It’s easy to avoid thinking about financial planning—after all, sometimes just financial existence seems like a victory. The problem is that by avoiding financial planning, you are actually creating more financial problems for your future. It’s just too easy to spend money without thinking—it’s saving money and planning that take some thought and effort. The problem is that most of us have no background in financial planning.

Part 1: Financial Planning will begin your introduction to personal finance. We will present some of the personal finance problems you will face in the future, along with a five-step process for budgeting and planning. You will also be introduced to ten fundamental principles of personal finance in Chapter 1 that reappear throughout the book. While the tools and techniques of personal finance may change or be forgotten over time, the logic that underlies these ten principles, once understood, will become part of your “financial personality,” and you will be able to draw upon these principles for the rest of your life.

In Part 1, we will focus on the first four principles:

Principle 1: The Best Protection Is Knowledge—After all financial advice is everywhere; the hard part is differentiating between the good and bad advice, and without that ability, you’re ripe for a financial disaster.

Principle 2: Nothing Happens Without a Plan—Financial planning doesn’t happen without a plan, so you’re going to want to begin by measuring your financial health by finding out where you stand financially, setting your goals, putting together a plan of action, and then putting that plan into play with a budget. Because without a plan, nothing will happen.

Principle 3: The Time Value of Money—In order to understand why it is so important to begin saving early you need to understand how powerful the time value of money is. Once you understand this concept, saving becomes much more fun.

Principle 4: Taxes Affect Personal Finance Decisions—Like it or not, taxes are part of life, and as a result, your financial plan must take taxes into account.
Learning Objectives

- Explain why personal financial planning is so important.
- Describe the five basic steps of personal financial planning.
- Set your financial goals.
- Explain how career management and education can determine your income level.
- Explain the personal finance lessons learned in the recent economic downturn.
- List ten principles of personal finance.
- Understand that achieving financial security is more difficult for women.

On the TV show *How I Met Your Mother*, Marshall and Lily play the part of loving, but somewhat goofy, newlyweds. Marshall is a young lawyer and Lily is a kindergarten teacher, who, along with their friends, Robin, Ted, and Barney, get into some improbable predicaments, but the financial problems they face are, unfortunately, all too realistic.

Marshall has his law degree, is loaded with student loan debt, and has to make a decision whether to take his low-paying dream job with the non-profit NRDC, or a high-paying job with an evil law firm. It’s a choice of money versus his dream, and he ends up taking the money. Meanwhile, Lily is back at their apartment with girlfriend Robin, looking over some of her new purchases. Robin asks, “How can you afford such expensive clothes?” The answer is as you might expect, on credit, and apparently Lily has a lot of debt. As Robin
says, “Lily, you have debt the size of Mount Waddington!” “Waddington?” Lily responds. “It’s the tallest mountain in Canada. It’s like 4,000 meters high,” Robin explains. “Meters?” Lily responds—apparently Lily knows about as much about meters as she does about personal finance.

Clever and improbable plot line? Not really. Unfortunately, personal financial problems and their avoidance are all too common. It’s much easier to postpone dealing with money problems than to confront them. In fact, Lily said she was intending to take care of her credit card debt just as soon as she finished furnishing their apartment. As Robin responded, “You should be on a reality show.”

How much do you know about personal finance? Hopefully more than Lily, but probably not enough. That’s pretty much how it is for everyone until they’ve made a real effort to learn about personal finance.

Being financially secure involves more than just making money—life will be easier when you learn to balance what you make with what you spend. Unfortunately, financial planning is not something that comes naturally to most people. This text will provide you with the know-how to avoid financial pitfalls and to achieve your financial goals, whether they include a new car, a vacation home, or early retirement. In addition to providing the necessary tools and techniques for managing your personal finances, you will also learn the logic behind them, allowing you to understand why they work. To make life a little easier, you will be introduced to ten basic principles, which reinforce this underlying logic. If you understand these principles, you are well on your way to successful financial planning. It’s just too bad Lily didn’t take this class.

**Facing Financial Challenges**

How big are the financial challenges you face? You may be gaining an appreciation for the cost of college. College tuition and fees at a private school average around
$27,300 per year; at a public school, the average is $7,605 per year. Add to this the cost of housing and food, textbooks and computer equipment, and the “essentials”—a minirefrigerator, a parking permit, lots of change for the laundry, a bit more cash to cover library fines, and late-night pizza money. How do most students finance the cost of college? The answer is, by borrowing.

Today, the typical grad with loans—and that’s about half of all college students—will leave college with both a diploma and about $24,000 in debts, and many students are far more in debt than that. Take, for example, Sheri Springs-Phillips, who was written about in the Wall Street Journal. She’s a neurology resident at Loyola University Medical Center. On her 11-year journey from the South Side of Chicago to becoming a doctor, she piled up $102,000 in debt. Although her friends think she’s got it made, she worries about the $2,500 monthly loan payments that begin when she finishes her residency. Fortunately, Sheri is an exception, but just the average level of debt can be daunting. However, with a solid financial plan, even this level of debt is manageable.

Financial planning may not help you earn more, but it can help you use the money you do earn to achieve your financial goals. Say you really hope to buy a Jeep when you graduate—one with a stereo loud enough to wake the neighbors (and the dead). That’s a financial goal, and a good financial plan will help you achieve it. A solid financial plan could also help you save enough to spend the summer in Europe, or help you balance your budget so maybe someday you won’t have a roommate. It may even help you pay off those student loans! Whatever your financial goals, the reality is this: Either you control your finances, or they control you—it’s your choice.

Managing your finances isn’t a skill you are born with. And, unfortunately, personal finance courses aren’t the norm in high school, and in many families money is not something to talk about—only to disagree on. In fact, financial problems can be a major cause of marital problems. Disagreements about money can instill a fear of finance at an early age, and a lack of financial education just makes matters worse. As a result, most people grow up feeling very uncomfortable about money. But there is nothing to be afraid of; personal financial management is a skill well worth learning.

When we first attempt to understand the subject of personal finance, we are often intimidated by the seemingly unending number of investment, insurance, and estate planning options, as well as by the fact that the subject has a language of its own. How can you make choices when you don’t speak the language? Well, you can’t. That’s why you’re reading this text and taking this course—to allow you to navigate the world of money. Specifically, this text and this course will allow you to accomplish the following:

- **Manage the unplanned**: It may seem odd to plan to deal with the unexpected or unplanned. Hey, stuff happens. Unfortunately, no matter how well you plan, much of what life throws at you is unexpected. A sound financial plan will allow you to bounce back from a hard knock instead of going down for the count.

- **Accumulate wealth for special expenses**: Travel, a big wedding, college for your children, or buying a summer home are all examples of events that carry expenses for which you’ll have to plan ahead financially. Financial planning will help you map out a strategy to pay for a house by the beach or a trip around the world.
Save for retirement: You may not think much about it now, but you don’t want to be penniless when you’re 65. A strong financial plan will help you look at the costs of retirement and develop a plan that allows you to live a life of retirement ease.

“Cover your assets”: A financial plan is no good if it doesn’t protect what you’ve got. A complete financial plan will include adequate insurance at as low a cost as possible.

Invest intelligently: When it comes to investing savings, arm yourself with an understanding of the basic principles of investment. And beware: There are some shady investments and investment advisors out there!

Minimize your payments to Uncle Sam: Why earn money for the government? Part of financial planning is to help you legally reduce the amount of tax you have to pay on your earnings.

The Personal Financial Planning Process

Financial planning is an ongoing process—it changes as your financial situation and position in life change. However, there are five basic steps to personal financial planning we should examine before we continue.

Step 1: Evaluate Your Financial Health

A financial plan begins with an examination of your current financial situation. How much money do you make? How much are you spending, and what are you spending it on? To survive financially, you have to see your whole financial picture, which requires careful record keeping, especially when it comes to spending.

Keeping track of what you spend may simply be a matter of taking a few minutes each evening to enter all of the day’s expenses into a book or a computer program. Is this record keeping tedious? Sure, but it will also be revealing, and it’s a first step toward taking control of your financial well-being. In Chapter 2 we take a closer look at the record-keeping process.

Step 2: Define Your Financial Goals

You can’t get what you want if you don’t know what you want. The second step of the financial planning process is defining your goals, which entails writing down or formalizing your financial goals, attaching costs to them, and determining when the money to accomplish those goals will be needed. Unfortunately, establishing personal financial goals is something most people never actually do, perhaps because the subject is intimidating, or because they have absolutely no idea how to achieve these goals. Although it is not a difficult task, it’s an easy one to put off. However, only when you set goals—and analyze them and decide if you’re willing to make the financial commitment necessary to achieve them—can you reach them.

STOP & THINK

According to a recent Retirement Confidence Survey, retirement was the number one savings goal for Americans. It was listed 3½ times more often by those surveyed than the number two savings goal, which was a child’s or grandchild’s education. But while Americans feel retirement savings are important, they don’t seem to be making much progress saving. That same survey showed that 54 percent of all workers had saved less than $25,000 (not including the value of their primary residence), and 63 percent of Americans aged 55 and older have less than $100,000 in savings. Only 30 percent of this same group have an annual income of more than $25,000; 45 percent have an annual income of less than $15,000! And these figures include Social Security benefits! Retirement is only one of many reasons financial planning is so important. As Carl Sandburg once wrote, “Nothing happens unless first a dream.” Why do you think goals are so important?
Step 3: Develop a Plan of Action

The third step of the process is developing an action plan to achieve your goals. A solid personal financial plan includes an informed and controlled budget, determines your investment strategy, and reflects your unique personal goals. Although everyone’s plan is a bit different, some common factors guide all sound financial plans: flexibility, liquidity, protection, and minimization of taxes.

**Flexibility**  Remember when we mentioned planning for the unplanned? That’s what flexibility is all about. Your financial plan must be flexible enough to respond to changes in your life and unexpected events, such as losing your job or rear-ending the Honda in front of you. An investment plan that doesn’t allow you to access your money until you retire doesn’t do you much good when you suddenly get fired for using your office computer to play Portal 2 or Shogun 2: Total War.

**Liquidity**  Dealing with unplanned events requires more than just flexibility. Sometimes it requires immediate access to cold, hard cash. **Liquidity** means the ability to get to your money when you need it. No one likes to think about things such as illness, losing a job, or even wrecking your car. But as we said earlier, stuff happens, so when it does, you need to make sure you have access to enough money to make it through.

**Protection**  What if the unexpected turns out to be catastrophic? Liquidity will pay the repair bill for a fender bender, but what if you are involved in a serious accident and you wind up badly injured? What if the cost of an unexpected event is a lot more than you’ve got? Liquidity allows you to carry on during an unexpected event, but insurance shields you from events that threaten your financial security. Insurance offers protection against the costliest unforeseen events, such as flood, fire, major illness, and death. However, insurance isn’t free. A good financial plan includes enough insurance to prevent financial ruin at reasonable rates.

**Minimization of Taxes**  Finally, your financial plan must take taxes into account. Keep in mind that a chunk of your earnings goes to the government, so if you need to earn $1,000 from an investment, make sure it yields $1,000 after taxes. While you want to pay as little in tax as possible, your goal in effect is not to minimize taxes but to maximize the cash that is available to you after taxes have been paid.

Step 4: Implement Your Plan

Although it’s important to carefully and thoughtfully develop a financial plan, it is equally important to actually stick to that plan. While you don’t want to become a slave to your financial plan, you will need to track income and spending, as well as keep an eye on your long-term goals.

Keep in mind that your financial plan is not the goal; it is the tool you use to achieve your goals. In effect, think of your financial plan not as punishment but as a road map. Your destination may change, and you may get lost or even go down a few dead ends, but if your map is good enough, you’ll always find your way again. Remember to add new roads to your map as they are built, and be prepared to pave a few yourself to get to where you want to go. Always keep your goals in mind and keep driving toward them.
Step 5: Review Your Progress, Reevaluate, and Revise Your Plan

Let’s say that on your next vacation you’d like to explore Alaska, but the only road map you have of that state is decades old. Well, to stay on course you’d better get a new map! The same is true for your financial strategy. As time passes and things change—maybe you get married or have children—you must review your progress and reexamine your plan. If necessary, you must be prepared to get a new map—to begin again and formulate a new plan. Remember, your financial plan is not the goal; it is the tool you use to achieve your goals. It’s a road map to your dreams. Your destination may change, and you may get lost or even go down a few dead ends, but if your map is clear, you’ll always be able to get back on course.

Figure 1.1 summarizes these five basic steps to financial planning.

Establishing Your Financial Goals

Financial goals cover three time horizons: (1) short term, (2) intermediate term, and (3) long term. Short-term goals, such as buying a television or taking a vacation, can be accomplished within a 1-year period. An intermediate-term goal may take from 1 year to 10 years to accomplish. Examples include putting aside college tuition money for your 12-year-old or accumulating enough money for a down payment on a new house. A long-term goal is one for which it takes more than 10 years to accumulate the money. Retirement is a common example of a long-term financial goal.

Figure 1.2 is a worksheet that lists examples of short-, intermediate-, and long-term goals. You can use it to determine your own objectives. In setting your goals, be as specific as possible. Rather than aim to “save money,” state the purpose of your saving efforts, such as buying a car, and determine exactly how much you want saved by what time. Also, be realistic. Your goals should reflect your financial and life situations. It’s a bit unrealistic to plan for a $100,000 Porsche on an income of $15,000 a year.

Once you’ve set up a list of goals, you need to rank them. Prioritizing goals may make you realize that some of your goals are simply unrealistic, and you may need to reevaluate them. However, once you have your final goals in place, they become the cornerstone of your personal financial plan, serving as a guide to action and a benchmark for assessing the effectiveness of the plan.
The Life Cycle of Financial Planning

As we said earlier, people’s goals change throughout their lives. Although many of these changes are due to unexpected events, the majority are based on a financial life cycle pattern. Figure 1.3 illustrates an example of a financial life cycle. Looking at this figure and thinking about what your own financial life cycle may look like allows you to foresee financial needs and plan ahead. Consider retirement. If you’re a college student, retirement may be the furthest thing from your mind. However, if you think about your financial life cycle, you’ll realize that you need to make retirement funding one of your first goals after graduation.

The first 17 or 18 years of our lives tend to involve negative income (and you thought it was only you). You can think of this as the “prenatal” stage of your financial life cycle. During this period most people are in school and still depend on their parents to pay the bills. After high school, you may get a job, or attend college, or do both. Regardless, once your education is completed, your financial life cycle may begin in earnest. This first stage can be decades long, and centers on the accumulation of wealth. For most people this period continues through their mid-50s. During this time, goal setting, insurance, home buying, and family formation get the spotlight in terms of planning.

<table>
<thead>
<tr>
<th>FIGURE 1.2 Personal Financial Goals Worksheet</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Short-Term Goals (less than 1 year)</strong></td>
</tr>
<tr>
<td>Goal</td>
</tr>
<tr>
<td>Accumulate Emergency Funds Equal to 3 Months’ Living Expenses</td>
</tr>
<tr>
<td>Pay Off Outstanding Bills</td>
</tr>
<tr>
<td>Pay Off Outstanding Credit Cards</td>
</tr>
<tr>
<td>Purchase Adequate Property, Health, Disability, and Liability Insurance</td>
</tr>
<tr>
<td>Purchase a Major Item</td>
</tr>
<tr>
<td>Finance a Vacation or Some Other Entertainment Item</td>
</tr>
<tr>
<td>Other Short-Term Goals (Specify)</td>
</tr>
<tr>
<td><strong>Intermediate-Term Goals (1 to 10 years)</strong></td>
</tr>
<tr>
<td>Save Funds for College for an Older Child</td>
</tr>
<tr>
<td>Save for a Major Home Improvement</td>
</tr>
<tr>
<td>Save for a Down Payment on a House</td>
</tr>
<tr>
<td>Pay Off Outstanding Major Debt</td>
</tr>
<tr>
<td>Finance Very Large Items (Weddings)</td>
</tr>
<tr>
<td>Purchase a Vacation Home or Time-Share Unit</td>
</tr>
<tr>
<td>Finance a Major Vacation (Overseas)</td>
</tr>
<tr>
<td>Other Intermediate-Term Goals (Specify)</td>
</tr>
<tr>
<td><strong>Long-Term Goals (greater than 10 years)</strong></td>
</tr>
<tr>
<td>Save Funds for College for a Young Child</td>
</tr>
<tr>
<td>Purchase a Second Home for Retirement</td>
</tr>
<tr>
<td>Create a Retirement Fund Large Enough to Supplement Your Pension So That You Can Live at Your Current Standard</td>
</tr>
<tr>
<td>Take Care of Your Parents After They Retire</td>
</tr>
<tr>
<td>Start Your Own Business</td>
</tr>
<tr>
<td>Other Long-Term Goals (Specify)</td>
</tr>
</tbody>
</table>
The second and third stages are shorter. During the second stage, which for some people may begin in their early 50s, financial goals shift to the preservation and continued growth of the wealth you have already accumulated. You may begin to think about estate planning, that is, planning for the passage of your wealth to your heirs. The third and final stage, retirement, often begins in the mid- to late-60s. During retirement you are no longer saving; you are spending. However, you must still allow for some growth in your savings simply to keep inflation from eating it away.

Think of the financial life cycle in terms of a family life cycle. Consider a couple that marries in their 20s or 30s, has kids shortly thereafter, spends the next 18 or 20 years raising the kids and putting them through college, and then settles down as a couple again when the kids move out to form their own families. Obviously, a typical individual’s experiences don’t fit everyone perfectly. Today, with more single-parent families and more young people postponing marriage, it simply isn’t reasonable to refer to any family experience as typical. However, regardless of how unusual your life is, you’ll be surprised at how much it has in common with a typical financial life cycle.

The early years are different for everyone. For many people, however, the biggest investment of a lifetime, purchasing a home, occurs during these early years.
With a house comes a long-term borrowing commitment and your introduction to debt planning. Although the costs of owning a home may dominate your financial life during this period, you can’t lose track of the rest of your plan. Therefore, you must develop a regular pattern of saving. The importance of making saving a habit cannot be overstressed. Once you make a commitment to save, then you need to ask the following questions: (1) How much can I save? (2) Is that enough? and (3) Where should I invest those savings dollars?

Decisions that may not seem financial will have a major impact on your financial situation. Take, for example, the decision to have a child. Although this isn’t considered primarily a financial decision, it certainly has enormous financial implications. As Table 1.1 illustrates, kids cost a lot. In fact, for a middle-income family earning $76,250 per year, the total cost of raising a child from birth to age 18 is $222,360. And the more you make, the more you spend on raising children. Those with annual incomes of more than $98,120 spend more than twice that of those with annual incomes less than $56,670. The major differences occur in housing, child care, and education. As you look at these figures, keep in mind that they cover only the costs of a child from birth to age 18—they don’t include the costs of college. Considering the $8,570 to $19,410 a year it costs to raise a child, saving to finance that child’s college education is a real challenge!

You must also buy insurance to protect your assets. Initially you may require only medical, disability, and liability insurance, but if you decide to have a family, you will need to provide for your dependents in the event of a tragedy. For families with children, adequate life insurance is essential. You will also need home, auto, and property insurance.

The second stage involves a transition from your earning years, when you will earn more than you spend, to your retirement years, when you will spend more than you earn. Exactly what happens during this transition stage and how long it lasts depends upon how well you are prepared for retirement. Much of this transition involves reassessing your financial goals—including insurance protection and estate planning—to make sure you are truly prepared for retirement. As you approach retirement, you must continuously review your financial decisions, including insurance protection and estate planning. Keep in mind that this is your last opportunity to save and prepare for your retirement years, and how well you succeed at that will determine how you live during retirement.

### TABLE 1.1 The Cost of Raising a Child

These calculations are for the second child in a two-child family. For families with only one child, the costs of raising that child are more and can be determined by multiplying the totals by 1.24. For families with two or more children, the costs of an additional child can be determined by multiplying the totals by 0.77.

<table>
<thead>
<tr>
<th>Annual Income</th>
<th>Annual Expenses First 3 Years</th>
<th>Total Expenses First 18 Years</th>
<th>Housing</th>
<th>Food</th>
<th>Transportation</th>
<th>Clothing</th>
<th>Health Care</th>
<th>Child Care and Education</th>
<th>Other&lt;sup&gt;a&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than $56,670</td>
<td>$8,570</td>
<td>$160,410</td>
<td>$29,760</td>
<td>$20,790</td>
<td>$10,980</td>
<td>$13,230</td>
<td>$21,720</td>
<td>$10,650</td>
<td></td>
</tr>
<tr>
<td>$56,670–$98,120</td>
<td>11,700</td>
<td>222,360</td>
<td>70,020</td>
<td>28,590</td>
<td>13,260</td>
<td>17,760</td>
<td>37,740</td>
<td>19,020</td>
<td></td>
</tr>
<tr>
<td>More than $98,120</td>
<td>19,410</td>
<td>369,360</td>
<td>126,540</td>
<td>41,790</td>
<td>18,750</td>
<td>20,460</td>
<td>81,210</td>
<td>35,040</td>
<td></td>
</tr>
</tbody>
</table>

<sup>a</sup>Other expenses include personal care items, entertainment, and reading material.

In the last stage, during your retirement years, you’ll be living off your savings. Certainly, the decision about when to retire will reflect how well you have saved. Once you retire, your financial focus is on ensuring your continued wealth, despite not having income. As always, you’ll spend much of your time overseeing the management of savings and assets, but now your concern will be making sure you don’t run out of money. You’ll be dealing with the question of how much of your savings can you tap into each year without ever running out of money, and your investment strategy will probably become less risky as you now need to preserve rather than create wealth. In addition, your insurance concerns may now include protection against the costs of an extended nursing home stay.

Finally, estate planning decisions become paramount. Things like wills, living wills, health proxies, power of attorney, and record keeping should all be in place to help protect you along with your assets for your heirs. These estate planning tools will help ensure that your wishes are kept as you reach the end of your life. They’ll also allow you to pass on your estate to whomever you want while keeping your estate taxes at a minimum.

**Facts of Life**

Forty-five percent of those in the United States aged 65 and older are financially dependent on relatives and another 30 percent live on charity. If you’re like most young people, fresh out of college, you probably will have an urge to spend all that cash that you may be making for the first time in your life. Feel free to spend, as long as you manage to save for your goals, and make sure you begin planning for your financial future now. The key is to start the personal financial planning process early in life and make saving a habit.

**Money Matters**

**Tips from Marcy Furney, ChFC, Certified Financial Planner™**

**The ABC’s of Finding an Advisor**

*Analyze your needs.* Are you a “do-it-yourselfer” who needs just a basic plan to follow, or do you need assistance in implementing any recommendations? Are you just starting out, or do you have a family and estate planning needs? Perhaps you have both personal and business concerns, such as a professional practice or your own firm.

*Decide what type of advisor you want.* Are you set on a “fee only” planner? Do you like the idea of a general practitioner, or does your situation dictate the need for a highly specialized individual, such as an estate attorney? Once you’ve figured out what type of advisor you want, attend seminars, or better yet, ask for referrals from friends and family.

*Visit with one or more advisors before you make a decision.* Most offer a complementary initial consultation. Caution: Don’t feel you have to keep shopping if you’re fortunate to find the right person on the first try.

*Investigate your candidates.* Ask for an explanation of services or a sample plan. Check for complaints and resolutions through the Better Business Bureau or regulatory bodies such as the CFP Board of Standards. Find out how long the firm has been in business. (Will they be there when you need them?) How is the advisor compensated?

*Set a deadline for selecting your advisor and stick to it.*

I have met people who admit to spending 5 or more years searching for the “perfect planner.”

*Open your mind!* Gray hair and wrinkles don’t always mean wisdom, and peach fuzz is not synonymous with fresh ideas. If the candidates are relatively new in practice, make sure they have, or are pursuing, a professional designation and that they have associates who can take over for them if they don’t continue in the practice.

*Rely on your knowledge and instincts.* If you’re not comfortable enough with the person to reveal all your financial details, run, don’t walk, away. Annoying “faults” and suspicions become major roadblocks with time. Select someone you like, trust, and respect—someone you think could be your lifetime financial advisor. As Mom always said, “Don’t date ‘em if you wouldn’t marry ‘em.”
Thinking About Your Career

Career planning is the process of identifying a job that you feel is important and that will lead to the lifestyle you want. When considering which career is right for you, think about the kind of work you find enjoyable and satisfying. It is also important to choose work that provides the standard of living you hope to achieve. In general, your first job isn’t the one you’ll spend the rest of your life doing. Most careers involve a series of positions that give you the opportunity to display your skills, that lead to a job that you find satisfying, and that allow you to balance work and your personal life. Figure 1.4 is a Job Search Worksheet that will help you manage your career.

Choosing a Major and a Career

The first steps in career planning are self-assessment and developing an understanding of what you want. First, consider your interests, skills, values, personal traits, and desired lifestyle. What activities do you enjoy? How do you like to spend your time? What other skills do you have that might be of value in a career? Look, too, at your educational record. Which courses did you like most and which did you like least? Which courses did you do the best in? From there, take a look at your work experience. Make a list of all the jobs you’ve had and all the volunteer activities you’ve taken part in. Think about each of these and determine what about them you found satisfying and not so satisfying. Why did you leave any of these situations?

Conducting an effective self-assessment means looking at many aspects of your life honestly. Once you are through, you will have a good idea of your skills and interests. Now you can research career alternatives and identify those in which your abilities are valued. Once you’ve narrowed down a list of options, look at both the positive and negative aspects of these professions. Do they offer the status and earning potential you are looking for? Are they part of a stable industry? Might they require travel or frequent relocation? Talk to people in the occupations you’ve targeted to learn more about what they do as well as what they like and dislike about their jobs.

Once you’ve made a self-assessment, looked at career options, and talked to people in the workplace, you may be ready to decide on a career field that fits your interests and that is realistically achievable. If you are a college student who has not yet chosen a major, you will want to consider which major puts you in line for the kind of job you’d like when you graduate. You may want to talk to the people at your school’s career center to find out more about how specific college majors relate to different occupations. While you want to make sure you choose a career that fits your interests, it is also good to have an idea of what that job pays when you’re making this decision. Let’s take a look at the average annual earnings of full-time employed college graduates with only a bachelor’s degree based upon their college major. As you can see from Table 1.2, the major you choose can affect how much you eventually earn. While looking at these numbers, keep in mind that these are averages—you might earn more or less than the figure given. And picking one of the “low earners” in terms of majors doesn’t mean you won’t be successful and earn a good wage—just look at Carly Fiorina who served as the CEO of Hewlett-Packard from 2000 through 2005 and is now a business commentator on Fox Business Network. She was a medieval history and philosophy major! Also keep in mind that while money isn’t everything, it shouldn’t be ignored.

If you’re still lost, you might want to try the Internet, which offers a wealth of career advice. The Career Guide to Industries, published by the...
**FIGURE 1.4 Job Search Worksheet**

<table>
<thead>
<tr>
<th>The Search (Complete items 1–3 on this checklist before starting your job search.)</th>
<th>Notes</th>
</tr>
</thead>
</table>
| **1. Identify Occupations** | List your work and life experience.  
Review information on jobs—find out what types of jobs are hiring.  
Identify jobs that use your talents. |
| **2. Identify Employers** | Tell relatives and friends that you are job hunting—you never know who may have a lead!  
Go to your state employment service office for assistance.  
Use the Internet or contact employers to get company and job information. |
| **3. Prepare Materials** | Write your résumé. Tailor it, if necessary, using job announcements to “fit” your skills with job requirements.  
Write cover letters or letters of application. |

<table>
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<tr>
<th>The Daily Effort</th>
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| **4. Contact Employers** | Call employers directly (even if they're not advertising openings).  
Ask to speak to the person who would supervise you if you were hired. Make note of names.  
Go to companies to fill out applications. |
| **5. Prepare for Interviews** | Check out the Internet and learn about the company you're interviewing with.  
Review job announcements to determine how your skills will help you do the job.  
Assemble résumés, application forms, etc. (make sure everything is neat). |
| **6. Go to Interviews** | Dress right for the interview—that, of course, will depend on the job you're applying for.  
Go alone.  
Be positive.  
Thank the interviewer. |
| **7. Evaluate Interviews** | Send a thank-you note to the interviewer within 24 hours of the interview.  
Think about how you could improve the interview—remember, this may not be your last interview. |
| **8. If You Have to Take Tests for the Job—Be Ready** | Find out about the test(s) you're taking.  
Prepare for the test and brush up on job skills.  
Relax and be confident. |
| **9. Accept the Job!** | Be flexible when discussing salary (but don't sell yourself short).  
If you're expecting more than they offer, ask for it. The worst that can happen is that they will say no.  
Congratulations! |
Part 1 • Financial Planning

U.S. Department of Labor, is a good source for career advice. This guide is located at www.bls.gov/oco/cg and provides information on available careers by industry, including the nature of the industry, working conditions, employment, occupations in the industry, training and advancement, earnings and benefits, and employment outlook along with lists of organizations that can provide additional information. It’s comprehensive, too; in fact, it discusses over 42 industries, accounting for over 7 out of every 10 wage and salary jobs.

Getting a Job

Getting your first real job is a job in itself. One of the most important things to remember is to start early. Remember what Woody Allen once said, “Eighty-five percent of success is simply showing up.” That means that if you’re graduating in May, you have to put your résumé together the summer before your senior year.

Why start that early? There are three reasons. First, the beginning of fall semester is generally hectic, so if you wait until then to create your résumé, you may get delayed by a month or two. Beginning in the summer guarantees you’ll be prepared to start your job search in the fall. Second, when you begin submitting your résumé before other seniors, you send a message to potential employers that you are both serious and organized—two traits employers love. Third, for many companies, the fall is the beginning of their recruiting cycle.

When you are selected for an interview, the key is to be prepared. While you can’t be ready for every question, there are some relatively standard questions that you should be equipped to answer. Recently, resumedoctor.com surveyed over 2,000 recruiters and hiring managers to find out what questions they ask during job interviews. Table 1.3 lists the top 15 interview questions.
If possible, practice interviewing. Many college career development offices provide courses or help in developing the interpersonal skills that are necessary for a good interview. Next, use the library or the Internet to find as much information as possible about the company you’re interviewing with. Understand how the company makes its money, know its history and its financial status, and read up on any new developments. And be sure to make a good first impression. Dress appropriately and get a good night’s rest before your interview. Plan to arrive about 30 minutes early to guard against any unexpected delays. Display strong body language: A firm handshake, good eye contact, and straight but relaxed posture are all part of a confident image. When the interview is ended, make sure you thank the interviewer for his or her time and for giving you the opportunity to meet. Finally, when you get home, send a follow-up letter, thanking the interviewer again, and reiterating your interest in the position.

Being Successful in Your Career

If you are just starting out, it is likely that you’ll work for at least three or four different companies and have more than ten different jobs over the course of your working life. You may switch jobs or even careers for many reasons: You may be offered great opportunities, your personal interests may shift, or the job market in your industry may change. In this era of regular corporate restructuring, job security is not what it used to be. To protect yourself, be sure to keep your skills marketable through education and by keeping up with changing technology. To increase your value as an employee:

- Do your best work.
- Project the right image—an image aligned with the organization’s values and wants.
- Gain an understanding of the power structure so that you can work within it.
- Gain visibility. Make those with power aware of your contributions.
- Take new assignments. Gain experience and an understanding of the various operations of the organization.

**FACTS of LIFE**

According to a recent recruiting survey, the most common mistake job interviewees make is: talking too much.

**TABLE 1.3 Most Common Interview Questions**

| 1. | Describe your ideal job and/or boss. |
| 2. | Why are you looking for a job? Why are you leaving your current position? |
| 3. | What unique experience or qualifications separate you from other candidates? |
| 4. | Tell me about yourself. |
| 5. | What are your strengths and weaknesses? |
| 6. | Describe some of your most important career accomplishments. |
| 7. | What are your short-term/long-term goals? |
| 8. | Describe a time when you were faced with a challenging situation and how you handled it. |
| 9. | What are your salary requirements? |
| 10. | Why are you interested in this position? Our company? |
| 11. | What would your former boss/colleagues say about you? |
| 12. | What are the best and worst aspects of your previous job? |
| 13. | What do you know about our company? |
| 14. | What motivates you? How do you motivate others? |
| 15. | Are you willing to relocate? |

Be loyal to and supportive of your boss. Remember, your boss controls your immediate future.

Continually acquire new skills, in particular, skills that are not easy to duplicate.

Develop a strong network of contacts in case you ever need to look for a new job.

Pay attention to ethics because the most damaging event you, as an employee, can experience is a loss of confidence in your ethical standards. Ethical violations end careers.

The bottom line is that managing your career is an ongoing process that will end only when you finally retire.

What Determines Your Income?

What you earn does not determine how happy you are, but it does determine the standard of living you can afford. However, there is great variation in what different people earn at the same job with different companies. But, one thing is clear, the more specialized skills and training a job requires, the higher it tends to pay.

Without question, the key differentiating factor in determining your eventual salary is how well educated you are as Figure 1.5 shows. Right now, you may be making the best single investment you will ever make—your education. Interestingly, being married is also a trait of the wealthy. Whereas a married couple heads 70 percent of the middle class households, that number climbs to 85 percent for wealthy households. Your financial plan must be realistic and it must be based on your income. Let’s look at some basic principles of a solid financial strategy.

Keeping a Perspective—Money Isn’t Everything

Your personal financial plan allows you to extend your financial strategy beyond the present—to allow you to achieve goals that are well off in the future. In effect,
personal financial planning allows you to be realistic about your finances—to act
your wage. Unfortunately, for some people financial goals become all consuming.
They see nothing but dollar signs and lose a healthy perspective on what is actually
important in life. In the first version of the movie Arthur there is an exchange between
Dudley Moore and Liza Minnelli in which Moore, who plays Arthur Bach, says “money has screwed
me up my whole life. I’ve always been rich, and I’ve never been happy.” To this Minnelli, who
plays Linda Marolla (Arthur’s girlfriend), replies, “Well, I’ve always been poor, and I’ve usually
been happy.” Arthur’s mother then steps in and responds, “I’ve always been rich, and I’ve always
been happy!” It’s true: Money does not equal happiness. In fact, the Wall Street Journal reported
the results of an international happiness survey and found respondents from
Forbes’s annual list of the 400 richest Americans score 5.8 on the happiness scale.
That’s the same score reported by the Inuit of northern Greenland and the hut-
dwelling Masai of Kenya. But keep in mind, while money doesn’t necessarily bring
happiness, facing college expenses or retirement without the necessary funding cer-
tainly brings anxiety.

Lessons from the Recent Economic Downturn

The economic downturn that started in 2008 has had a painful impact on all
Americans in one way or another. This pain has two root causes: first, a dramatic
and swift rise in unemployment and, second, a disruption of our financial markets.
Together, these two events have resulted in loss of wealth and a level of difficulty in
borrowing that has not been experienced since the great depression. At one point,
stocks had dropped in value by over 50 percent and banks were not lending money—
in short, it has been a financial disaster of historic proportion. Unfortunately, no one
can change the past, but the question remains: Can the lessons learned be used to
change your financial future? If not, you will be destined to relive the past over and
over again.

In December 2010, a Rockefeller Foundation report detailed how Americans
were impacted by the recession that began in 2008. The report focuses not only on
financial hardship, but also on citizens’ worries, stress, and concerns for the future.
Why is it so important that we take a close look at the impact of the recent downturn
on Americans? First, it paints a frightening picture of how vulnerable Americans are.
Second, it gives you an idea of the deep concerns Americans have about their retire-
ment. For students, retirement is generally the farthest thing from your mind—after
all, you don’t even have a job yet, retirement is years and years away, and you know
things will work out because they always seem to. But by looking at the financial
fears of those a generation ahead of you, you can get a clearer picture of what you
might face in the future if you don’t take action now. Finally, when it comes to pain,
we all have short memories. As we move out of the recession and the memory of
the financial pain fades, we are destined to repeat the past if we don’t learn from it,
falling into the old habits that brought on all the financial pain—overspending, not
saving, and acquiring too much debt.

Let’s take a look at some of the findings. First, let’s look at how Americans felt about their financial situation:

- From March 2008 to September 2009, 93 percent of households experienced a financial shock either in the form of a substantial decline in their wealth or earnings, or a huge increase in spending, most often from medical expenses or from monetarily assisting family members.
- Twenty-three percent of households reported a drop of at least one-quarter of their annual household income.
- Not just the poor were affected; the middle class was also impacted: More than half of families with incomes of $60,000 to $100,000 who experienced medical expenses or a job loss said they were unable to meet at least one basic economic need such as food, shelter, or medical care.

Clearly, all Americans were affected by this recession.

Now let’s look at Figure 1.6, which examines how long a household can go without income before hardship sets in. From that figure you can see:

- Just over 29 percent of Americans reported that their household could be maintained 6 months or longer without experiencing hardship if their earnings were to stop tomorrow.
- Nearly half of households could not be maintained longer than 2 months without hardship setting in.
- About 1 in 5 households could only go 2 weeks without experiencing hardships.

What lesson can we learn from all this? First, in looking back at the recent economic downturn it becomes evident that too many of us have insufficient emergency funds—one of your first financial goals should be to put together an emergency fund that is sufficient to carry you through a financial emergency. We will talk about that in the next chapter, and it will form the foundation for one of our Ten Principles of Personal Finance, which will be introduced in the next section.

What financial issues do Americans worry about the most? According to the Rockefeller Foundation report, without question, the answer is retirement. Over 50 percent of Americans worry about their ability to pay for retirement, with about 60 percent of those who were worried saying they were “very worried.”

Retirement concerns rise above employment, housing value, debt, medical costs,
and health care in terms of areas of concern. For that reason we will provide you with a strong foundation in personal finance directly related to retirement planning. While retirement may be many years away, a comfortable and secure retirement won’t come without a plan coupled with an early start.

Too much debt and health care were also identified as major concerns for Americans, with approximately 40 percent of Americans indicating that they are worried about their ability to make their debt payments. In addition, both the ability to secure adequate health insurance and to pay medical bills also showed up as a worry for about 40 percent of Americans.

Without a doubt, the economic recession of the late 2000s not only exacerbated the financial problems of most Americans, but it also gave us a look into the future by shedding light on the problems that will again haunt us if we do not prepare for them. Fortunately, with some financial planning, things like having sufficient emergency funds available when you need them; being able to afford a comfortable retirement and being able to retire when you want to; avoiding too much debt; and having adequate health insurance—all currently major concerns for many Americans—won’t be worries for you.

Ten Principles of Personal Finance

To the first-time student of personal finance, this text may seem like a collection of tools and techniques held together solely by the binding on the book. Not so! In fact, the techniques and tools we use to teach personal financial management are all based on very straightforward logic. We can sum up this logic in ten simple principles. Although it’s not necessary to understand personal finance in order to understand these principles, it’s necessary to understand these principles in order to understand personal finance.

These principles are used throughout the text to unify and relate the topics being presented, which will help you better understand the logic behind why the tools work. Let’s face it, your situation and the personal finance challenges you’ll face won’t fit into a simple formula. You have to understand the logic behind the material in the book in order to apply it to your life.

Let’s identify the ten principles that form the foundations of personal finance. Some are as much statements of common sense as they are theoretical statements. If all you remember from this course are these principles, you’ll still have an excellent grasp of personal finance and, thus, a better chance of attaining wealth and achieving your financial goals.

**Principle 1: The Best Protection Is Knowledge**

Finding advice on personal finance isn’t hard—the hard part is differentiating between the good and bad advice. The Internet, radio, television, newspapers, magazines, and even old-fashioned books are teaming up with financial gurus and guru wannabees, showering you with the latest advice on what to do with your money. While much of that advice will make someone rich, it may not be you; it may be the advice giver instead—and even worse, that someone may be getting rich at your expense. You can turn to a professional financial planner to help you establish a lifetime financial plan, but it will be up to you to manage it. The bottom line is that you need to understand the basics of personal financial management if you are going to achieve your financial goals—it’s also the only way you can protect yourself. A solid understanding of personal finance will:

- Enable you to protect yourself from the danger of an incompetent investment advisor.
- Provide you with an understanding of the importance of planning for your future.
Give you the ability to make intelligent investments and take advantage of changes in the economy and interest rates.

Allow you to extract the principles you learn here and elsewhere and apply them to your own situation.

Because financial problems in real life seldom perfectly reflect textbook problems and solutions, you must be able to abstract what you learn in order to apply it. The only way you can effectively abstract something is to understand it. As with most else in life, it’s much easier to do it right if you understand what you’re doing and why you’re doing it.

And when you know what you’re doing you don’t have to rely on insurance salespeople, personal financial advisors, and stockbrokers—after all, they may actually be acting in their own interests rather than in your best interest. For example, an insurance salesperson, motivated by a potential commission, may try to sell you insurance you don’t need. A personal financial advisor may try to sell you financial products, such as mutual funds, that are more expensive than similar products because he or she receives a hefty commission on them.

That doesn’t mean you should avoid insurance salespeople or financial planners but you should choose them carefully. Pick a financial planner just as you pick a competent and trustworthy doctor—look for one that fits your needs and has a proven record of ethical and effective assistance to clients. If you trust your doctor—or financial planner—you have to believe he or she has your best interests at heart. Just keep your eyes open, and of course, be aware of ulterior motives when making financial decisions.

**Principle 2: Nothing Happens Without a Plan**

Most people spend more time planning their summer vacation than they do planning their financial future. It’s easy to avoid thinking about retirement, to avoid thinking about how you’re going to pay for your children’s education, and to avoid thinking about tightening your financial belt and saving money. We began this book with the statement that it is easier to spend than to save. We can go beyond even that and say it is easier to think about how you’re going to spend your money than it is to think about how you’re going to save your money.

If you’re like most people, you can probably spend money without thinking about it, but you can’t save money without thinking about it. That’s the problem. Saving isn’t a natural event: It must be planned. Unfortunately, planning isn’t natural either. Begin with a modest, uncomplicated financial plan. Once the discipline of saving becomes second nature, or at least accepted behavior, modify and expand your plan. The longer you put off devising a financial plan, the more difficult accomplishing goals becomes. When goals appear insurmountable, you may not even attempt to reach them.

**Principle 3: The Time Value of Money**

Perhaps the most important concept in personal finance is that money has a time value associated with it. Simply stated, because you can earn interest on any money you receive, money received today is worth more than money received in, say, a year. For example, if you earn $1,000 today, and invest that money at 5 percent, 1 year from today that $1,000 will be worth $1,050. If, however, 1 year from today you earn another $1,000, that will be worth just that $1,000—$50 less than the $1,000 you earned today. Although this idea is not a major surprise to most people, they simply don’t grasp its importance. The importance of the time value of money is twofold. First, it allows us to understand how investments grow over time. Second, it allows us to compare dollar amounts in different time periods. If you can’t do that, you’ll be lost in personal finance.
In this text, we focus on ways to create and preserve wealth. To create wealth, we invest savings and allow it to grow over time. This growth is an illustration of the time value of money. In fact, much of personal finance involves efforts to move money through time. Early in your financial life cycle you may borrow money to buy a house. In taking out that home mortgage, you are really spending money today and paying later. In saving for retirement, you are saving money today with the intention of spending it later. In each case money is moved through time. You either spend in today’s dollars and pay back in tomorrow’s dollars, or save in today’s dollars and later spend in tomorrow’s dollars. Without recognizing the existence of the time value of money, it is impossible to understand compound interest, which allows investments to grow over time.

You’ll also find that time is your ally. If you are 20 right now, plan on retiring at 67, and you are earning 12 percent on your investments, you’ll end up with $1 million if you begin today and save $33 a month, begin at age 40 and save $366 a month, or begin at age 50 and save $1,319 a month, as shown in Table 1.4. As you can see, it’s a lot easier if you start early. This is all because of the time value of money.

**Principle 4: Taxes Affect Personal Finance Decisions**

Because taxes help determine the realized return of an investment, they play an important role in personal finance. No investment decision should be made without considering the tax consequences.
first knowing the effect of taxes on the return of that investment. Thus, you must look at all your alternatives on an after-tax basis. Taxes aren’t the same on all investments, so you will find that effective personal financial planning requires you to have an understanding of the tax laws and how they affect investment decisions.

**Principle 5: Stuff Happens, or the Importance of Liquidity**

Although much of the focus of personal financial planning is on long-term investing for lifetime goals, you must also plan for the unexpected. This means that some of your money must be available to you at any time, or *liquid*. If liquid funds are not available, an unexpected need, such as job loss or injury, may push you to have to cash in a longer-term investment. You may need to act immediately, which might entail, for example, having to sell a rental property when real estate prices are low. And what if you don’t have something to sell? In that case you’ll have to borrow money fast. That kind of borrowing may carry a high interest rate. It will also mean making unexpected loan repayments, which you may not be financially prepared to make. Generally, unplanned borrowing is tough to pay off; it is just one reason to have adequate liquid funds available and that generally means having enough liquid funds to cover 3 to 6 months of living expenses; exactly how much is needed will be discussed in the next chapter.

**Principle 6: Waste Not, Want Not—Smart Spending Matters**

Personal finance and managing your money involves more than just saving and investing—it also involves spending, specifically smart spending. If you’re going to work hard for your money, you don’t want to waste it. Unfortunately, smart spending isn’t always practiced. In fact, studies estimate that over 1 in 20 of us—that’s over 17 million Americans—are shopaholics; that is, they can’t control their urge to shop. When we talk about smart shopping we will not only be talking about the four-dollar lattes, the two-pack-a-day cigarette habit, the magazines, and the 450 extra satellite channels; we’ll also talk about buying a car and a house, and getting the most out of every dollar you spend.

The first step in smart buying is to differentiate want from need and understand how each purchase fits into your life. The second step involves doing your homework to make sure what you get has the quality that you expect. The third step involves making a purchase and getting the best price, and finally, the last step involves maintaining your purchase.

**Principle 7: Protect Yourself Against Major Catastrophes**

The worst time to find out that you don’t have the right amount or right kind of insurance is just after a tragedy occurs. Just look at the flood victims in New Orleans, after Hurricane Katrina, who didn’t have flood insurance. As you’ll see, insurance is an unusual item to purchase. In fact, most people don’t “buy” insurance, they’re “sold” insurance. It’s generally the insurance salesperson who initiates the sale and leads the client through the process of determining what to purchase.

What makes this process a problem is that it is extremely difficult to compare policies because of the many subtle differences they contain. Moreover, most individuals have insurance but have never read their policies. To avoid the consequences of a major tragedy, you need to buy the kind of insurance that’s right for you and to know what your insurance policy really says.

The focus of insurance should be on major catastrophes—those events that, although remote, can be financially devastating. Hurricanes, floods, earthquakes, and fires are examples. These are the events you can’t afford, and these are the events insurance should protect you against.
**Principle 8: Risk and Return Go Hand in Hand**

Why do people save money? The answer is simple: People generally save money and invest it in order to earn interest and grow their money so they will have even more money in the future. What determines how much return or interest you get on your money? Well, investors demand a *minimum return* greater than the anticipated level of inflation. Why? If inflation is expected to be 6 percent and the expected returns on the investment are only 2 percent, then the return isn’t enough to cover the loss of purchasing power due to inflation. That means the investor has, in effect, lost money, and there’s no sense in making an investment that loses money.

Now that you know what the minimum return is, how do you decide among investment alternatives? While all investments are risky to some degree, some are safer than others. Why would investors put their money in a risky investment when there are safer alternatives? The answer is they won’t unless they are compensated for taking that additional risk. In other words, investors demand additional expected return for taking on added risk. Notice that we refer to “expected” return rather than “actual” return. You may have expectations and even assurances of what the returns from investing will be, but because risk exists, you can never be sure what those returns are actually going to be.

Let’s face it, when it comes to investing, nothing is guaranteed in the future, and some investments have more uncertainty or risk—that is, there’s a greater chance that the fat return you’re expecting may not turn out. Just look at investing in government bonds versus bonds issued by General Motors. In each case you’re lending money—that’s what you’re doing when you buy a bond because a bond is just like a loan. The person that issues the bond is borrowing the money and the person that buys the bond is lending the money. Because there is more risk with GM bonds—that is, there’s a greater chance GM might not be able to pay you back—GM bonds pay a higher rate of interest than government bonds do; otherwise, no one would buy GM bonds. After all, you know the government will be around to pay off its loans, but GM may not be. It’s that added incentive of additional interest that convinces some investors to take on the added risk of a GM bond rather than a government bond. The more risk an investment has, the higher its expected return should be. This relationship between risk and expected return is shown graphically in Figure 1.7.

Fortunately, diversification lets you reduce, or “diversify away,” some of your risk without affecting your expected return. The concept of diversification is illustrated by the old saying, “Don’t put all your eggs in one basket.” When you diversify, you are spreading your money in several investments instead of putting all your money in one. Then, if one of those investments goes bust, another—you hope—goes boom to make up for the loss. In effect, diversification allows you to weather the ups

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**FIGURE 1.7 The Risk–Return Trade-Off**

Diversification

*Acquisition of a variety of different investments instead of just one to reduce risk.*
and downs of investing. You don’t experience the great returns, but you don’t experience the great losses either—in fact, you receive the average return.

How much risk can you afford to take? In general, the longer you intend to hold an investment for, the more risk you can afford to take on. Take stocks, for example. Over the past 82 years, large-company stock prices have risen an average of 10.4 percent per year. However, it has not been a smooth ride. The problem with stocks is that “an average” may not be what you actually get. You may, for whatever reason, put your money in the stock market during the wrong period. If you need your money for your child’s college education, which begins next year, the stock market is not the right place to invest it. You do not want to stake your child’s college education on the hope that this will be a good year—or, more important, that this will not be a bad year.

However, if you are in your 20s and saving for your retirement, investing in the stock market makes sense. Although the market will surely vary over time, in the long run, your money is likely to grow more in the stock market than it would if you invested it in safer investments such as money markets or bonds.

**Principle 9: Mind Games, Your Financial Personality, and Your Money**

Sure you want to avoid financial mistakes—the problem is a lot of those mistakes are built right into your brain. In recent years a lot has been discovered about how our behavioral biases can lead to big financial mistakes. In effect, your mind can get in the way of good financial decision making. Take for instance what’s called “mental accounting.” Mental accounting refers to the tendency for people to separate money into different mental accounts, or buckets, each with a different purpose. How does this impact your personal finance decisions? It shows itself when you keep money in a savings account that pays 3 percent interest, while not paying off your credit card that charges you 14 percent interest. It also shows up when you get your tax return and you view it as “mad money” and promptly go out and spend it, while at the same time you are pinching pennies to save for your child’s education.

This idea of “mental accounts” is just one of several behavioral biases and mental shortcuts that lead us unknowingly down the path to major financial mistakes. Let’s look at another one of these behavioral biases, the “sunk cost effect”—once we put money into something, we become attached to it and are more likely to spend good money after bad money. For example, you just bought a very used car for $1,000, and almost immediately after buying it the transmission goes out. A new transmission is going to cost $1,500. This bias leads you to want to make the repair, even though the repair will cost more than the car is worth. That’s because if you don’t repair your car, that $1,000 you spent for it is wasted. But what’s happened in the past doesn’t matter; you want to base your decisions on what they’re going to produce in the future. In effect, the sunk cost effect can cause you to make decisions based on the amount of money and time you have already invested in something, and the end result of that can be to pour good money after bad money into a car, a house, or almost anything.

Making all this harder is that everyone relates to money and financial decisions differently—and for many, it is difficult to separate out the emotions involved. In addition, some of us are more sensitive to advertising and more easily swayed to buy what we might not have intended to buy, while others take naturally to
financial discipline. Unfortunately, your financial personality is tough to change. At an early age, many people seem to become “financially wired” in ways that make it hard to save while others find it hard to spend. Our views on spending and saving and whether we have a fear of money-related issues resulting in the tendency to “just not think about it” will go a long way toward determining our financial success. In fact, there are also people who view money as an evil and feel uncomfortable with wealth. Recognizing your financial personality will allow you to gain control over your financial life and help you to make decisions based on choice rather than emotion and habit. Moreover, when you recognize what your financial personality is and how it impacts your decisions, you won’t have to repeat the same financial mistakes for the rest of your life. Just look at Lily in the introduction to this chapter—she simply couldn’t stop spending, in spite of the fact that she didn’t have any money.

Throughout the book we will try to alert you to some of the things that might be going on in your brain that you don’t know about—at least those things that impact your financial decisions. If you understand these biases, you can control them, and if you recognize what your financial personality is, you can take it out of the process and avoid some of the pitfalls you’d otherwise be subject to. In fact, the last principle that we will look at is based upon one of these behavioral biases, and it’s made tougher for some because of their financial personality.

**Principle 10: Just Do It!**

Making the commitment to actually get started may be the most difficult step in the entire personal financial planning process. In fact, people are programmed against taking on unpleasant tasks—it’s one of the behavioral biases that we all have—because of a natural desire to procrastinate. If you don’t believe that, just think of the last term paper you had to write—more likely than not, much of it was written the night before it was due, even though you knew that it would be due weeks before. However, the positive reinforcement associated with making progress toward your goals and taking control of your financial affairs generally means that, once you take the first step, the following steps become much easier.

It’s much easier to save than to spend, right? No, just checking—you know the opposite is true. For most people, savings are a residual. That means that you spend what you like and save what is left, and the amount you save is simply what you earn minus what you spend. When you pay yourself first, what you spend becomes the residual. That is, you first set aside your savings, and what is left becomes the amount you can spend—that’s the first step in putting your financial plan into play.

**Women and Personal Finance**

The basic principles of personal finance are the same for men and women, as is the desire for financial security. However, the effort needed to achieve your financial goals does differ: It’s much tougher to achieve financial security if you’re a woman. Some of the reasons for this are that women generally earn less money, are less likely to have pensions, qualify for less income from Social Security because they generally earn less over their lifetime, and live longer than men. As a result, planning for their financial independence, in particular during their retirement years, is more difficult for women than it is for men.
Consider these facts:  

- Over 90 percent of all women will take sole responsibility for their financial decisions at some point in their lives.
- Women live, on average, 7 years longer than men.
- Almost 45 percent of all nonmarried (divorced, widowed, or never married) women 65 and older get 90 percent of their income from Social Security compared to 35 percent of comparable men.
- Twenty percent of all women never marry.
- Forty-seven percent of first marriages and 49 percent of second marriages end in divorce.
- Seventy-five percent of women do not know how much they need to save for retirement.
- Only 28 percent of women 65 and older receive pension benefits, versus 45 percent of men, and the median amount of men’s pension income is twice that of women.
- Women tend to be more conservative with their investments, which means their investments tend to earn less.
- At age 65, women outnumber men by 3 to 2, and at 85 they outnumber them 5 to 2.
- Seventy-five percent of married women eventually end up widowed, and the average age of widowhood is 56.
- Although only about 12 percent of all elderly people live in poverty, about three-fourths of them are women.
- Eighty percent of all widows who are now living in poverty were not living in poverty when their husbands died.
- In 2009, the median personal income for women 65 and older was $15,209. For men in the same age group, it was $25,409.
- For every dollar of wealth owned by single men, single women own 36 cents.
- More single young women ages 21–34 (53 percent) said they were living from paycheck to paycheck than did single young men (42 percent).

What does all this mean? It means it’s not a fair world out there and women have to take charge of their money and their financial future. Unfortunately, it will take more than the Lilly Ledbetter Fair Pay Act, signed into law in 2009, to fix the fact that women on average earn 78 cents for every dollar men earn. So, where does a woman start?

The first step is to acquire knowledge; remember Principle 1: The Best Protection Is Knowledge—that’s what this book is all about. You’ll notice that this book is filled with action ideas—put them to use—you’ll learn how to track your spending, make financial decisions, and take the mystery out of investing. You might also want to join an investment club, which is a great way to learn more about investments and

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3The Lilly Ledbetter Fair Pay Act of 2009 was named for a supervisor in a tire factory in Alabama who after 20 years of employment, received an anonymous note containing the salaries of three male supervisors. Lilly was the sole female supervisor and in spite of the fact that she had more seniority than some of the other 15 male supervisors, she earned $3,727 per month while her male counterparts earned between $4,286 and $5,236 per month. On January 29, 2009, President Obama signed this act into law stating, “Lilly knows this story isn’t just about her. It’s the story of women across this country still earning just 78 cents for every dollar men earn—women of color earn even less—which means that today, in the year 2009, countless women are still losing thousands of dollars in salary, income, and retirement savings over the course of a lifetime.”
The next step is to make things happen. That means you need a plan. As we know from Principle 2: Nothing Happens Without a Plan. The principles in this text apply to both men and women. Although the principles are gender neutral, there are some essential actions you should consider if you’re a woman. You want to make sure your plan recognizes that women live longer than men and that half of all marriages end in divorce. If you are married, make sure you’re involved in your husband’s pension decisions, and make sure you fund any employer-sponsored retirement plans and spousal IRAs to the fullest. Finally, if you aren’t convinced about the soundness of your financial situation, see a financial planner about your specific concerns. An advisor will be able to build your confidence and give you direction. Just as important, a financial advisor can serve as a great motivator.

Summary

Explain why personal financial planning is so important.
Personal financial planning will allow you to (1) manage the unplanned, (2) accumulate wealth for special expenses, (3) realistically save for retirement, (4) “cover your assets,” (5) invest intelligently, and (6) minimize your payments to Uncle Sam.

Describe the five basic steps of personal financial planning.
There are five basic steps to personal financial planning:

1. Evaluate your financial health.
2. Define your financial goals.
3. Develop a plan of action.
4. Implement your plan.
5. Review your progress, reevaluate, and revise your plan.

In fact, the last step in financial planning is often the first, because no plan is fixed for life.

Set your financial goals.
To reach your financial goals you must first set them. This process involves writing down your financial goals and attaching costs to them, along with identifying when the money to accomplish those goals will be needed. Once you have set your goals, they will become the cornerstone of your personal financial plan, a guide to action, and a benchmark for evaluating the effectiveness of the plan. Over your lifetime your goals will change and you will see that a general financial life cycle pattern applies to most people, even you. There are three stages in the financial life cycle: (1) the early years—a time of wealth accumulation, (2) approaching retirement—the golden years, and (3) the retirement years.

Explain how career management and education can determine your income level.
In general, the more educated you are, the more you will earn. This is because the more specialized skills and training needed for a job, the higher it tends to pay.
Explain the personal finance lessons learned in the recent economic downturn.
The recent economic downturn demonstrated that too many of us have insufficient emergency funds. In addition, it showed that the financial issue that most Americans worry about is retirement. Other major problems that surfaced involved having too much debt and inadequate health insurance. A lack of financial planning left many Americans ill-prepared for the economic downturn.

List ten principles of personal finance.
There are ten principles on which personal financial planning is built and that motivate the techniques and tools introduced in this text.

Understand that achieving financial security is more difficult for women.
Without question, it’s much tougher to achieve financial security if you’re a woman. That’s because women generally earn less, are less likely to have pensions, qualify for less income from Social Security because they generally earn less, and live longer than men. As a result, it is of the utmost importance that women take responsibility for their financial future.

Review Questions
1. Why is financial planning, or just plain money management, a challenge for most people?
2. Review the six financial accomplishments that may result from studying personal finance. In your opinion, which three are most important? Why?
3. Summarize the five steps that make up the financial planning process.
4. What three steps are required to define financial goals? Once identified, why is it important to rank goals?
5. List and explain the four common concerns that should guide all financial plans.
6. How does Step 5 of the financial planning process contribute to the idea that “financial planning is an ongoing process”?
7. Explain the time horizon for short-term, intermediate-term, and long-term goals. Give an example of each.
8. Why are financial goals the cornerstone of a financial plan?
9. List and characterize the stages of the financial life cycle. What three financial concerns are addressed across all three stages?
10. Define career planning. How is it related to financial planning?
11. Explain why planning for financial independence is more difficult for women than men.
12. Summarize two strategies that women should implement to compensate for the unique financial challenges they face.
13. List three reasons why college seniors returning to campus for the fall semester should have a résumé already prepared.
14. Describe a good, or effective, job interview.
15. What do you think will be the five most important strategies for success in your career field?
16. List and describe two important factors that help determine your current and future income.
17. Why is financial knowledge the best protection when faced with daily financial decisions?
18. Explain why it is important to review past economic downturns when studying personal finance.
19. What are the two reasons investors demand compensation when saving money or making an investment? Explain how Principles 3 and 8 impact the choice to delay consumption. Why might investors who ignore these principles lose money?
20. Define the terms “diversification” and “liquidity.” Give an example to illustrate each concept.
21. Describe the “sunk cost effect” and why this is considered a financial bias.

Develop Your Skills—Problems and Activities

These problems are available in MyFinanceLab.

1. What financial strategies should you develop as a result of studying personal financial planning? What financial problems might you avoid?
2. List the five steps in the financial planning process. For each, list an activity, or financial task, that you should accomplish in each stage of the financial life cycle.
3. Financial goals should be specific, realistic, prioritized, and anchored in time. Using these characteristics, identify five financial goals for yourself.
4. As the cornerstone of your financial plan, goals should reflect your lifestyle, serve as a guide to action, and act as a benchmark for evaluating the effectiveness of your plan. For one of the goals identified in Problem 3, explain this statement.
5. The goal of financing the cost of education is obviously important in your present stage of the financial life cycle. Explain how this goal might continue to be important in future stages.
6. For three of the questions in Table 1.3, write a concise and descriptive response. Practice your answers and then present them to someone willing to give you suggestions for improving your responses or your delivery.
7. Explain how Principle 5: Stuff Happens, or the Importance of Liquidity and Principle 7: Protect Yourself Against Major Catastrophes may be related. What are you currently doing to protect yourself, and your financial future, from “stuff and other major catastrophes”?

Learn by Doing—Suggested Projects

1. Interview three heads of household, each from a household representing a different stage of the life cycle or socioeconomic status. Inquire about their financial planning process and their strategies to identify and save for short-term, intermediate-term, and long-term goals. Report your findings.
2. You can think of a financial plan as a “financial road map to guide you through life.” Develop a visual display that illustrates this concept and the five steps of the financial planning process. Try to incorporate examples that illustrate how the “new roads” on the map may change over the life cycle.
3. Visit your campus career counseling office to learn about the services available to assist you with your career search and your job search. What career management services, if any, are available after you graduate?

4. Jason Zweig, author of *Your Money and Your Brain* (2007), poses the question, which animal is responsible for the greatest number of deaths in the United States annually? The options given are alligator, bear, deer, shark, or snake. But how is the question related to money? Just as inflation should be the larger worry for anyone investing for retirement or other long-term future goals, investors tend to focus on the “attack” of a significant stock market drop as the more dangerous of the two. Similarly, most people are influenced by the biases of recent or vivid events when responding to Zweig’s question. Most don’t recognize that the deer, typically not associated with fear or fierce attacks, is responsible for 130 times more deaths than the other four animals combined. To learn more about behavioral finance and neuroeconomics, conduct an Internet search or visit your local library.

5. As a foundation for your financial planning, visit the U.S. Department of Labor Career Guide to Industries at www.bls.gov/oco/cg to determine the earnings, benefits, and employment outlook for a position in your career field. What educational requirements are necessary for entry and advancement in the field? Don’t have a chosen field? Then check out the resources on the Internet or your campus career services office to start your career self-assessment. You can’t plan your finances without an income (to learn more, visit www.payscale.com or other Internet sites with salary data)—and remember, it’s hard to plan for career success in a job you hate!

6. As a group project, have each member of the group visit a financial professional (e.g., benefits officer, stockbroker, insurance company representative, loan officer, banker, financial planner, etc.). Present the list of ten principles that form the foundations of personal finance. Ask the professional to pick the three to five principles that he or she considers to be most important to personal financial success. Share the results in your group and prepare an essay or oral report of your findings. Which principles appear to be most important?

**Be a Financial Planner—Discussion Case 1**

*This case is available in MyFinanceLab.*

Jimmy, an accountant, and Bethany just returned from their honeymoon in the Bahamas. They celebrated their marriage and the completion of Bethany’s M.B.A. program. They have been encouraged by their parents to establish some personal and financial goals for their future. However, they do not know how to set or achieve these goals. They know that they would like to own their own home and have children, but those are the only goals they have considered. Jimmy knows of a financial advisor who might be able to help with their predicament, but they don’t think they can afford professional help.

**Questions**

1. If you were serving as the couple’s financial advisor, how would you explain the five steps in the financial planning process and their importance to future financial success?

2. What financial goals (short term, intermediate, and long term) would you determine to be the most important or least important to Jimmy and Bethany considering their current life cycle stage? Support your answer. (Hint: See Worksheet 1 or Worksheet 2.)

3. What four common concerns should guide the development of their financial plan? How do these relate to Principles 4, 5, and 7?
4. List five tips for Bethany to keep in mind when preparing for interviews. (Hint: Review Worksheet 3.)

5. Identify three important strategies for young professionals such as Jimmy and Bethany to remember to ensure success in their chosen careers. Why do “ethical violations end careers”?

6. Why is Principle 10 the most important principle? Why is it equally relevant to financial and career planning?

Be a Financial Planner—Discussion Case 2

This case is available in MyFinanceLab.

Nicholas and Marita Delgado, from Rochester, Minnesota, are the proud new parents of twin daughters. This was quite a shock to them and 2-year-old Jarred. They were not prepared for twins and this has muddled their financial plans as well as most everything else! They had planned to pay for education costs, but now they are unsure of how to prepare for having three children in college at the same time. They love their family, and truly believe that money isn’t everything, but their dream to retire early and travel seems to be fading with every new expense. They need help with Step 5: Review Your Progress, Reevaluate, and Revise Your Plan. Marita has told Nicholas that she wants to attend a personal finance class at the community center, but Nicholas thinks they should seek assistance from a financial planner. As Nicholas points out, although expenses are rising, they both have good jobs with the potential for rapid advancement and salary increases.

Questions

1. Explain to Nicholas and Marita why personal financial planning is crucial to their future. Why are Principles 1 and 2 important if they choose to seek professional advice? How might the behavioral finance biases of mental accounting and sunk costs influence their response to the professional’s advice?

2. Using the information in Table 1.1, estimate the cost of raising Jarred and the twins from birth to age 18 if the Delgados’ current annual income is approximately $95,000 and both parents plan to continue working full-time.

3. Explain how understanding and applying Principles 3 and 8 will be critical to funding the children’s education.

4. Setting financial goals involves specifically defining the goal, its future cost, and the future time when the money will be needed. Write a specific and realistic goal for funding the children’s education.

5. In addition to funding the children’s education, name two other short-, intermediate-, and long-term goals the Delgados should consider as they revise their financial plan.

6. With three children to consider, how might Principles 5, 6, and 7 pertain to the Delgados’ situation?