will be lower during retirement (because you will be making less income); the traditional 401(k) may be the right choice. This structure makes the Roth 401(k) ideal for many young adults because they are likely to be in a lower tax bracket at the current point in their lives than they will be during retirement. Typically, withdrawals from any 401(k) plan prior to age 59 and a half will incur tax penalties by the government. Because of this, it is generally not in the investor's best interest to withdraw funds early.<sup>67</sup>

<sup>66</sup> (Little, *Personal Finance Desk Reference*, 629)

<sup>67</sup> (Little, *Personal Finance Desk Reference*, 624-625)



## The IRA

An **IRA** is a non-employee sponsored retirement savings plan. An individual can't contribute up to \$5,000 (or \$6,000 if you are over 50) into a tax-deferred account. These contributions can typically be deducted from your income taxes; however, you may have to meet certain requirements to qualify. You have control over the different types of investment options and your money is able to grow tax-free. Like the traditional 401(k), you pay taxes on withdrawals during retirement. You are also forced to pay penalties on withdrawals prior to age 59 and a half, much like the 401(k) plans. In addition to this, you must start withdrawing funds from the IRA the year you turn 70 and a half; otherwise, you will have to pay a tax penalty.<sup>68</sup>

## The Nondeductible IRA

If you are not able to qualify for the tax deductions of a traditional IRA, it may be beneficial to open a **nondeductible IRA**. Even though you will not be able to deduct the contributions from your taxes, your money will still have the advantage of growing in a tax-deferred environment.<sup>69</sup>

## The Roth IRA

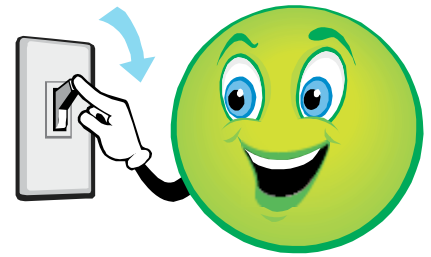
Much like the Roth 401(k), **Roth IRAs** provide tax-free income during retirement and your contributions are able to grow in a tax-free environment. However, contributions are not deductible from your current income taxes, which means you must pay taxes on them up front. Like the Roth 401(k), if you believe that you are in a lower tax bracket now, as opposed to during retirement, the Roth setup is right for you. There are also some differences with the withdrawal guidelines of the Roth IRA. If you have had the account for longer than five years, you can withdraw earnings prior to age 59 and a half without incurring a penalty. This is because you have already paid taxes on the funds. Another potential advantage of the Roth IRA is that there are no requirements to withdraw funds when you turn 70 and a half. If you are able to live off other savings or you decide to get another job, you are not forced to make withdrawals.<sup>70</sup>

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<sup>68</sup> (Little, *Personal Finance Desk Reference*, 638-643)

<sup>69</sup> (Little, *Personal Finance Desk Reference*, 648)

<sup>70</sup> (Little, *Personal Finance Desk Reference*, 649-650)



## Conversions

It is also possible to start with a traditional IRA and convert to a Roth IRA. Provided that you meet the income requirements (usually a \$100,000 limit on your modified gross income), and you pay taxes on your previous contributions and earnings, you can make the conversion. You could also decide to convert only a portion of your account, to decrease the tax obligations. Also, you should obviously be aware of the differences between the traditional IRA and the Roth IRA, and be sure that the switch will benefit you in the future.<sup>71</sup>



## Social Security

**Social security** was created by the government to provide a safety net for elderly citizens. It was designed to provide a small amount of income to retired citizens in case they were unable to save for retirement on their own. The setup of the system is as follows: the government taxes all citizens in the workforce and gives the money to retired citizens (this can be called a pay-as-you-go system). This is important because it means that you are not guaranteed the funds you pay into the system while you are working. In general, the current workforce is obligated to support the citizens who have reached full retirement. The benefit that you receive during retirement depends on the number of years you have worked and contributed. It works on a formula of credits; the more credits you accumulate, the higher the benefit you can collect. The formula is designed so that the lower paid workers will receive more credits. You must consult the current information about the program to find your designated full retirement age, which is based on the year you are born. If you decide to collect benefits before this age, you will be permanently penalized with reduced payments.<sup>72</sup>

You must also be aware of how working affects the social security benefits that you receive. If you work during retirement (after you start receiving benefits) it may increase the amount you receive. This is because the government awards you for earning income during retirement. However, if you decide to take early retirement (you receive benefits before your full retirement age), working will reduce the amount you receive.<sup>73</sup>

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<sup>71</sup> (Little, *Personal Finance Desk Reference*, 651-652)

<sup>72</sup> (Little, *Personal Finance At Your Fingertips*, 335)

<sup>73</sup> (Little, *Personal Finance Desk Reference*, 667)



It is also very important to note that social security benefits *should not* be counted on. This system may not be available forever and could go bankrupt in the future. As a financially responsible individual, it is up to you to save for retirement. You should not rely on the government or the current labor force to support you during your golden years.

## Chapter 3.2: Life Insurance Planning

In general, insurance protects individuals by providing funds in the case of an unfortunate event. This can be a car crash, in the case of auto insurance, an injury, in the case of disability insurance, or a death, in the case of life insurance. In this chapter, we will only be talking about life insurance because it is a very important part of the financial plan.

Life insurance is bought out of love for your family. The primary purpose of life insurance is to provide financial support to your loved ones in case of your death. In general, it protects your ability to support your family as an income earner.<sup>74</sup> In other words, the insurance company would pay money to those who depend on your income in the event of your death. The money that is paid out by the insurance company when you die is called the **death benefit**. In exchange for this, you make a monthly payment, or **premium**, to the insurance company. The company requires you to take a medical exam and answer a variety of health questions. They then use this information to calculate the probability of your death (or the probability that they will have to pay the death benefit). The younger and healthier you are, the more likely you will qualify to get insurance; also, the cheaper it will be. However, the older and more unhealthy you get, the less likely you are to qualify and the more expensive it will be. For example, individuals who smoke generally have a lower likelihood of qualifying and they usually pay more to receive insurance.



### Do I Need Insurance?

Clearly, if you are a financially responsible individual and your family depends on you for income, it is important to protect them with life insurance. However, it can be difficult to decide whether or not this is the case for you, and if so, how much is enough? The key is to analyze your personal financial situation and think about what would happen if you were to pass away. If you were to die, would it be more difficult for your family members to maintain their current lifestyle because of the absence of your income? These questions can be answered with the help of a financial planner or insurance agent.



Don't forget, most insurance agents are salesmen at heart. Generally, the only way they make money is when they sell insurance policies. This may lead them to overestimate your insurance needs. Like with any area of financial planning, it is important to get guidance from people you trust.

<sup>74</sup> (Little, *Personal Finance At Your Fingertips*, 140)

In general, there are two basic types of insurance, Term Insurance and Whole Life Insurance; however, there are several different variations of these two main forms. Term and Whole Life are both very different and should be used in different financial situations throughout life. This is because the need for insurance fluctuates as you move through different stages of your life. There may be little to no need when you are young and single; however, as you get older and you begin to start a family, you will have more individuals who depend on your income. In addition to family growth, your lifestyle needs will evolve as you take on more responsibility.<sup>75</sup> Therefore, much like the other parts of the financial plan, insurance planning should evolve as you evolve as a financially responsible individual with changing needs. We will begin by discussing Term Insurance because it is arguably the most straightforward form of insurance you can buy.



## Term Insurance

The most important aspect of Term Life Insurance is that it is for a specific period of time (usually 1-30 years).<sup>76</sup> If you die during this period of time, your beneficiaries are paid the death benefit. However, if you outlive the policy you are not covered in the event of your death, which can be dangerous. This is why you might want to consider the **renewability clause** on the policy. This clause can enable the insured individual to renew the policy without medically qualifying again. This is usually a good factor to look for in a Term Insurance policy because it protects you if you were to get sick during the term. However, even though you may automatically qualify, Term Insurance Policies tend to increase in price as you age.<sup>77</sup> This means that your monthly payments will likely increase when you renew the policy. While they are initially much cheaper than Whole Life Insurance, they may get much more expensive in the long run.<sup>78</sup> Some of the important factors of Term Insurance are listed in the following chart:

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<sup>75</sup> (Little, *Personal Finance Desk Reference*, 247)

<sup>76</sup> (Little, *Personal Finance Desk Reference*, 248)

<sup>77</sup> (Little, *Personal Finance Desk Reference*, 250)

<sup>78</sup> (Little, *Personal Finance At Your Fingertips*, 141)

## Features of Term Life Insurance:

1. Specific Period of Time- Term Life Insurance is bought for a specific period of time. If the insured individual dies during this time period, the death benefit is paid; if the insured individual outlives the term, he or she is no longer insured.
2. Price- Term Life Insurance is initially cheaper than Whole Life Insurance. However, as you age you will need to renew the policy and it may be more expensive overall.
3. Renewal Clause- Some Term Insurance policies have a renewal clause which allows the insured individual to renew the policy after the term expires with no medical evaluation. This can be beneficial if your health declines as you age.

The above features of Term Life Insurance make it very easy to fit into an overall financial plan. It is a very straightforward setup; you simply buy a specific amount of insurance for a specific period of time. However, all the aspects that make it attractive may also make it a poor choice for a long-term plan. For example, you may outlive the term, which may force you to medically qualify again. In addition to this, it may be more expensive in the long run and if you cannot afford to pay the monthly premium, you may be left without insurance coverage. This can be a very dangerous scenario.

The specific attributes of Term Insurance make it ideal for many families who are just starting to have children. At this point in time, insurance needs are typically the highest they will ever be (because your children depend on you for school, lifestyle and basic needs). However, once the children complete their education and are able to earn a living on their own, the insurance needs of the parents decrease (because the children are less dependent on the parents). During this period of time, Term Insurance can be bought in addition to Whole Life Insurance to balance this increased need for insurance.





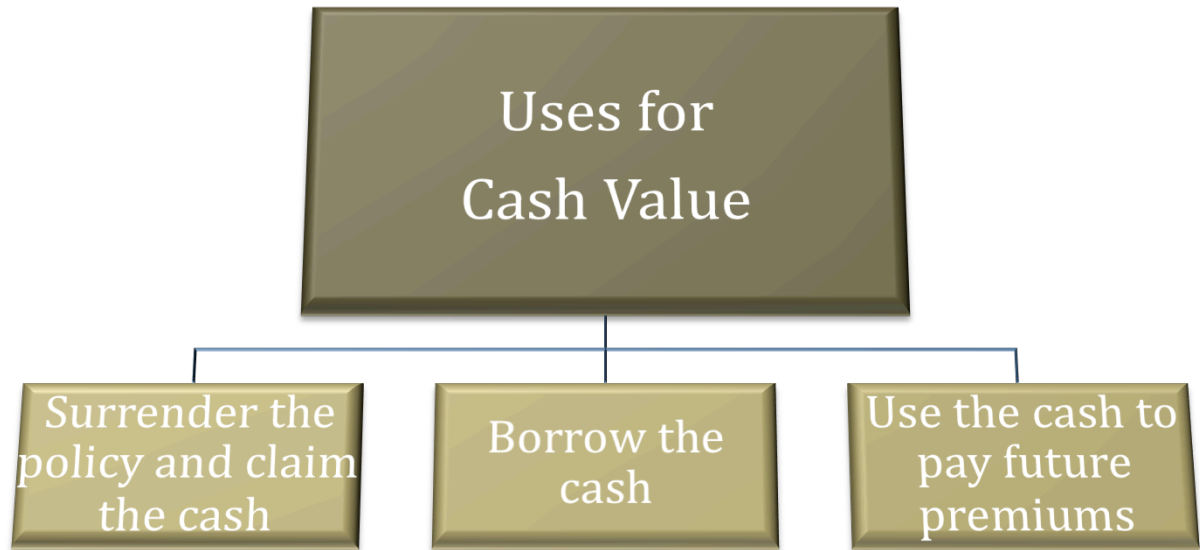
## Whole Life Insurance

A Traditional Whole Life Insurance policy is very different than a Term Insurance policy. There are some distinct advantages that may give Whole Life Insurance an edge over Term Insurance in many instances. Whole Life Insurance provides the same type of protection as Term Insurance; your beneficiaries are still paid a death benefit in the event of your death. However, Whole Life Insurance lasts as long as you keep paying your monthly premiums. The policy does not lapse after a certain period of time like term insurance. This guarantees that you will be covered for the duration of your life, which is the most important part of buying insurance. If you consider this, along with some other features of the Whole Life policy, it may be worth paying a higher premium for.

In addition to providing basic life insurance protection, Whole Life Insurance policies also provide a savings option called a **cash value**. This means that part of your premium funds a savings account that is invested in different vehicles. These investments grow over time in a tax-deferred environment (much like retirement accounts).<sup>79</sup> This is a good option if you find it difficult to accumulate savings on your own. The money adds up over time and can be used for many things when it becomes significant. This can provide several advantages and may give Whole Life Insurance policies an edge over Term Insurance Policies. Some popular uses for the cash value component of Whole Life Insurance policies are shown on the following chart:

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<sup>79</sup> (Little, *Personal Finance At Your Fingertips*, 142)



Perhaps the most helpful of these options is the ability to use the cash value to pay future premiums. If the cash value is invested well, it may accumulate enough money to pay the premiums on the policy. This setup is often called **vanishing premiums** and it basically frees the insured individual from his or her monthly payments. However, you should be aware that the insurance agents often use this as a big selling point on policies. They often show prospective buyers a projection (or an estimate) of how the cash value could accumulate and when you will be able to stop paying monthly premiums. You should beware that this estimate may not actually become a reality. These projections may be calculated at rates that are inflated, the actual growth of your cash value could differ tremendously.

While the other options sound attractive, they have some disadvantages. It is generally not a good idea to surrender the policy and claim the cash unless you cannot afford the monthly premiums. If this is done, the insured individual will not be covered in the event of death. Borrowing from the cash value is also generally a poor use of the account. It must be paid back with interest. If the insured individual dies without paying back the loan, the death benefit is reduced by the full amount of the loan plus any interest that has accumulated.<sup>80</sup>

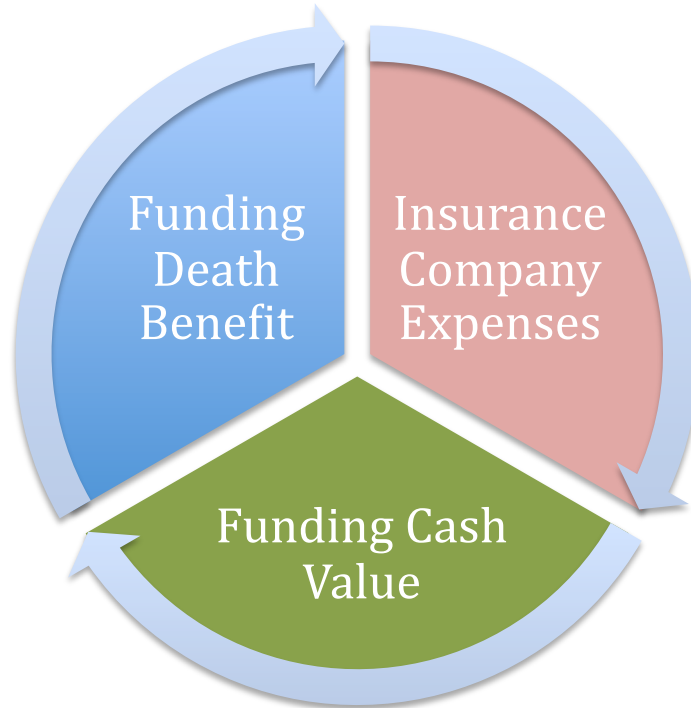
## Universal Insurance

Universal Insurance is a form of Whole Life Insurance. It has a very similar set up and provides the same basic benefits. However, it offers individuals more flexibility and control over their policy. As with Whole Life, the premium that you pay each month is divided into three parts. Part of this payment goes to funding the death benefit, part gets invested to accumulate cash value, and part goes to the insurance company to cover expenses.<sup>81</sup> This is displayed in the following pie chart:

<sup>80</sup> (Little, *Personal Finance At Your Fingertips*, 142)

<sup>81</sup> (Little, *Personal Finance Desk Reference*, 254)

## Parts of Whole Life Premium Payment



The difference between Universal Insurance and Traditional Whole Life Insurance is that Universal Insurance gives the insured individual the ability to control the way the premium is split. If desired, he or she can request a larger percentage of the premium to go towards the death benefit and lessen the percentage that goes towards the cash value. Universal Insurance also offers the ability to lower the death benefit. The insured individual can withdraw the cash value and decrease the death benefit.<sup>82</sup> As with any insurance policy, the death benefit can be increased by purchasing more insurance.



## Variable Whole Life Insurance

Variable whole life is similar to Traditional Whole Life Insurance policies. They are similar in structure and provide the same protection. The difference is how the cash value is invested. With a Traditional Whole Life policy, the insurance company invests the cash value in specific investments with stable rates. However, with a Variable Whole Life policy, the insured individual has more control over these investments. The money can be put in a variety of

<sup>82</sup> (Little, *Personal Finance Desk Reference*, 257)

different investments with varying degrees of risk. This is attractive to some investors who enjoy having total control of their investments. However, you must be aware that if the investments do poorly, there is a chance that the cash value could decrease or even disappear. This is a riskier alternative for individuals who enjoy controlling their own investments and are confident in their ability to do so.<sup>83</sup>

## Variable Universal Life

Variable Universal Life is another form of Whole Life Insurance. It gives the insured individual the most control of all the various policy structures we have discussed. You get the freedom of Universal Life with the control of Variable Whole Life. It provides the same benefits as the other Whole Life policies and has similar attributes. However, you get the ability to control the way the premium is split, and the death benefit can be reduced (as with Universal Life). Also, you get the control and access to investment vehicles like a Variable Whole Life policy. As with Variable Whole Life, this access comes with both increased risk and increased potential for reward. Variable Universal Life is for the individual who desires control over both the insurance policy structure and investment accounts. This increased responsibility also requires a high level of financial knowledge. If you feel unsure about how to invest or how high your death benefit should be, this policy may not be the best fit for you.<sup>84</sup>

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<sup>83</sup> (Little, *Personal Finance Desk Reference*, 259)

<sup>84</sup> (Franklin, 2007, *Risk Planning*)

## Chapter 3.3: Estate Planning

Estate planning is a crucial element of the financial plan that is often neglected. This is because many individuals fear death and are hesitant to plan for it. In general, estate planning is taking the appropriate steps to secure your financial assets for your death. While it may be a difficult subject to plan for, it is very important that you prepare your finances to be passed on to your loved ones. It is a common misconception that everything you own is automatically transferred to your family and friends after you pass away. There is actually a large amount of preparation required to accomplish this task.

In theory, estate planning is very similar to life insurance planning. It is done out of love for your family and friends. Proper Estate Planning can make it easier for your loved ones to cope with the financial burden of your death. It can save time, money and keep individuals from fighting over the property you leave behind. Proper Estate Planning often requires both an attorney and a financial advisor. In some scenarios it may be a relatively easy process, and in others, it may be more strenuous. Usually, the more complicated your financial situation is (because of family difficulties and an abundance of financial assets), the more effort will be required for a financially sound estate plan.



### What is an Estate?

In general, an estate consists of everything that is owned by an individual during his or her lifetime. For Estate Planning purposes, there are two types of estates that you must distinguish between. These types are defined in the following diagram:

#### Taxable Estate

- Or gross estate; this is all property or assets that an individual owns. This includes: real estate, investments, physical property, business ownerships, etc. If it was owned in any fashion by the individual, it is included in some way.

#### Probate Estate

- This includes all assets or property that must go through the probate process.

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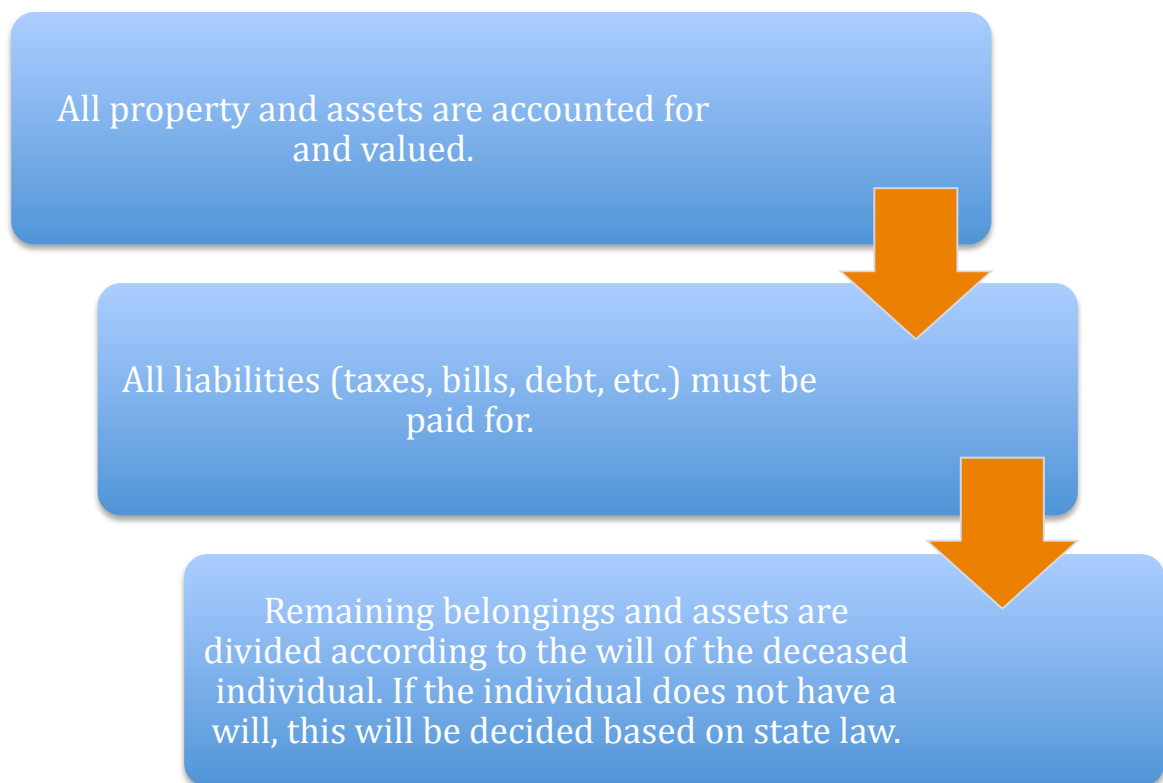
<sup>85</sup> (Little, *Personal Finance At Your Fingertips*, 368-369)



## The Probate Process

The probate process refers to the court of law in which your **probate estate** is settled. This usually takes place in the county of your legal residence.<sup>86</sup> This process can be time consuming, emotional and expensive for loved ones. However, with the proper planning, the aggravation of the probate process can be greatly reduced. Before we discuss these planning options, it is important to understand the probate process. An overview of the process is displayed in the following chart:

### The Probate Process



As you can see, if you do not have a will the wishes of you and your loved ones may not be honored. The court must rule based on state law, despite the pleas of your friends and family. The court decides how each specific asset is split among family members. This may not be a fair

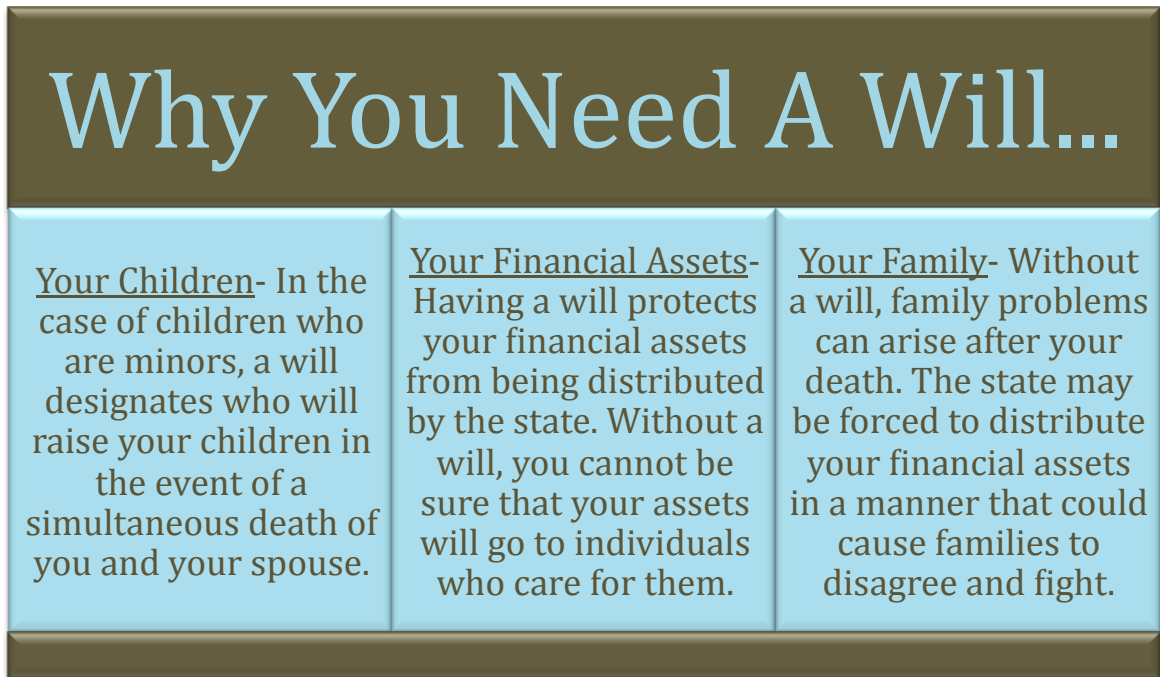
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<sup>86</sup> (Little, *Personal Finance Desk Reference*, 687)

distribution based on your wishes, and this process could cause your family a lot of pain and hardship. This is why it is extremely important to prepare a written will before your death.

## Preparing a Will

A **will** is perhaps the most important document in the Estate Plan. It is a document that is written when you are still alive explaining how your assets should be distributed after you pass away. It clearly states your final wishes so that your finances and family lifestyle can remain intact. It is very important that any financially stable individual write a will and update it throughout their life. A will is typically written with the help of a financial planner and an attorney (or a single individual who is qualified in both areas) who you trust. There is usually a small fee for writing a will; but it can save your family time, money and emotional hardship after your death.<sup>87</sup> In addition to distributing your personal financial assets, writing a will also has several other benefits. The advantages of keeping an up to date will are listed in the following diagram:



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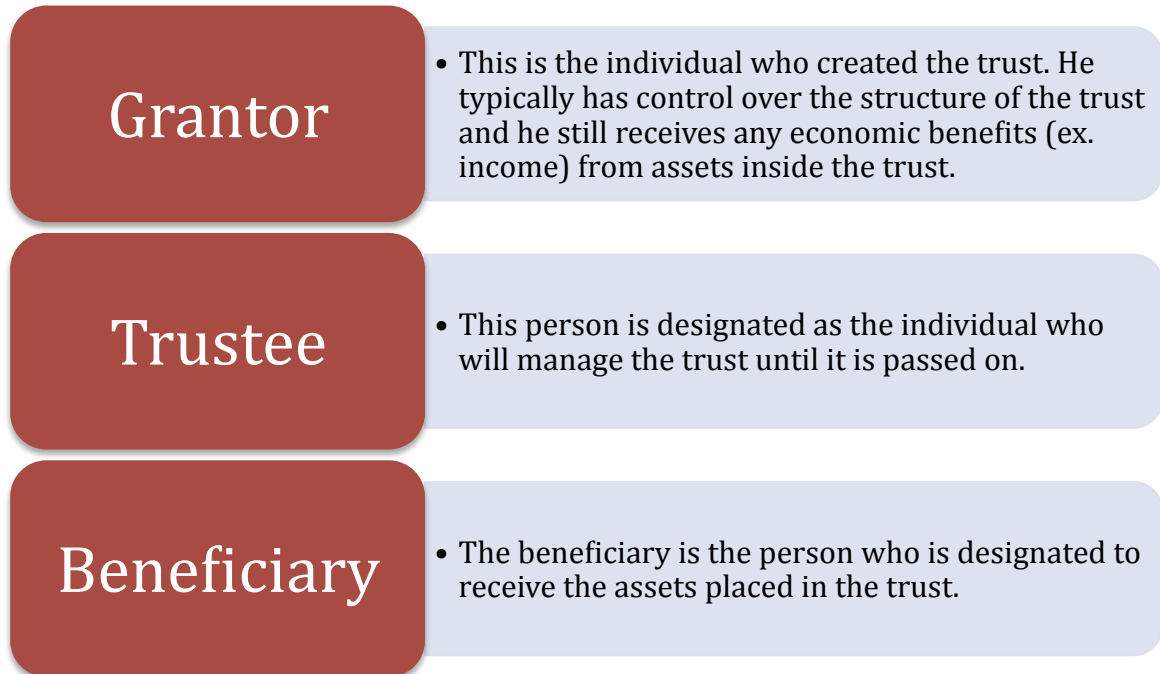
## Trusts

A **trust** is an agreement stating that another individual will manage your assets and properties until you die. Upon your death, these assets will be transferred to the beneficiary

<sup>87</sup> (Little, *Personal Finance Desk Reference*, 680)

<sup>88</sup> (Tyson, 2006, 359)

(person who you decide should receive the assets) of your choice.<sup>89</sup> Before we discuss the structure of a trust and the different types, it is first important to define some terminology. Please refer to the following illustration for definitions of the basic individuals involved in a trust agreement:



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The main benefit of creating a trust is to assist your loved ones with the probate process. Trusts make it considerably easier and less expensive to distribute your assets to future generations after you die. Some assets will be able to pass directly to the designated beneficiary and skip the probate process all together.<sup>91</sup> The setup of a trust is relatively simple; the general idea is displayed in the following diagram:

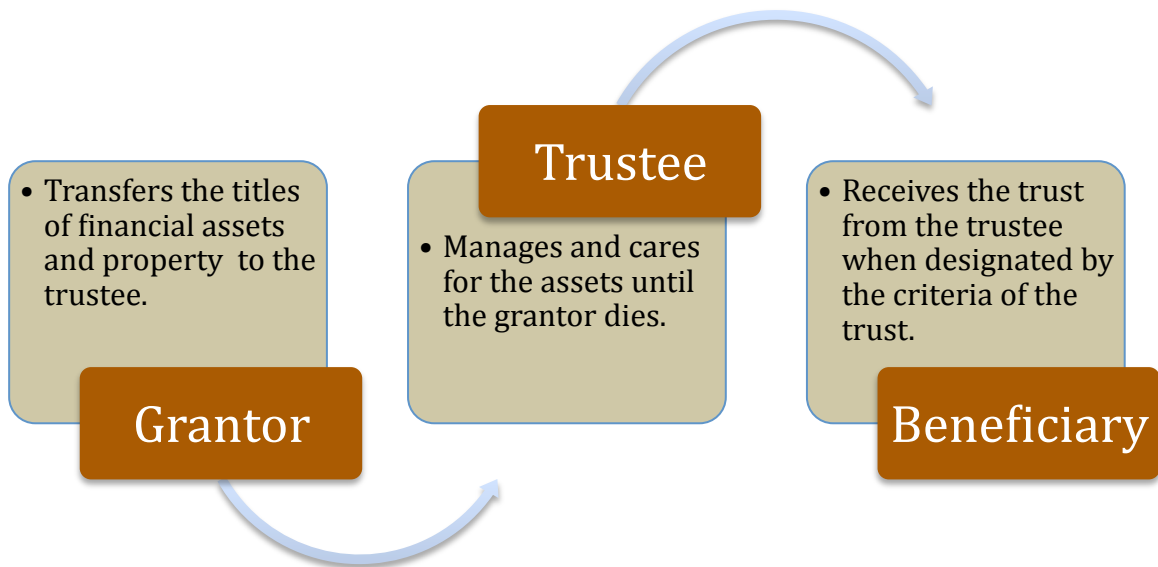
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<sup>89</sup> (Little, *Personal Finance Desk Reference*, 692)

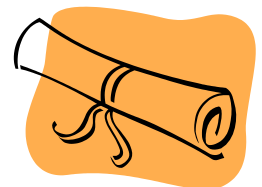
<sup>90</sup> (Little, *Personal Finance Desk Reference*, 692)

<sup>91</sup> (Little, *Personal Finance Desk Reference*, 693)





Trusts can be very helpful in controlling your finances from the grave. As the grantor, you can designate the criteria that must be accomplished by the beneficiary before he or she is able to receive the trust. This can be as simple as the age of the beneficiary; or it can involve any type of required accomplishment, such as getting certain grades in college. This is a great way to uphold the standards of your financial accomplishments and ensure future generations will care for your assets.



## Types of Trusts

In general there are two types of trusts. They are named based on when they are created. The first type is called a **living trust**. A living trust is created while the grantor is still alive. The grantor can choose to setup the trust as a **revocable trust** (which enables the grantor to alter the terms and conditions at any time), or an **irrevocable trust**, which cannot be changed. The other type of trust is called a **testimonial trust** and it is created by the grantor's will after he or she has passed away. Testimonial trusts are always irrevocable because the grantor has already passed away and cannot make changes.<sup>92</sup> In both living trusts and testimonial trusts the structure and benefits are the same.

<sup>92</sup> (Little, *Personal Finance Desk Reference*, 694)



## Does a Trust Replace a Will?

The answer to this question is ***no***. Even though a trust allows for the transfer of financial assets and property to a beneficiary a will is still a necessity. As mentioned before, the will is still the most important document in an estate plan. If you do make use of a trust to transfer your assets, you will still require a **pour over will**. This is a special will that explains what to do with assets that are acquired prior to the establishment of the trust. This usually allows for these additional assets to be added to the trust and received by the beneficiary along with the others at the designated time.<sup>93</sup>

## The Taxable Estate

The previous section has discussed how to handle the distribution of your probate estate. However, as mentioned before, you must also consider your taxable estate when planning for your death. Your **taxable estate** is all property or assets that an individual owns. This includes: all property, retirement accounts, life insurance policies, financial assets, etc. If the deceased individual owned the asset in any fashion, it is included in some way.

As the name implies, your taxable estate is what your beneficiaries will be forced to pay taxes on after you die. The bad news is: these taxes are called **estate taxes** and they are very high (near 50%). The reason why estate taxes are so high is because the government wants individuals to spend money while they are alive to help the economy. However there is also good news: there is what is called an **exemption limit**; if your taxable estate is below this limit (\$3.5 million in 2009), you will be exempt from estate taxes. While \$3.5 million might sound very high, you will be surprised how much you have accumulated in total wealth by the end of your life. It is important to get professional assistance in calculating this amount and discussing how to avoid estate tax if possible.<sup>94</sup> One effective option is through gifting.

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<sup>93</sup> (Little, *Personal Finance Desk Reference*, 696)

<sup>94</sup> (Little, *Personal Finance Desk Reference*, 705-706)



## Gifts

Gifts are a fairly straightforward way to help avoid estate taxes when you die. If you know your Taxable estate is not exempt from estate taxes and you want to transfer wealth to your children or grandchildren, you can do this by giving gifts. Legally, an individual is allowed to give up to \$12,000 per year to any other individual. This means that a couple can give up to \$24,000 per year to each beneficiary without any tax consequences. This can be a slow but effective way to transfer wealth throughout ones lifetime.<sup>95</sup>

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<sup>95</sup> (Little, *Personal Finance Desk Reference*, 706)

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## Financial Planning for High School Students

### *Capstone Project Summary*

Imagine being 65 years old and eager to relax and enjoy your golden years. You quit your job, and begin to live a life that a working individual could only dream of. However, a few years into your retirement you come to the crude realization that you were unable to save a suitable amount of money to support your lifestyle. Or, you are an entering freshman at Syracuse University. You are excited to learn material that interests you and plan for your future career and life. You arrive at school, and all the incoming freshmen are out on the quad enjoying what's left of the summer before the upper class students arrive at campus. During this exciting opening weekend convention you learn about a company that can do your laundry for you, a club sports team that you can join, and a credit card that you can open to earn points to travel during spring break. You take advantage of all of these options and on that credit card you charge one meal. However, you were caught up in the rush of opening weekend; and for one reason or another you do not remember that meal that you charged at 2:00 AM. You go on to be a successful college student who never uses the card again. You are now a senior and looking forward to pursue your dreams only to realize that you are unable to get a job, buy a car or get a loan because of your horrendous credit score, not to mention the severe amount of debt you will have as a result of not paying for your purchase.

Unfortunately, these situations arise in the lives of many Americans today. Personal Finance is a topic that is very rarely taught to High School students. This has led to an American society that is ignorant to proper personal financial management. This problem has often been

referred to as a financial illiteracy epidemic. I believe that this is a very serious situation that must be addressed. It threatens our people, our economy and our future generations. We have recently learned the danger that can arise when the general public does not properly manage their personal finances through the housing crisis. This catastrophe could have been prevented through proper education of personal finance at an early age.

As the most powerful nation in the world, we are obligated to educate our people to the best of our ability. It is a disgrace that Personal Finance is not a mandatory class for all high school students. If an individual is incompetent at managing his or her money, it is almost as bad as not having a job at all. This issue may, in part, be triggered by the lack of resources available to educate students. Currently, a textbook aimed at educating high school students on Personal Financial Planning is not widespread. This presents a perfect opportunity to shape the financial knowledge of future generations. A well-organized textbook that can be easily read and understood by high school students will be a valuable asset for many high schools across the country.

*Financial Planning for High School Students* is a textbook aimed to fight the financial illiteracy epidemic in our country and educate kids on the importance of proper personal financial management. The text covers a variety of topics, split into three sections: *Strategies for Young Adults, Adults and Old Age*. This is done to provide organization and educate the reader about how the financial plan changes as an individual moves through life. Within each section are chapters dedicated to various facets of the financial plan. Some major topics covered are: *Budgeting, Credit Planning, Taxes, Investing, Insurance Planning and Estate Planning*. I believe that these topics are the most useful for the students to understand when learning about financial planning. Each chapter is written in a concise and organized fashion to enable easy

comprehension. Large sets of information have been condensed into helpful graphs and diagrams that are both visually appealing and informative.

Hopefully, this text will find it's way into the hands of high school students across the country. The benefits in helping future generations understand the basic concepts of financial planning are extensive. This knowledge could potentially help keep individuals financial secure, aid in identifying unrealistic scams, and preserve the integrity of our economy.