Returned Missionary

Course Manual

A Course in Personal Finance

BYU MARRIOTT
SCHOOL OF BUSINESS

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

Introduction by the Dean

Welcome to the BYU Marriott project on personal finance. A solid understanding of basic financial principles and the ability to manage finances wisely are important factors in the well-being of individuals and families. This project is one of our many efforts to increase the financial literacy and self-reliance of our students as well as of families and friends outside the University.

As you work through this course, I hope you will take the time to do three things.

First, read and study the material. Each chapter offers valuable information that will enrich your understanding of personal finance. The chapters have been carefully reviewed by the faculty and staff at BYU Marriott. We think they are informative and clearly written. They are organized to be useful to young people with little financial knowledge, people who have extensive experience in financial matters, and everyone in between.

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

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

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

Sincerely,

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

Author's Note

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

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

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

Bryan L. Sudweeks, Ph.D., CFA

August 2019

How This Course Is Different

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

First, we take a different perspective on personal finance. Perspective—the way we look at things—influences our financial self-reliance because it influences the choices we make. Concerning perspective, the historian Will Durant wrote, "We need 'to seize the value and perspective of passing things. . . . We want to know that the little things are little, and the big things big, before it is too late; we want to see things now as they will seem forever—'in the light of eternity.'"[1]

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

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

> [The] inspired statement, "I teach them correct principles, and they govern themselves," still applies. The Lord uses that pattern with us. . . Your consistent adherence to principle overcomes the alluring yet false life-styles that surround you. Your faithful compliance to correct principles will generate criticism and ridicule from others, yet the results are so eternally worthwhile that they warrant your every sacrifice.[2]

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

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

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

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

PowerPoint presentations, learning tools, videos of personal finance classes taught at BYU, and other personal finance manuals compiled and developed by the faculty and staff at Brigham Young University. These tools will help you catch your vision, set goals, and develop plans and strategies to help you create a budget, work toward getting out of debt, evaluate different investments, buy a house or a car, invest wisely, save for retirement, and more. You will also receive extensive instructions for developing your own Personal Financial Plan, including helpful examples of completed financial plans.

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

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Copyright and Other Restrictions

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

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

Introduction

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

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

Objectives

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

Understand how to bring Christ into your finances

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

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

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

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

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

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

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

Understand the Importance of Perspective and Our Perspective for this Course

The dictionary defines *perspective* as "one's point of view, the choice of a context for opinions, beliefs, and experiences."[15] The historian Will Durant wrote of the human need "to seize the value and perspective of passing things. . . We want to know that the little things are little, and the big things big, before it is too late; we want to see things now as they will seem forever—'in the light of eternity.'"[16]

The challenge then is to see things in a consistent perspective--as they will be forever. Neal A. Maxwell wrote of those without this perspective, "Living without God in the world brings a functional lack of consistent perspective. If there were no eternal truths, to what principles would mortals look for guidance? If not accountable to God, to whom are we ultimately accountable?"[17]

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

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

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

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

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

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

> We hope we can help our young men and young women to realize, even sooner than they do now, that they need to make *certain* decisions only *once* . . . We can make a single decision about certain things that we will incorporate in our lives and then make them ours—without having to brood and re-decide a hundred times what it is we will do and what we will not do.… My young brothers [and sisters], if you have not done so yet, *decide to decide*![19]

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

Our perspective is simple: *Wise money management is simply living the gospel of Jesus Christ*. It is putting Christ first in our lives, not our pocketbooks. "But seek ye first the kingdom of God, and his righteousness; and all these things shall be added unto you".[20] It is the temporal application of eternal principles.

Understand our Framework for Learning: Doctrines, Principles and Application

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

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

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

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

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

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

Doctrines or "Whys" of Personal Finance

Doctrines are the truth about ourselves, our lives, our history, and our relationship to our Father in Heaven and his Son Jesus Christ. Boyd K. Packer said, "True doctrine, understood, changes attitudes and behavior. The study of the doctrines of the gospel will improve behavior quicker than a study of behavior will improve behavior. . . That is why we stress so forcefully the study of the doctrines of the gospel."[23]

David A. Bednar reminds us,

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

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

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

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

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

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

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

C. Max Caldwell said:

> Whatever the problem may be in a person's life—failure to pay tithing, breaking the Word of Wisdom, casual church attendance, [or, I add, poor financial habits, the]—real issue is faith in Jesus Christ. If we can help people obtain the gift of faith in Christ, good works will follow. The end purpose of any law of God is to bring us to Christ. And how well will the law work? It depends on what we think of the Author of the law.[28]

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

> [We] have been counseled for many years to prepare for adversity by having a little money set aside. Doing so adds immeasurably to security and well-being. Every family has a responsibility to provide for its own needs to the extent possible . . . If you have paid your debts and have a financial reserve, even though it be small, you and your family will feel more secure and enjoy greater peace in your hearts. May the Lord bless you in your family financial efforts.[29]

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

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

Personal finance helps us learn to be wiser financial stewards over the things with which God has blessed us. Joe J. Christensen said, "Our resources are a stewardship, not our possessions. I am confident that we will literally be called upon to make an accounting before God concerning how we have used them to bless lives and build the kingdom."[31]

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

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

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

We will be disappointed in life if we gain the world's riches and lose our spouses and families. We must learn to better apply personal finance in the Lord's way, using His plan and obeying His commandments. In short, an eternal perspective on finances can prepare us for eternal marriage, strengthen existing marriages, and be a conduit for positive parenting.

Individual: Personal finance can help us prepare for and accomplish our divine missions. The fourth perspective is individual. We all have divine missions to perform here on earth, and personal finance can help us learn the lessons and develop the skills we need to accomplish those missions. Many of our missions will required material resources. Gene R. Cook said, "I bear testimony of the fact that if you keep the commandments, He nourishes you, strengthens you, and provides you means for accomplishing all things necessary to faithfully finish your divine mission here on earth."[33]

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

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

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

Principles or "What's" of Personal Finance

Principles are fundamental laws or doctrines, which, if understood, will allow us to live or act according to truth. Richard G. Scott commented:

> [The] inspired statement, "I teach them correct principles, and they govern themselves," still applies. The Lord uses that pattern with us. You will find correct principles in the

> teachings of the Savior, His prophets, and the scriptures. While easy to find, true principles are not easy to live until they become an established pattern of life . . . Yet, as you resolutely follow correct principles, you will forge strength of character available to you in times of urgent need. Your consistent adherence to principle overcomes the alluring yet false life-styles that surround you. Your faithful compliance to correct principles will generate criticism and ridicule from others, yet the results are so eternally worthwhile that they warrant your every sacrifice.[34]

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

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

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

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

Principle 2: Stewardship. We are stewards over all that the Lord has, is, or will share with us. A steward is one who actively directs the affairs of another. The apostle Paul stated, "Let a man so account of us, as of the ministers of Christ, and stewards of the mysteries of God. Moreover it is required in stewards, that a man be found faithful."[42] The Lord stated, "It is expedient that I, the Lord, should make every man accountable, as a steward over earthly blessings, which I have made and prepared for my creatures."[43]

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

Principle 3: Agency. The gift of "choice" is man's most precious inheritance. President Thomas S. Monson taught, "When we came to the earth, we brought with us that great gift from God—even our agency. In thousands of ways we are privileged to choose for ourselves."[44]

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

David O. McKay wrote, "Next to the bestowal of life itself, the right to direct that life is God's greatest gift to man . . . Freedom of choice is more to be treasured than any possession earth can give.[46]

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

Principle 4: Accountability. We are accountable for every choice we make, including our financial choices. We have been blessed with the gift of agency, but we will also be held accountable for its use. The Lord counseled, "For it is required of the Lord, at the hand of every steward, to render an account of his stewardship, both in time and in eternity."[47]

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

These four principles establish a spiritual foundation for understanding wealth that is based on our dependence on God and our need for financial self-reliance to fulfill His purposes.

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

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

Everything we have is God's, and the things we receive are all blessings from Him. They are not ours, but they have been given to us as a stewardship for which we can make choices. We should choose well, as we will be held responsible for what we choose and do.

Application or the "How's" of Personal Finance

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

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

creators, which we truly are.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Let me share one possible pattern.

The Creative Process

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Our Conduct on the Journey is as Important as our Destination

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Understand the Implications of this Learning Framework

This learning framework is important for six specific reasons.

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

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

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

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

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

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

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

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

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

Summary

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

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

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

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

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

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

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

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

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

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

- We strive to change daily and become more like Him. We know that doctrines and principles, confirmed by the Spirit, change behavior.

- We learn to apply His words and create our lives more closely with Him. For we know that application is an invitation to learn and create.

- We always remember Him. As we do, we remember our conduct on our journey is as important as out destination.

It is our responsibility to be financially wise and use the resources we have been blessed with in blessing the lives of our families and others. We do that best when we daily bring Christ more into our lives and finances. The purpose of this manual and accompanying website, PowerPoints and learning tools is to help you accomplish that purpose.

Assignments

Financial Plan Assignments

Think about the things we have discussed regarding the doctrines ("why's"), principles ("what's"), and application ("how's") of personal finance. Why is this learning framework different? What things will this framework help us understand? These are the reasons we should be learning this material and we have a process on how to do it. With this framework we can change, as Dieter F. Uchtdorf states, "our small acts of obedience into holy acts of consecration."[85] With this understanding, we can avoid the problems that come with the world's different perspectives on wealth – generally incorrect ones. To become truly wealthy, we must first have a correct perspective and understand the key doctrines and principles for using wealth wisely. The scriptures state, "For God so loved the world, that he gave his only begotten Son, that whosoever believeth in him should not perish, but have everlasting life."[86] This is the true kind of wealth. Think about what is necessary to have this correct perspective on wealth.

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

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

Learning Tools

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

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

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

Review Materials

Terminology Review

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Review Questions

1. Why is it important to "decide to decide" now? What problems can it help us avoid?
2. Why does God want us to learn wise money management?
3. What is our perspective and why is it important?
4. What are the four key principles on which that perspective is based? Why are they important? What can we do to incorporate these principles into our lives now?
5. Some have asked, "If wealth is so bad, should we seek for riches?" What did Jacob say about this question in Jacob 2:18–19? What should we seek for first?
6. What are the benefits of this doctrines, principles and application learning framework?

Case Studies

Case Study 1

Data

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

Application

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

Case Study 1 Answers

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

Case Study 2

Data

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

Application

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

Case Study 2 Answers

There are several good answers for these questions. You might respond with:
Our perspective is that personal finance is simply living the gospel of Jesus Christ. That perspective is based on four key principles:

1. Ownership: Everything we have or are is a gift from God.
   - It is important because the things we have are not ours but are on loan from a loving Father in Heaven.
   - We can incorporate this principle into our lives by learning that when we share with others, we are only giving back to God what was His in the first place.
2. Stewardship: We are stewards over the things the Lord has blessed us with.
   - It is important because we must learn to be better stewards over our blessings because we will be held accountable for what we do with these blessings.
   - We can incorporate this into our lives by learning as much as we can about the things we need to do so we can become the best stewards we can over the blessings our Heavenly Father shares with us.
3. Agency: The gift of "choice" is man's most precious inheritance.
   - It is important because we need to use this gift wisely so we can return and live with God eternally.
   - We can incorporate this into our lives by studying all areas of our decisions and decision-making processes so we can have the information needed to make the best decisions possible.
4. Accountability: We are accountable for our choices, including our financial choices.
   - We are the final decision-makers in life.
   - It is important because we must learn to choose wisely.
   - We can incorporate this into our lives by setting good goals and then by making wise choices to help us attain those goals—goals that our Heavenly Father would have us seek.

Case Study 3

Data

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

Application

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

Case Study 3 Answers

The prophet Jacob said seeking for riches is OK "if" we first seek the Kingdom of God, and if we seek riches for the right intent--for righteous purposes.
But before ye seek for riches, seek ye for the kingdom of God. "And after ye have obtained a hope in Christ ye shall obtain riches, if ye seek them; and ye will seek them for the intent to do good-to clothe the naked, and to feed the hungry, and to liberate the captive, and administer relief to the sick and the afflicted (Jacob 2:18-19).

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

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2. Your Personal Financial Plan: Planning Your Financial Future

Introduction

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

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

Catching the vision for your life is not simply writing a list of goals you would "like" to accomplish. Rather, it is a process of understanding yourself, who you really are, your aspirations, desires, values, and what you want to become and accomplish. Then it is trying to understand what God wants you to accomplish, your divine mission or destiny. Once you have determined these things, you must then combine your understanding of yourself and what God desires for you into a plan of action to help you become your best self. Marvin J. Ashton commented, "True happiness is not made in getting something. True happiness is becoming something. This can be done by being committed to lofty goals. We cannot become something without commitment."[2]

Objectives

There are four objectives for this chapter:

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

Understand the Importance of Planning your Financial Future and your PFP

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

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

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

> *Plan for your financial future.* As you move through life toward retirement and the decades which follow, we invite all . . . to plan frugally for the years following full-time employment. Be even more cautious . . . about "get-rich" schemes, mortgaging homes, or investing in uncertain ventures. Proceed cautiously so that the planning of a lifetime is not disrupted by one or a series of poor financial decisions. Plan your financial future early; then follow the plan.[4]

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

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

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

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

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

Your Personal Financial Plan (PFP) is a document that accounts for all critical areas of your personal financial life. It is your individual roadmap for achieving your personal and family goals. It includes your vision, goals, tactical plans, constraints, and accountability to achieve those goals. It includes your plans for budgeting, taxes, cash management, debt reduction, insurance, investing, retirement and estate planning. It includes plans for your home and auto decision, plans to help pay for your children's education and missions if you so choose to help. Finally, it includes your giving plan on how you will give back, to help make the world a better place. All of this is a critical part of Ezra Taft Benson's admonition to "plan for your financial future early, and then follow the plans."[5] It requires you to catch your vision of who you are and what you want, determine where you are now, set goals for where you want to be, develop a plan to get you there, and then creating your future with confidence by implementing and revising the plan as needed.

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

Step 1: Catch Your Vision for your Life

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

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

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

Step 2: Decide How You Will Evaluate Your Life

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

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

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

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

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

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

Step 4: Evaluate Your Financial Health

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

Step 5: Develop Your Plans and Strategies, Constraints, and Accountability in each of the 15 Areas

Once you have your vision and your goals, you must develop your tactical plans on how you will achieve those goals and when. Your plan should be:

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

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

Step 6: Implement Your Plan and Revise as Necessary

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

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

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

Much of your plan is personal and challenging as you try to understand yourself, your family, and the things you want to accomplish. The purpose of this course is to help you identify critical areas and make important decisions. In this course we will help you do Steps 1 – 4.

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

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

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

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

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

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

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

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

Your Vision, Mission and Values Statements

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

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

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

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

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

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

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

> Every accountable child of God needs to set goals, short- and long-range goals. A man who is pressing forward to accomplish worthy goals can soon put despondency under his feet, and once a goal is accomplished, others can be set up. Some will be continuing goals. . . Now there is a lifetime goal—to walk in his steps, to perfect ourselves in every virtue as he has done, to seek his face, and to work to make our calling and election sure.[20]

To best understand goals, we must look to the Master and ask, "What is God's ultimate goal for His children?" As we read and study, His ultimate goal for us is eternal life.[21] We all likely have a similar goal—eternal life for ourselves and our families. So we have our first and overall goal, eternal life with our families. The rest of our goals are then intermediate goals to help us to our overall goal.

A philosopher over a century ago said, "We are not human beings having a spiritual experience. We are spiritual beings having a human experience."[22] The key then is to keep both the spiritual and the temporal balanced in our personal and family goals.

As we think of goals, I like the framework by Steven Wheelwright that there are three different types of goals we should be aware of: goals related to identity, integrity, and temporal measures.[23] Identity goals are goals that relate to our long-term view of how we see ourselves. These goals help us be better in our long-term view of what we are and what we want to become.

- We are of divine parentage with "Heavenly Parents."[24]
- We are "all the children of God by faith in Jesus Christ"[25]
- We may be spouses.
- We may be parents to children.
- Regardless, we must never lose sight of who we are.

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

- Our "divine mission and destiny"[26]
- How we will work
- What we will and will not do
- Characteristics and skills we wish to attain

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

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

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

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

Understanding the different types of goals can help us to have balance in our goals. Balance is important. Temporal goals, if unchecked, might override more lasting and eternal goals of identity and integrity. They also, if not balanced, may lead to trade-offs, such as working longer hours, spending less time with family, or taking assignments inconsistent with personal values due to "extenuating circumstances." If you are not careful, life can easily become an "unending stream of extenuating circumstances."[27] Goals in other areas could also cause concern if not worked toward in a balanced manner.

We have been given counsel to help us in our process of setting goals:

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

> only true master, and "laying up treasures in Heaven.[28]

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

Understand and Create your Plan for Life

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

> I am so thoroughly convinced that if we don't set goals in our life and learn how to *master the techniques of living to reach our goals*, we can reach a ripe old age and look back on our life only to see that we reached but a small part of our potential. When one learns to *master the principles of setting a goal*, he will then be able to make a great difference in the results he attains in this life.[29]

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

1. Know Yourself, and Catch Your Vision and Goals

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

> That any wage I had asked of Life, Life would have willingly paid.[49]

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

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

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

H. Burke Peterson wrote:

> Do you think for a moment that Heavenly Father would have sent one of His children to this earth by accident, without the possibility of a significant work to perform? . . . If you will let Him, I testify that our Father in Heaven will walk with you through the journey of life and inspire you to know your special purpose here.[53]

Russell M. Nelson said,

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

Finding out what Heavenly Father would have us do or become is not easy, nor does it happen in a short amount of time. But we can come to know and have God's guidance in our lives, if we seek it. We have been promised, "Ask, and it shall be given you; seek, and ye shall find; knock, and it shall be opened unto you."[55]

I have also found that if we do what Heavenly Father wants us to do first, He will help us accomplish what we want to do, and we will do it better because we have His help.

I made this discovery as a newly married PhD student in Washington, D.C. I was attending school full-time in the afternoon and evenings, working part-time at the Capital Markets Department of the World Bank, and trying to be a good husband and father. The leader of our local congregation asked me to teach seminary, an early morning scripture study class for high school students each weekday morning at 6 a.m. I remember discussing this with my wife and thinking how easy it would be to justify declining the request to teach. But we also realized that if we wanted God's help with my PhD program, we needed to serve where He wanted us. So we accepted the calling. I enjoyed teaching seminary and getting to know those amazing young people, and while I filled this calling, with God's help I was able to complete my PhD program in less than three years.

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

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

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

2. Decide How you will Evaluate Your Life

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

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

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

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

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

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

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

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

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

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

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

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

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

- Tithing. "And verily it is a day of sacrifice, and a day for the tithing of my people; for he that is tithed shall not be burned at his coming."[65]

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

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

God would like to help us understand what He would have us do. The scriptures note "Trust in the Lord with all thine heart; and lean not unto thine own understanding. In all thy ways acknowledge him, and he shall direct thy paths."[68] As we do the "small and simple thing," God will direct our paths.

4. Start with the End in Mind

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

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

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

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

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

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

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

6. Make Your Goals SMARTER

We have all heard about SMART goals. Yours should be SMARTER. SMARTER is an acronym that may help as you strive to set effective goals.

S = Specific. Goals should be specific. They should answer the questions of who, what, where, when, and why. A general goal would be to get in shape. A specific goal would be to run three miles three times a week at 5:30 a.m. on Monday, Wednesday and Friday mornings.

M = Measurable. Goals should be measurable. You must be able to track progress toward your goal. A non-measurable goal would be to save for retirement. A measurable goal would be to have an annuity that pays you $50,000 per year in retirement or to have a savings goal of 20% of your gross income each year saved in retirement or other savings accounts.

A = Achievable. Goals should be achievable. Achievable goals are goals that your attitudes, abilities, skills, and interests can help you accomplish.

R = Reportable. Reportable goals are goals that you can and are willing to report on each period: to yourself, to a spouse or friend, and to God. When we share our goals with others, it increases dramatically our likelihood of working toward them.

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

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

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

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

That which we remember and review often, we are more likely to accomplish. Write down your goals and review them often. I recommend that you set aside time to periodically review and update your goals on either a daily or a weekly basis. The more important the goal, the more often we should review it. Generally, setting a specific time each week to work on your goals, i.e., Sunday evenings at 8:30 p.m. is a much better option.

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

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

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

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

> Set your goals—without goals you cannot measure your progress. But don't become frustrated because there are no obvious victories. Remind yourself that striving can be more important than arriving. If you are striving for excellence—if you are trying your best day by day with the wisest use of your time and energy to reach realistic goals—you are a success.[69]

Finding Balance

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

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

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

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

From Obedience to Consecration

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

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

Key Doctrines

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Summary

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

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

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

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

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

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

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

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

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

Assignments

Financial Plan Assignments

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

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

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

Vision and Goals. Next, think through your vision, goals, and your plans for accomplishing your vision and goals. This is not a short-term assignment, and it is likely the most important part of your entire financial plan. The purpose of this assignment is to write down your vision, goals and plans for your future and determine where you want to be in the next day, week, month, year, or in 50 years. Thomas S. Monson stated, "When we deal in generalities, we rarely have success; but when we deal in specifics, we rarely have a failure."[99] Be very specific with the vision and goals you set.

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

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

As you work on your vision, bring in the Lord to help expand your mind. The scriptures remind us "Behold I am Jesus Christ, the Savior of the world. Treasure these things up in your hearts, and let the solemnities of eternity rest upon your minds."[100] Once you have your vision, then think what your goals should be to create that vision. Recognize the many different ways to organize your goals. You can organize them by time frame: short-term, less than one year; medium-term, more than one year and fewer than 10 years; and long-term, more than 10 years. You can organize them by responsibility: family, work, education, church, and so on. Or you can organize them by priorities, with your highest-priority goals first.

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

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

Next, answer the question: What do you think God wants you to do or become? The challenge is to come to understand His will for us and to try to become that. While it often takes a lifetime to truly understand what He wants for us, we can know, through study, prayer, and hard work, some important information about the direction our lives should take. Learning about your mission will be a lifetime activity.

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

Learning Tools

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

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

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

Vision, Mission and Values Assignment (LT38)

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

Review Materials

Terminology Review

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

what we want to accomplish.

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

Integrity goals. Integrity goals relate to the characteristics and standards you want to achieve in the work and service you provide. These goals relate to how we will work and live, what we will and will not do, and characteristics and skills we wish to attain.

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

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

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

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

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

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

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

Review Questions

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

[1] "To the Elderly in the Church," *Ensign*, Nov. 1989, 4, italics added.
[2] "The Word Is Commitment," *Ensign*, Nov. 1983, 61.

[3] Bednar, p. 170.
[4] Ezra Taft Benson, "To the Elderly in the Church," *Ensign*, Nov. 1989, 4, italics added.
[5] Ibid.
[6] Anonymous.
[7] Tad R. Callister, "Our Identity and our Destiny," BYU Speeches, Aug. 14, 2012.
[8] Galatians 3:26.
[9] Matt 6:21.
[10] Clayton Christensen, "How Will You Measure your Life," Harvard Business Review HBR.org, July–August 2010.
[11] Webster's Online Dictionary at https://www.merriam-webster.com/dictionary/vision.
[12] Proverbs 29:18.
[13] Hebrews 11:13.
[14] Alma 5:15.
[15] Ether 12:5.
[16] Ether 12:19.
[17] M. Russell Ballard, "Return and Receive," General Conference Afternoon Session, April 2017.
[18] Ether 12:19.
[19] 2 Nephi 28:30.
[20] Ezra Taft Benson, "Do Not Despair," *Ensign*, Nov. 1974, 65.
[21] Moses 1:39.
[22] Pierre Teilhard de Chardin.
[23] See Steven C. Wheelwright, "Setting Worthy Goals," Devotional at BYU-H, January 11, 2011.
[24] Gordon B. Hinckley, "Proclamation on the Family," 1995
[25] Gal. 3:26.
[26] Gordon B. Hinckley, "Proclamation on the Family," 1995.
[27] Clayton M. Christensen, "How Will You Measure Your Life," *Harvard Business Review*, July-August 2010.
[28] Ibid.
[29] *Preach My Gospel*, Intellectual Reserve, Inc., 2004, 146, italics added.
[30] Proverbs 29:18.
[31] M. Russell Ballard, "Return and Receive," *Ensign*, May 2017.
[32] Robert C. Oaks, "Understand Who You Are," BYU Speeches, Mar, 21, 2006.
[33] O. Vincent Haleck, "Having the Vision to Do," *Ensign*, May 2012.
[34] Gordon B. Hinckley, "The Family: A Proclamation to the World," *Ensign*, November 1995.
[35] Gal. 3:26.
[36] Gordon B. Hinckley, "The Family: A Proclamation to the World," *Ensign*, November 1995.
[37] Romans 8:17.
[38] Moses 1:13-16.
[39] Bruce R. McConkie, *The Promised Messiah: The First Coming of Christ* (Salt Lake City: Deseret Book, 1978), 133.
[40] Thomas S. Monson, "Canaries with Gray on Their Wings," Ensign or Liahona, June 2010, 4; emphasis added.
[41] Donald L. Hallstrom, "I am a Child of God," *Ensign*, May 2016.
[42] Boyd K. Packer, "To Young Women and Men," *Ensign*, May 1989, 54.
[43] Marianne Williamson, *A Return to Love: Reflections on the Principles of a Course in Miracles*, Harper Collins, 1992, pp. 190-191.
[44] Tad R. Callister, "Our Identity and our Destiny," BYU Speeches, Aug. 14, 2012.
[45] Ether 12:5.
[46] Ether 12:19.
[47] Ted R. Callister, "The Power in the Priesthood in the Boy," *Ensign*, May 2013.
[48] Nelson Mandela.
[49] Quoted in *Think and Grow Rich*, Napoleon Hill, 1960, p. 40.
[50] M. Russell Ballard, "Return and Receive," General Conference Afternoon Session, April 2017.
[51] Gordon B. Hinckley, "Proclamation on the Family," 1995
[52] Tad R. Callister, "Our Identity and Our Destiny," BYU Speeches, Aug. 14, 2012.
[53] "Your Life Has a Purpose," *New Era*, May 1979, pp. 4–5.
[54] "Hope of Israel," Worldwide Youth Devotional, Salt Lake City, Utah, Jun 3, 2018.
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[57] "How Will You Measure Your Life," *Harvard Business Review*, July-August 2010.
[58] Luke 11:9.

[59] 2 Nephi 31:13.
[60] Alma 37:6.
[61] 2 Nephi 37:2.
[62] Exodus 20:8.
[63] D&C 59:9.
[64] D&C 88:76.
[65] D&C 64:23.
[66] D&C 132:47.
[67] D&C 98:16.
[68] Proverbs 3:5-6.
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[70] David A. Bednar, Increase in Learning, Deseret Book, 2011, p. 170.
[71] Gal. 3:26.
[72] Romans 8:17.
[73] Bruce R. McConkie, *The Promised Messiah: The First Coming of Christ* (Salt Lake City: Deseret Book, 1978), 133.
[74] Spencer W. Kimball, "The Family: A Proclamation to the World," 1995.
[75] Moses 1:39.
[76] Tad R. Callister, "Our Identity and Our Destiny," BYU Speeches, Aug. 14, 2012.
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[79] D&C 130: 20-21.
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[82] "Choose you this Day," Ensign, Nov. 2018.
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[86] D&C 51:19.
[87] D&C 78:22.
[88] Guide to the Scriptures, "Agency."
[89] D&C 29:35.
[90] Josh. 24:15.
[91] Moses 7:32.
[92] Italics added, D&C 43:34.
[93] A of F 1:2.
[94] Rev. 20:12.
[95] Alma 12:14.
[96] D&C 104:11-12.
[97] Ephesians 2:21.
[98] Bednar, "Exceeding Great and Precious Promises," *Ensign*, Nov. 2017.
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3. Saving, Income and Expense Planning: Giving Every Dollar a Name

Introduction

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

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

Objectives

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

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

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

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

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

A balance sheet records your assets (what you own) and liabilities (what you owe) at a specific point in time, usually at the end of a month, quarter, or year. An income statement records spending over a specific period of time, generally a month or a year. A budget is planning for future spending, a balance sheet is a record of your spending (as represented by your assets and liabilities) as of the present time, and an income statement is a record of your past spending.

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

Understand Family Record Keeping

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

Records to Update and Keep Forever

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

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

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

Records you save for at least 7 years

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

Where Should you Store Your Records?

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

Understand the Principles of Successful Saving, Income and Expense Planning

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

For most individuals, using a saving, income and expense plan effectively will likely have a greater impact on whether or not you will achieve your financial goals than any other change you could make to your financial habits. In addition to keeping a record of expected saving, income and expenses for the coming month or year, a budget is a way of making sure your financial resources are being used for the things that matter most to you—your personal and family goals.

While it is fairly easy to create your saving, income and expense plans, it takes discipline and sacrifice to actually follow through on the plans you outlined. While not easy, the results are apparent. Research has shown that those who effectively budget accumulate more wealth than those who do not.

Savings Planning

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

> After paying your tithing of 10 percent to the Lord, you pay yourself a predetermined amount directly into savings. That leaves you a balance of your income to budget for taxes, food, clothing, shelter, transportation, etc. It is amazing to me that so many people work all of their lives for the grocer, the landlord, the power company, the automobile salesman, and the bank, and yet think so little of their own efforts that they pay themselves nothing."[1]

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

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

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

Income Planning

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

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

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

Expense Planning

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

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

Principles

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

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

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

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

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

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

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

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

Doctrines

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

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

From Obedience to Consecration

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

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

Saving, Income and Expense Methods and Process

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

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

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

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

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

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

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

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

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

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

3. Allows adequate categorization of spending for income, spending, reporting and tax purposes; and
4. Minimizes the time spent in doing finances (I spend roughly 1-2 hours per week).

Individuals and families should use whatever method is best for them. As record keeping helps, what I recommend for most individuals and families is Mint.com for those starting out (they use military grade encryption so they are very safe), spreadsheets for the few Excel wizards among us, and Quicken for more advanced users.

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

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

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

Chart 1. Monthly Saving, Income and Expense Plan

Monthly Plan for the Month of _____ 20XX

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

Income minus Expenditures _____ _____ _____

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

Step 1: Know What You Want to Accomplish

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

Step 2: Track your Saving, Income and Expenses

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

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

Step 3: Develop a Cash Saving, Income and Expense Plan (A Better Way)

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

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

Next, you must determine your expenses. To complete this step, refer to the record you made while tracking your expenses. First, identify all fixed expenses. Be sure your fixed expenses are truly fixed expenses. Fixed expenses are expenses those you don't directly control; they are often

(but not always) monthly or semiannual expenses. Examples of fixed expenses include mortgage payments, rent, tuition and books, and life and health insurance costs. While some might consider cable TV or cell phone plans fixed expenses, they are generally variable expenses.

After you have identified your fixed expenses, identify your variable expenses. Variable expenses are expenses those you have control over—you can modify or eliminate the amount you spend on these things. Variable expenses include things like food (to a degree), entertainment, fuel, clothing, magazine subscriptions, and cable TV (contrary to some people's beliefs, you can live without cable TV, the internet, a cell phone or an iPad).

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

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

> If there is any one thing that will bring peace and contentment into the human heart, and into the family, it is to live within [one's] means. And if there is any one thing that is grinding and discouraging and disheartening, it is to have debts and obligations that one cannot meet.[4]

The Old Way. I would like to recommend a better way to budget. Many individuals determine how much they will save according to how much money is left at the end of each month. They receive their paychecks, pay their tithes and expenses, and then save what they do not spend during the rest of the month. This is an incorrect pattern for budgeting monthly income because individuals are paying themselves last. The old method for preparing a cash budget is found in Chart 2. I recommend a different pattern.

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

> In managing the affairs of the Church, we have tried to set an example. We have, as a matter of policy, stringently followed the practice of setting aside each year a percentage of the income of the Church against a possible day of need. I am grateful to be able to say that the Church . . . is able to function without borrowed money. If we cannot get along, we will curtail our programs. We will shrink expenditures to fit the income. We will not borrow.[5]

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

Chart 2. Budgeting: The Old Way

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

> After paying your tithing of 10 percent to the Lord, you pay yourself a predetermined amount directly into savings. That leaves you a balance of your income to budget for taxes, food, clothing, shelter, transportation, etc. It is amazing to me that so many people work all of their lives for the grocer, the landlord, the power company, the automobile salesman, and the bank, and yet think so little of their own efforts that they pay themselves nothing.[6]

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

Step 4: Implement Your Saving, Income and Expense Plan

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

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

Chart 3. Budgeting: The Better Way

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

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

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

Total Income minus Expenditures	0	9	-9

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

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

> Some claim living within a budget takes the fun out of life and is too restrictive. But those who avoid the inconvenience of a budget must suffer the pains of living outside of it. The Church operates within a budget. Successful business functions within a budget. Families free of crushing debt have a budget. *Budget guidelines encourage better performance and management*.[7]

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

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

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

Creating a Saving, Income and Expense Plan is a learning experience. You will not create a perfect budget right away, but you can refine it after each month. If your budgeting plan fails repeatedly, the "envelope system" may work.

Calculate Your Net Worth Using a Personal Balance Sheet

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

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

There are multiple ways to appraise each type of asset or liability. Calculate the value of each asset or liability correctly, because if you do not, you will have an incorrect view of your financial position. Having an incorrect view of your financial position may result in making bad financial decisions.

An example of a balance sheet is found in Chart 5. In addition, a balance sheet template can be found in Budget, Balance Sheet and Income Statements template (LT04) and Balance Sheet and Ratios (LT04B).

Chart 5. Balance Sheet Example

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

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

Net Worth (Assets minus Liabilities) $10,250

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

Automobiles and other vehicle assets include tangible assets such as cars, trucks, and recreational vehicles, which typically must be inspected and licensed. These assets provide transportation, recreation, and other benefits. The value of a vehicle asset is based on its current

market value or its book value. The value of this type of asset usually depreciates each year.

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

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

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

Assets: What You Own

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

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

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

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

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

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

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

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

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

Liabilities: What You Owe

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

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

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

Chart 6. Income Statement Example, Bill and Suzy Smith

Monthly Income Statement
for the Month of January, 201X

Income:	Actual
Wages/Salaries (After Taxes)	2,400
Other Income	250
Income Available for Living Expenses	2,650
Expenditures for Donations/Savings	
Tithes and Offerings	318
Savings	398
Expenditures for Living Expenses	
Food	320
Rent	700
Utilities	325
Transportation	165
Debt Payments	50
Insurance	150
Medical	40
Clothing	100
Other	75
Total Expenditures for Living Expenses	1,925
Total Living Expenses and Offerings/Savings	2,641
Total Income minus Expenditures	9

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

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

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

Net Worth: What You Are Worth Financially

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

What is a good level of net worth? The word *good* is relative when it comes to net worth. Your

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

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

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

Develop a Personal Income Statement and Use Ratios to Analyze Your Spending

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

Income: Cash Inflows

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

Expenditures: Cash Outflows

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

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

Using Ratios to Analyze Your Spending

Once you have completed your personal balance sheet and your personal income statement, use your financial statements to answer the following three questions. They will help you understand where you are financially. To answer these questions you will calculate six financial ratios.

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

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

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

Question 1: Do I have adequate liquidity in case of emergency? Two ratios can help you determine whether or not you have enough monetary assets to pay for a large, unexpected expense or to tide you over in case of a period of reduced or eliminated income: the current ratio and the "month's living expenses covered" ratio.

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

The second important ratio is the "month's living expenses covered" ratio. This ratio tells you how many months you could survive financially if you lost all current sources of income. To calculate this ratio, divide the amount of your monetary assets by the amount of your monthly living expenses. Realize that your living expenses should not include charitable contributions, taxes, or savings, because if you lost your job, you would not have these expenses or savings.

A ratio that allows you to pay your living expenses for three to six months is recommended. The ratio should be equal to at least as many months as it would take to get a new job if you lost your current job. Again, track the trend of this ratio—it should be improving. If it isn't, you need to make some changes to improve your financial situation.

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

Their "month's living expenses covered" ratio is calculated as monetary assets divided by monthly living expenses. Bill and Suzy have $6,000 in current or monetary assets divided by $1,925, which is their monthly living expenses, or a ratio of 3.1 times. Bill and Suzy could pay

3.1 months of living expenses with their existing monetary assets. They are within the recommended range of three to six months, although they are on the lower side.

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

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

Your long-term debt coverage ratio tells you how long you could continue to make payments on your long-term debt based on the amount of money you have for living expenses. To calculate this ratio, divide the amount you have available for living expenses (i.e., wages minus taxes) by the amount of your long-term debt payments. The higher this ratio, the better; a higher ratio indicates that you could cover your debt payments for a longer period of time. Track this trend; this ratio should go up over time.

In the example above, Bill and Suzy's debt ratio is $4,200 divided by $14,450 or 29 percent. Roughly 29 percent of their assets are financed with borrowings, and most of that is with student loans. Once Bill and Suzy buy their first home, this ratio will likely increase. A good goal is to make this ratio zero percent, meaning you have paid off all your liabilities, including your mortgage.

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

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

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

Your net savings ratio tells you what proportion of your after-tax income you are saving. To calculate this ratio, divide the amount of income you save by the amount of income you use to cover living expenses. In the United States, the average ratio has ranged between negative 2

percent and 8 percent; however, your ratio may vary from this average depending on your current financial stage and your personal goals. As always, track the trend of this ratio—if it is decreasing, make the necessary changes.

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

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

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

Understand and Create Your Saving, Income and Expense Plan

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

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

Vision

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

Goals

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

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

Plans and Strategies

Savings

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

Income

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

Expenses

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

Constraints

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

Accountability

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

Summary

Before you can attain your goals, you must first understand where you are financially. To do this, you must prepare the various financial statements described in this chapter and keep important family records. Family record keeping is important if you are to do better financially and if you want to minimize your tax payments to the government.

Of these financial statements, the most important is your budget or income and expense plan. Following your budget is critical to living within your means. You must know what income you have coming in and what income you are spending. Living on a budget and saving is the single biggest contributor and constraint to individuals and families achieving their financial and other goals.

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

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

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

Joseph B. Wirthlin commented:

> I advise you to be patient in financial matters. Avoid rash or hurried financial decisions; such decisions require patience and study. Get-rich-quick schemes seldom work. Beware of debt. Be especially careful of easily obtained credit even if the interest is tax deductible. You young couples should not expect to begin your married lives with homes, automobiles, appliances, and conveniences comparable to those your parents have spent years accumulating.[8]

Assignments

Financial Plan Assignments

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

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

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

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

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

Finally, calculate your financial ratios regarding liquidity, debt, and savings. Are your assets as liquid as they should be? Are you reducing debt as you should? Are you saving as much as you should? A useful tool to help you calculate your financial ratios is Balance Sheet and Ratios (LT04B). You can use monthly or annually for your period, although I recommend monthly.

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

Learning Tools

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

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

Budget, Balance Sheet and Income Statements template (LT04)
This is an excel spreadsheet that includes a one-year budget, a two-period balance sheet, an income statement, and financial ratios for determining where you are financially.

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

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

Financial Calculator Tutorial (LT03)
This document is a financial calculator tutorial about most of the major financial calculators. It also includes the financial formulas if you would prefer to program your own calculator.

Excel Financial Calculator (LT12)
This Excel spreadsheet is a simple financial calculator for those who prefer to use spreadsheets. This tool can perform most of the functions of a financial calculator, including present value, future value, payments, interest rates, and number of periods.

Review Materials

Terminology Review

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

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

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

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

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

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

Review Questions

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

5. Why is it important to calculate your net worth? What does your net worth say about your financial position? What is a "good" net worth?

Case Studies

Case Study 1

Data

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

Calculations

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

Case Study 1 Answers

The balance sheet for Steve and Mary Jo should look like this:

Assets	
Primary Residence	$150,000
Monetary Assets	$5,000
Automobiles	$20,000
Furniture	$10,000
Total Assets	$185,000
Liabilities	
Current Bills	$1,150
First Mortgage	$100,000
College Loan	$10,000
Automobiles (2 * $10,000)	$20,000
Total Liabilities	$131,150
Net Worth (Assets – Liabilities)	$53,850

Generally, they are doing OK. While they have a positive net worth, most of that value is from the equity of their home. Using Balance Sheet and Ratios (LT4B),

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

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

Month: January | Day: 31 | Year: 2019

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

Case Study 2

Data

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

Calculations

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

Case Study 2 Answers

Their income statement should look like this:

Annual Income	
Wages	$50,000
Taxes (15%)	7,500
Income for Living Expenses	42,500
Paying the Lord (12%)	6,000
Paying Yourself (10%)	5,000
Total Income	$31,500
Expenses	
Mortgage	$7,730
Utilities, Taxes	2,270
Food	6,000
Insurance	1,500
College Loan	1,160
Car Payment	7,410
Other Expenses	5,430

Total Living Expenses $31,500

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

This is the way Steve and Mary Jo calculated their annual expenses. (For information on using a financial calculator, see Financial Calculator Tutorial (LT03) and Excel Financial Calculator (LT12).

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

Case Study 3

Data

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

Calculations

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

Application

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

Case Study 3 Answers

Liquidity Ratios

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

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

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

Debt Ratios

Debt ratio = total liabilities / total assets
$131,150 / 185,000 = 70.9%

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

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

Their debt service ratio or inverse of the long-term debt coverage ratio is $16,300 / 42,500 = 38.6%. They have lots of debt—71 percent of their assets are financed, and their long-term debt ratio is 2.6 times, just above the 2.5 times caution level. Thirty-nine percent of their total income available goes to cover just debt payments. Just think—they could be investing that money instead of paying it!

Savings Ratios

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

$5,000 (PY) / 42,500 (W – T) = 11.8%

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

$5,000 / 50,000 = 10%

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

Ratio Summary

Overall Situation	Actual	Recommended
Liquidity		
Current Ratio	4.4 Times	> 2
Month's LEC Ratio	1.9 Times	> 3 – 6+
Debt		
Debt Ratio	70.9%	0% (See Note 1)
LT Debt Cov. Ratio	2.6 Times	> 2.5
% Inc. to Pay Debt	38.0%	0% (See Note 1)
Savings		
Savings Ratio	11.8%	> 10%
Gross Savings Ratio	10.0%	10% Min (See Note 2)

Notes:

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

Using Balance Sheet and Ratios (LT4B), it is

Annual Financial Ratios for Steve and Mary Jo

as of January 31, 2019

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

6 Key Ratios Differences

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

- Page 1 of 3 -

Recommendations:

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

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

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

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

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

Introduction

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

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

Objectives

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

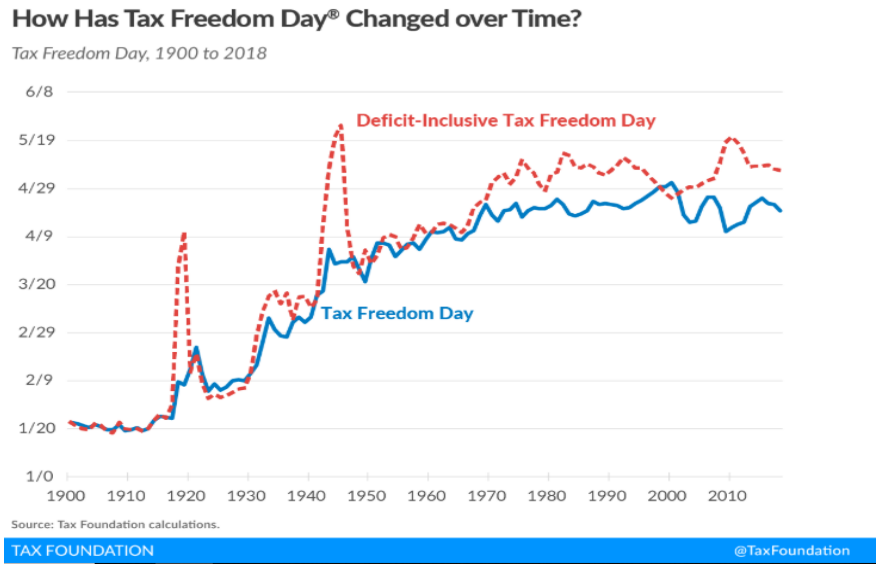
A. Understand how tax planning can help you attain your personal goals and the principles of tax planning.
B. Understand the Federal tax processs.
C. Understand the major tax features of the U.S. tax system and tax strategies to help you lower your taxes (legally and honestly).
D. Understand and create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

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

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

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

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



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

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

Principles of Tax Planning

There are five key principles of effective tax management:

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

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

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

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

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

Finding Balance

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

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

From Obedience to Consecration

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

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

Understand the Federal Tax Process

Preparing your income tax is a seven-step process:

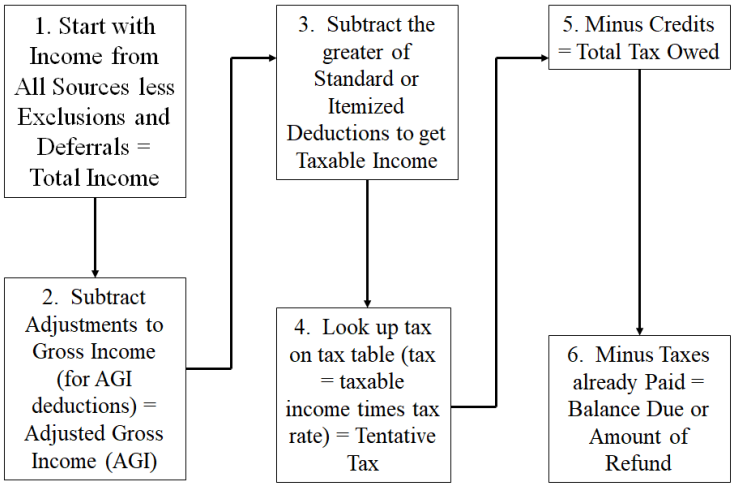
1. Calculate your gross income from all sources minus IRS-allowed losses, exclusions, and deferrals.
2. Subtract adjustments to gross income to get your adjusted gross income (AGI).
3. Subtract the greater of your standard deduction or your itemized deductions.
4. Refer to the IRS tax table and calculate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

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

Step 1: Calculate Your Total Income

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

Table 1. The Tax Process



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

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

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

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

Step 3: Subtract Itemized or Standard Deductions

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

Table 2 Standard Deductions

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

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

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

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

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

Table 3. Mileage Deductions

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

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

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

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

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

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

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

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

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

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

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

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

Table 5. Tax Tables for Married Filing Jointly

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

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

Step 5: Subtract Credits to Calculate Total Tax Owed

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

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

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

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

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

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

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

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

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

Income Taxes

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

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

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

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

Capital Gains Taxes

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

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

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

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

* Combined rate = 1.45% employer contribution.

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

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

Income-Based Taxes

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

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

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

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

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

Non–Income-Based Taxes

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

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

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

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

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

1. Maximize Your Deductions

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

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

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

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

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

Here are some key suggestions:

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

3. Earn Tax-Exempt Income

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

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

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

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

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

4. Defer Taxes to the Future or Eliminate Future Taxes

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

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

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

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

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

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

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

Learn to Be More Efficient with Your Taxes

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

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

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

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

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

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

Understand and Create Your Tax Plan

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

Vision

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

Goals

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

Plans and Strategies

Before Retirement

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

During Retirement

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

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

Constraints

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

Accountability

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

Summary

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

Preparing your income tax is a six-step process:

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

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

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

Tax strategies to minimize your tax payments include:

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

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

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

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

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

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

Assignments

Financial Plan Assignments

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

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

Learning Tools

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

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

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

Review Materials

Terminology Review

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Review Questions

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

Case Studies

Case Study #1

Data

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

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

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

Calculations

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

Recommendations

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

Case Study #1 Answers

Calculations: Standard Deduction Method

1. Income from all Sources $90,000

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

Calculations: Itemized Deduction Method

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

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

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

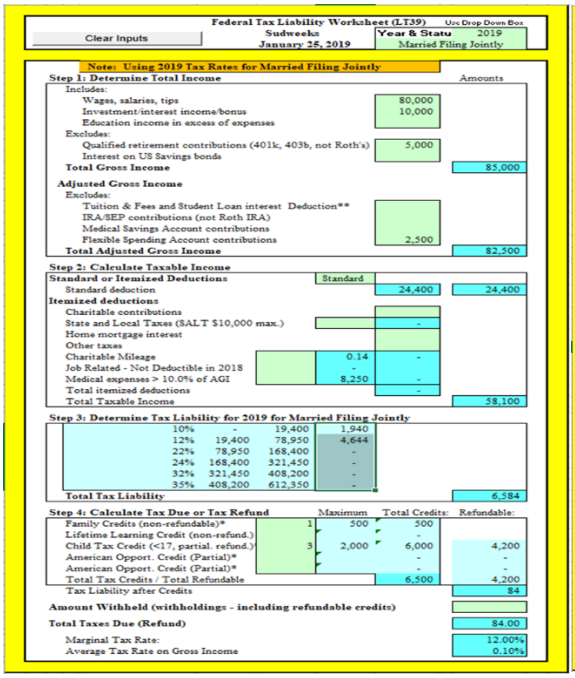
Their marginal tax rate, the tax rate they would pay on each new dollar of income is 15% for both the standard and itemized deduction calculation.

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

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

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

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



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

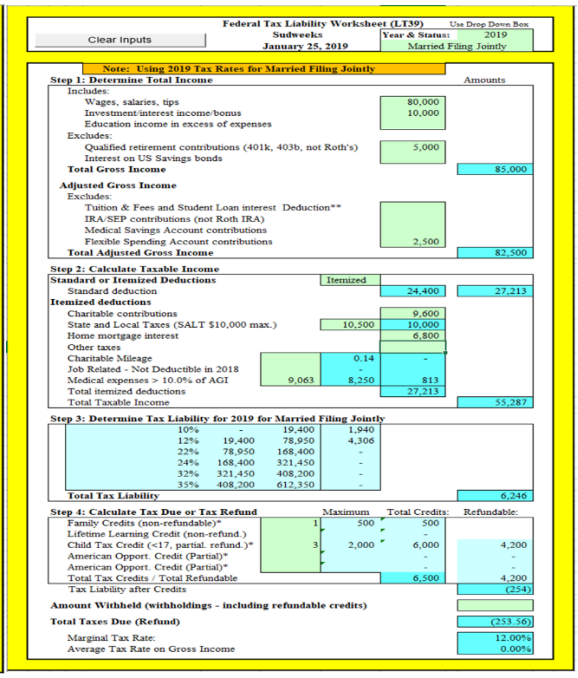
Note: Using 2019 Tax Rates for Married Filing Jointly

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

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

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

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



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

Note: Using 2019 Tax Rates for Married Filing Jointly

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

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

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

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

Recommendations

Method:

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

What could they do to reduce their taxes?

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

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

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

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

Case Study #2

Data

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

Application

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

Case Study #2 Answer

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

Case Study #3[3]

Data

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

Recommendations

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

Case Study #3 Answers

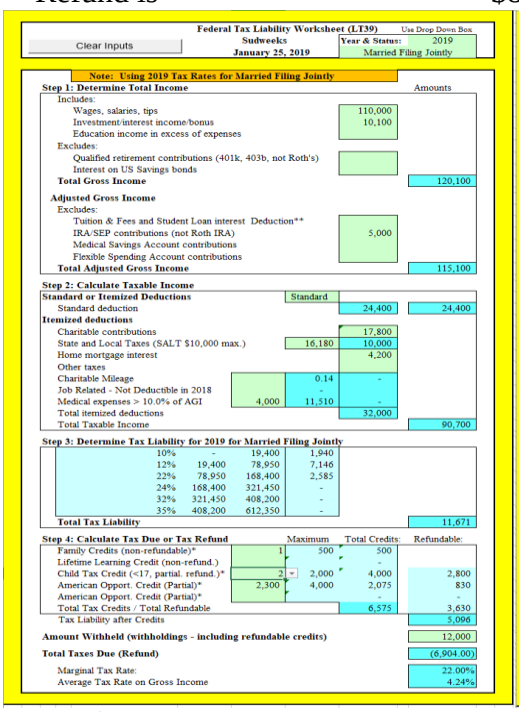
Calculations: Standard Deduction Method

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

Calculations: Itemized Deduction Method

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

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



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

Note: Using 2019 Tax Rates for Married Filing Jointly

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

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

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

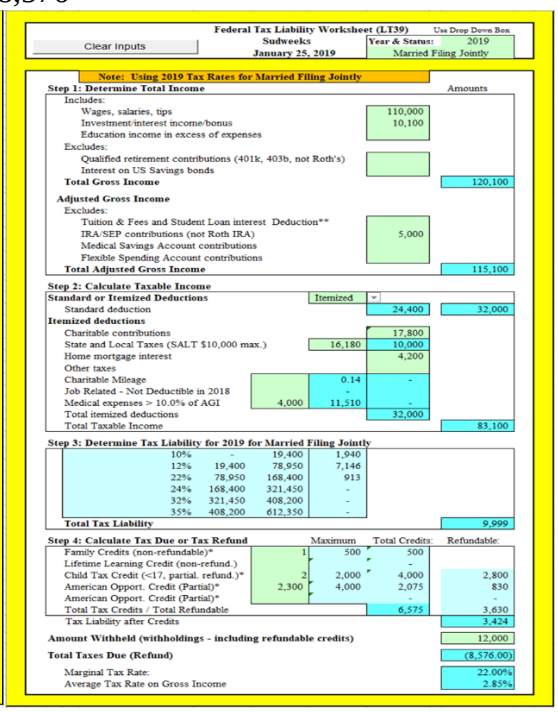
Step 3: Determine Tax Liability for 2019 for Married Filing Jointly

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

Total Tax Liability: 11,671

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

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



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

Note: Using 2019 Tax Rates for Married Filing Jointly

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

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

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

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

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

Total Tax Liability: 9,999

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

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

Case Study #4[4]

Data

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

Calculate their:

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

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

Case Study #4 Answers

Calculate their AGI:

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

Calculate their Taxable Income:

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

Calculate their tax liability:

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

Calculate their refund:

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

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

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

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

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

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

5. Cash Management: Making the Little Things Count

Introduction

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

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

Objectives

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

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

Understand the Importance and Principles of Cash Management

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

The principles of cash management were best summed up by Benjamin Franklin when he wrote "A penny saved is a penny earned." We are stewards over the resources we have, not only the large stewardships, but also over the small stewardships as well, i.e. the pennies. And as we take care of the small stewardships, we will find that the larger stewardships (the dollars) take care of themselves.

Trade-offs of Cash Management

There are three main trade-offs regarding cash management. The first is the risk-return trade-off: higher liquidity means less risk and lower returns. Generally speaking, the more liquid the financial asset, the lower the return you can expect to receive on the asset.

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

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

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

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

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

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

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

> May the Lord bless you . . . to set your houses in order. If you have paid your debts, if you have a reserve, even though it be small, then should storms howl about your head, you will have shelter for your [spouse] and children and peace in your hearts.[1]

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

Principles of Cash Management

The principles of effective cash management are:

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

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

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

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

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

Finding Balance

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

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

From Obedience to Consecration

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

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

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

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

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

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

- Commercial banks generally compete by offering the widest variety of services; however, they usually do not offer the highest interest rates on deposits or the lowest interest rates on loans.

- Savings and loan associations have slightly different ownership arrangements than banks but are similar to commercial banks. Savings and loan associations may offer slightly higher rates on deposits and somewhat lower rates on loans than commercial banks.

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

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

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

Mutual fund companies have broken into the banking arena. With many mutual fund companies, you can now write checks against funds in your mutual fund account. Brokerage firms have also

gotten into the act. Many brokerage firms now issue credit cards and ATM cards, make loans, and allow you to write checks. Brokerage firms offer these and many other account features that were once reserved for traditional banks.

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

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

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

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

Choosing a Financial Institution

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

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

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

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

with you?

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

Making the Time Commitment

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

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

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

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

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

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

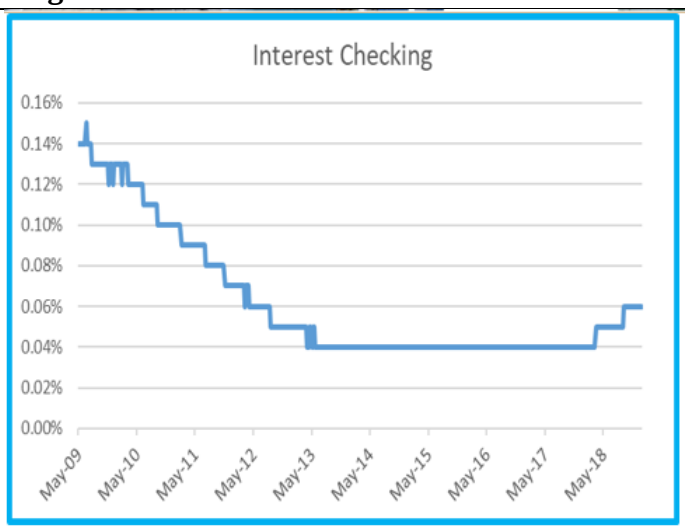
> Board of Governors of the Federal Reserve System
> Division of Consumer and Community Affairs
> 20th Street and Constitution Avenue, N.W., Stop 801
> Washington, D.C. 20551

Understand Cash-Management Alternatives and How to Compare Them

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

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

Chart 1. Checking Account Rates over Time



Source: St. Louis Federal Reserve at Fred.org

Checking Accounts

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

interest at all. The rates on interest-bearing accounts are generally low and fixed.

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

Savings Accounts

Savings accounts, also called time deposits, are next on the cash-management list. In the past, withdrawals and other transactions that affected a savings account would be registered in a "passbook"; hence the term "passbook savings" was coined. Savings accounts are now called statement accounts, and the customer receives a monthly statement from the financial institution.

Money in a savings account is deposited for a specific term (e.g., a day, week, month, or quarter) and hence is less liquid than money in a checking account. However, with the reduction in liquidity there is usually a slight increase in interest rate. Required minimum balances are low in savings accounts, although the amount does depend on the type of account. Savings accounts are very safe and are generally FDIC-insured; however, there are penalties for early withdrawal. Information on setting up savings accounts is available from banks, credit unions, and other financial institutions.

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

A MMA is similar to a savings account, but instead of having a fixed rate of interest, its interest rate varies with the current level of market interest rates (see Chart 2). Such accounts are also known as money market demand or deposit accounts.

Chart 2. Money Market Account Rates over Time

Source: Bankrate.com 2019/01/25

Money Market Accounts (MMA)

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

Certificates of Deposit (CDs)

Certificates of deposit pay a fixed rate of interest for keeping funds in your account for a fixed period of time. They are similar to savings accounts and time deposits. Interest rates are fixed for the life of the deposit, and the longer the term of the deposit, the higher the interest rate (see Chart 3).

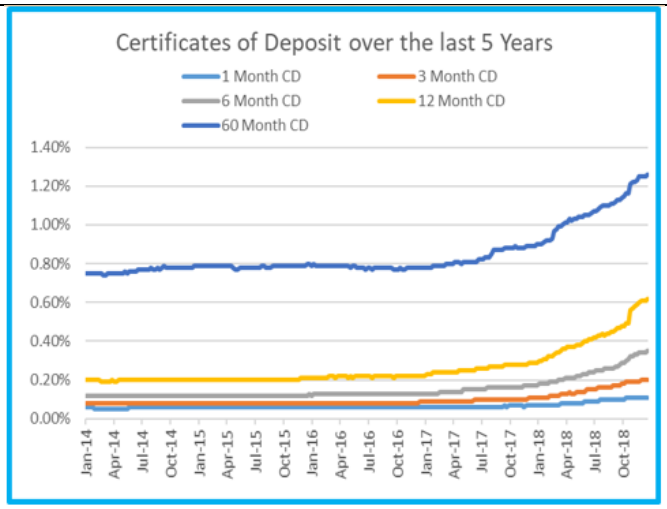
CDs are less liquid than other cash-management alternatives because the money must be deposited for a certain amount of time; however, with that reduction in liquidity comes a higher interest rate. The required minimum balance for a CD account is generally higher than it is for a savings or checking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

Money Market Mutual Funds (MMMFs)

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

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

Chart 3. CD Rates over time



Source: Fred.org 2019/01/25

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

Short-term Bond Mutual Funds (STBMFs)

Short-term bond mutual funds pool money from many investors to buy higher yielding debt securities, less than 1 year maturity. Because they are working with pooled assets, mutual fund companies can usually purchase higher-yielding investments that give higher returns to investors. Investments can be either taxable securities or tax-advantaged securities, such as municipal bonds, which are federal tax free. We recommend you purchase no-load short-term mutual funds, which means they do not have a sales charge. You can review the structure and performance of these mutual funds on websites such as www.morningstar.com.

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

U.S. Treasury Bills

Treasury bills (T-bills) are short-term notes of debt that are issued by the federal government. They can take from one to 12 months to mature, and investors do not receive explicit interest on these assets. T-bills are purchased at a discount to their face value, and when the bill matures, investors receive the full face value (see Chart 4).

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

Chart 1. Cash Management Alternatives 2019

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

U.S. Series EE Bonds

U.S. Series EE bonds are government savings bonds that are issued by the Treasury in small denominations (as small as $25); these bonds have variable interest rates. Bonds are purchased at face value, and when the bonds mature, principle and interest is paid. The interest rate paid on EE bonds is fixed for six months; interest rates are set biannually (see Chart 5).

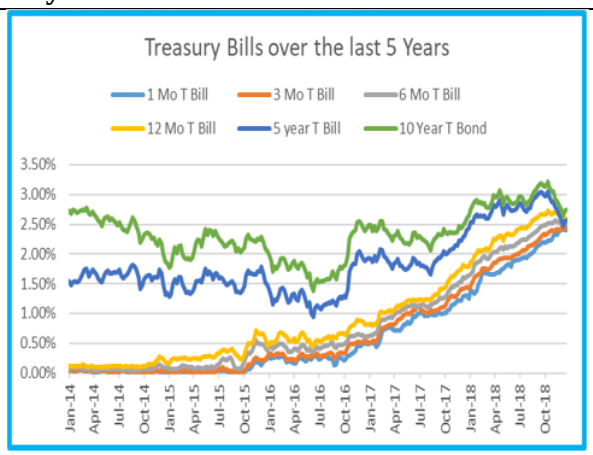
Series EE bonds are liquid in the sense that they can be cashed at any time after one year. Ideally, you should hold them for at least five years to ensure there will not be an interest penalty; after five years, these bonds can be cashed at any bank. Interest rates are competitive. Required minimum balances are low, and these bonds can be purchased in denominations from $25 to $10,000. Series EE bonds are very secure because they have an implicit government guarantee. Other features include interest being exempt from state and local income tax; interest may even be federal tax-free if the interest and principal are spent on eligible college expenses (mainly tuition and fees). One drawback to Series EE bonds is that there is a three-month interest penalty if you withdraw funds before the five-year term is over. Information on rates and how to purchase Series EE bonds can be found at www.savingbonds.gov. Investors can purchase savings bonds for up to $10,000 per year in electronic bonds and another $5,000 per year from

their IRS tax refund. If your Modified Adjusted Gross Income (MAGI) is above specified limits in the year you cash the bonds, you cannot exclude the interest income from your income taxes for EE and I Savings bonds (see Table 1).

U.S. Series I Bonds

U.S. Series I bonds are government savings bonds that are also issued by the Treasury in small denominations (as small as $25). Series I bonds have variable interest rates that are linked to inflation and a specified real rate of return (see Chart 6).

Chart 4. Treasury Bill Rates over Time



Source: Fred.org 2019/01/25

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

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

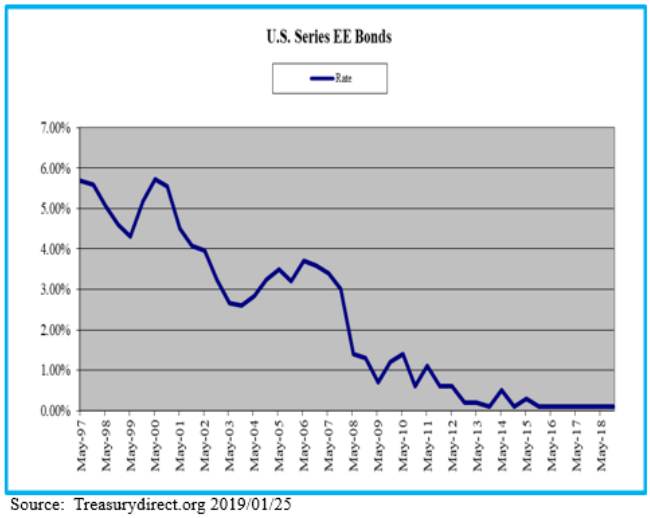
Year	Filing Single	Married Filing Jointly
2014	$76,000–91,950	$113,950–143,900
2015	$77,200-92,199	$115,751-145,749
2016	$77,550–92,550	$116,300–146,300
2017	$78,150–93,150	$117,250–147,250
2018	$79,700–94,700	$119,550–149,550*

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

Series I bonds, like Series EE bonds, are liquid in the sense that they can be cashed at any time. Ideally, you should hold them for at least five years to ensure there will be no interest penalty; after that they are very liquid and can be cashed at any bank. Interest rates are variable and change with inflation. Required minimum balances are low, and bonds can be purchased in denominations ranging from $25 to $10,000. Series I bonds are very secure because they have an

implicit government guarantee. There is a three-month interest penalty if you cash these bonds before five years. Other features include interest being exempt from state and local income tax; interest may even be federal tax-free if the interest and principal are spent on eligible college expenses (mainly tuition and fees). Because interest is not paid until maturity, there are no taxes on interest until the bond is redeemed. Information on rates and how to purchase Series I bonds can be found at www.savingsbonds.gov. Series I bonds have the same MAGI limits as Series EE bonds above (see Table 1).

Chart 5. US Series EE Bond Rates over Time



Source: Treasurydirect.org 2019/01/25

Comparing Cash-Management Alternatives

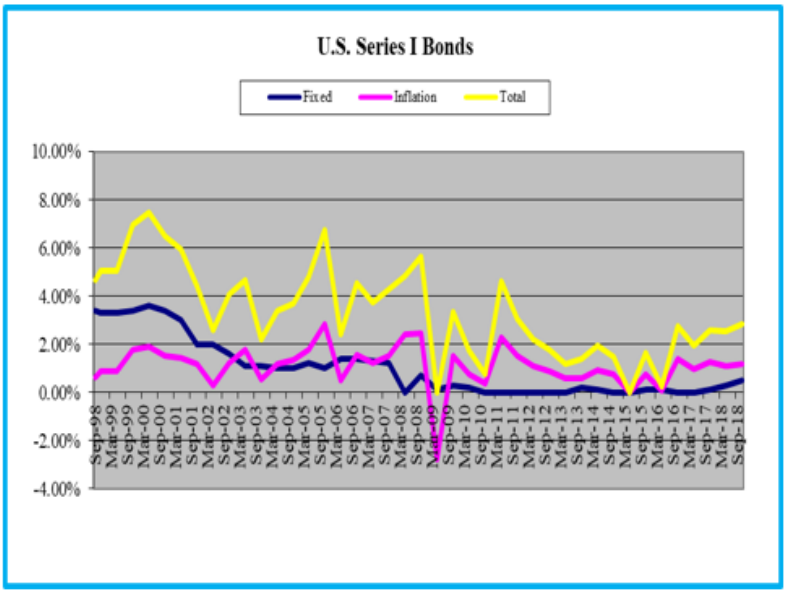
When comparing cash-management alternatives, it is critical to understand and accurately compare the following five areas:

1. Interest rates: Certain cash-management assets are compounded annually, others are compounded quarterly, and still others are compounded daily. Use a consistent method of comparing interest rates when considering cash-management alternatives. Because of the Truth in Savings Act of 1993, financial institutions are required to report the rate of interest using the annual percentage yield (APY). The Annual Percentage Yield is the effective rate of return taking into account the effect of compounding interest. Look for this APY yield when comparing alternatives. It includes the impact of different compounding periods. The formula for APY = $(1 + [APR/Periods])^{Periods} – 1$.

2. After-tax returns: While certain assets may have lower returns, these same assets may be exempt from federal, state, and local taxes. Consider tax advantages and after-tax returns. The after-tax return equals your before-tax return (the reported APY) times one minus your marginal tax rate (the tax rate of each additional dollar of earnings). The formula for After-Tax Return = Before-Tax Return * (1 – Marginal Tax Rate)

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

Chart 6: US Series I Bond Rates over Time



Source: Treasurydirect.org 2019/01/25

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

To calculate the ETY, first calculate the after-tax return of the tax-advantaged asset. Second, divide that after-tax return by one minus your marginal tax rate (your marginal federal, state, and local tax rates). The formula for ETY = After-Tax Return / (1 – Marginal Tax Rate).

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

3. Inflation: Remember, it is not what you earn but what you keep after taxes and inflation that makes you wealthy. Calculating the return after inflation, or the "real return," is important. The real return is calculated as Real Return = [(1 + nominal return) / (1 + inflation)] – 1 where nominal return is the return including inflation.

If inflation is a concern for you, there are inflation-linked bonds, such as U.S. Government Series I bonds and Treasury Inflation-Protected Securities (TIPS), that take changes in inflation into account to determine yields.

4. Safety: Some investors consider all deposits at financial institutions to be safe. However,

some banks and other financial institutions have historically made decisions that are not consistent with proper fiscal responsibility, and some investor deposits have been lost. FDIC and NCUA insurance are available for up to $250,000 per depositor (not per account). If your assets are greater than $250,000 and you want more insurance, deposit your assets in multiple federally insured institutions.

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

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

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

Understand and Create Your Cash Management Plan

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

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

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

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

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

Vision

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

Goals

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

Plans and Strategies

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

Constraints

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

Accountability

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

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

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

Summary

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

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

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

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

When you are comparing cash-management alternatives, it is critical to accurately evaluate four areas. First, use a consistent method for comparing interest rates. Cash-management assets can be compounded annually, quarterly, or daily. Use a consistent method of comparing interest rates when considering cash-management alternatives.

Second, use a consistent method of comparing after-tax returns. While certain assets may have lower returns, these same assets are often exempt from state and local taxes, and they may be exempt from federal taxes if the assets are used for college tuition. If the assets have tax advantages, calculate the equivalent taxable yield; the taxable yield is the yield you would have to make on a taxable asset to give you the same after-tax return as the tax-advantaged asset.

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

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

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

Assignments

Financial Plan Assignments

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

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

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

Plans and Strategies. You Action Plan should be the cash-management vehicles to help you get higher interest rates on savings or checking accounts and still maintain adequate liquidity to meet your needs for cash. Are there less-traditional alternatives, (Internet banks) that can give you a higher return with the same amount of liquidity and safety?

Start by reviewing your current cash-management framework. What interest rate(s) are you earning on your savings account(s)? What are you paying in fees and expenses on your savings account(s)? Which of these current vehicles, if any, do you use? What rates are you earning on your checking and saving accounts? What monthly and other fees are you paying.

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

Accountability. Who will you be accountable to?

Learning Tools

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

After-Tax, ETY, and Other After-Inflation Returns (LT26)
This document is an example of a spreadsheet you can use to calculate your after-

tax returns, equivalent taxable yields on tax-advantaged assets, and after-inflation returns on all assets.

Review Materials

Terminology Review

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

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

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

CD Laddering: the process of getting a higher interest rate by buying longer term CDs and purchasing them more often. For example, 1 month CD rates are too low, but you like 6 month rates. Take the amount of money you want to invest, divide it by 6 (or any number), then invest 1/6 of your money every month in a 6 month rate. You are creating a ladder of CDs, and every month you have money coming in. You would then reinvest that in another 6 month CD.

CDs: Certificates of Deposit are savings certificates with a fixed maturity date, a specific interest rate and can be issued in any denomination. A CD restricts access to the funds until the maturity date, and are generally issued by a commercial bank.

Checking Accounts: Checking accounts are deposits help at a financial institution that allows withdrawals and deposits on demand; hence, it is also called a demand account.

Commercial Banks. These financial institutions generally compete by offering the widest variety of services; however, they usually do not offer the highest interest rates on deposits or the lowest interest rates on loans.

Corporate bonds: Debt instruments issued by corporations to fund the requirements of the companies.

Credit unions. These institutions are similar to savings and loan associations, but they are not-for-profit organizations and are owned by their members. They can sometimes offer higher rates on savings accounts and lower rates on loans because they are not driven to provide a profit to shareholders.

EE Bonds: US government savings bonds where the interest rate is set every 6 months and tied to current market interest rates.

Equivalent Taxable Yield: This is the yield you would need to earn on a fully taxable security to give the same after-tax return that you receive on a tax advantaged security, i.e., a security that has specific tax advantages (i.e., tax free for Federal or State or both).

I Bonds: Inflation linked US government savings bonds, where the rates on the bonds are tied to inflation.

Inflation: This is the rate of general level of prices are changing

Interest Rates: This is the amount charged by a lender to allow a borrower the use of the

funds. It is expressed as a percentage of principal; and typically noted as the APR or annual percentage rate.

Interest Rate Adjustments: With certain cash management instruments, the interest rates can change over time, depending on a specific index and a spread.

Internet Banks: These financial institutions are electronic banks that do not have traditional brick-and-mortar branches. Because they have fewer branches, employees, and capital expenditures than traditional banks, they can generally pay higher interest rates on deposits and charge less for loans than traditional banks do.

Maturity: Maturity is the amount time certain financial instruments require the investment to be held, i.e., 3 months, 5 years, or 10 years.

Money Market Account or Money Market Deposit Account: A non-financial account that pays interest based on current interest rates in the money markets. They typically require a higher minimum balance to avoid monthly fees and typically have a higher rate of interest.

Real Interest Rate: The real rate is the interest rate that has been adjust to eliminate the effects of inflation.

Safety: Safety refers to the ability to invest without losing principle. Banks and credit unions have FDIC and NCUA insurance are available for up to $250,000 per depositor (not per account).

Savings and loan associations. These institutions have slightly different ownership arrangements than banks but are similar to commercial banks. Savings and loan associations may offer slightly higher rates on deposits and somewhat lower rates on loans than commercial banks.

Savings Bonds: Bonds issued by the US government with tax advantages to encourage savings.

US Treasury Bills: These are short-term debt obligations of the US Government with a maturity of generally less than one year, are sold in different maturities, and are issued at a discount from par. Investors do not receive regular payments as with a coupon bond, but do receive interest at maturity.

Review Questions

1. What are the three main trade-offs regarding cash management?
2. What is the key to using liquidity wisely? Why?
3. What is an emergency fund? Why should you have one? How much should you have in your emergency fund?
4. What are six account characteristics that can be used to analyze cash-management alternatives?
5. What are the four key areas used to compare cash-management alternatives?

Case Studies

Case Study 1

Data

Bill is an investor in the 15-percent federal marginal tax bracket and 7-percent state tax bracket. Suzie is an investor in the 35-percent federal tax bracket and 7-percent state tax bracket. They are each considering purchasing one of the following bonds for their investment portfolios:

1. A 6.5-percent corporate bond (all taxable)
2. A 4.75-percent municipal bond (federal tax free)
3. A 5.0-percent treasury bond (state tax free)

Calculations

Calculate the after-tax returns for each of the above bonds for both Bill and Suzie. Which bonds should Bill and Suzie purchase and why?

Case Study 1 Answers

Calculations

Bill (Taxable return * (1 – tax rate) = after-tax return)

CB:	6.50% * (1 – (.15 + .07))	=	5.07%
MB:	4.75% * (1 – .07)	=	4.42%
TB:	5.00% * (1 – .15)	=	4.25%

Suzie

CB:	6.5% * (1 – (.35 + .07))	=	3.77%
MB:	4.75% * (1 – .07)	=	4.42%
TB:	5.0 * (1 – .35)	=	3.25%

Recommendations

The corporate bond is the best for Bill. The municipal bond is the best for Suzie.

Case Study 2

Data

Kaili and Taylor are in the 25-percent federal and 7-percent state tax bracket. They have a $3,000 wedding gift that they will invest either for school tuition or for a vacation.

Calculations

If they invest the $3,000 in a U.S. Series I bond that earns 4.8 percent, what is the equivalent taxable yield (ETY) if the principal and interest are

A. used to pay for law school tuition?
B. used to pay for a family vacation?

Case Study 2 Answers

Calculations

A. If Kaili and Taylor use the principal and interest for tuition, the bond is both federal

and state tax exempt. The formula is

Return after tax = return before tax * (1 – tax rate)

Since this asset is federal and state tax free, the equivalent yield on a taxable bond would be the tax-free return divided by 1 minus the tax rate, which includes both federal and state taxes (mathematically, you divide both sides of the equation by (1 – tax rate)).

4.8% = x * (1 – (.25+.07)) or x = 4.8% / .68

x = 7.06%

B. If Kaili and Taylor use the principal and interest for a family vacation, it is only state tax-free.

The after-tax rate yield is

After-tax rate = 4.8% * (1 - .25) or 3.6%

The equivalent taxable yield is

ETY = 3.6% / (1 – (.25 + .07))

x = 5.29%

<u>Case Study 3</u>

Data

Your buddy Paul asks you about real returns. After you show him the correct method for calculating real returns, he wants to know what his real return is on his money market account. He shows you his brokerage statement, where he is earning a 4.5-percent yield. He also estimates that inflation will be 3.5 percent this year. Paul is in the 35-percent federal and 7-percent state marginal tax brackets.

Calculations

What is his after-tax, after-inflation return?

Recommendations

What are the implications of this result for cash-management decisions?

Case Study 3 Answers

Calculations

After-tax return = before-tax return * (1 – (federal + state marginal tax rate))

4.5% * (1 – (.35 + .07)) = The after-tax return is 2.61%

Real Return = [(1+ after-tax return) / (1 + inflation)] - 1

The after-tax, after-inflation return is: (1.0261/1.035) –1 = –.86%

Note: You must take out taxes before you take out the impact of inflation.

Implications

- It is very difficult to do much more than keep up with taxes and inflation with liquid assets.

Only the amount needed to meet immediate emergency needs and short-term goals should be

invested in this account

[1] "To the Boys and to the Men," *Ensign*, Nov. 1998, 51
[2] Thomas J. Stanley and William D. Danko, *The Millionaire Next Door*, Pocket Books, New York, 1996, 71.

6. Credit: Understanding and Using It Wisely

Introduction

Credit is a wonderful tool that has allowed many people to achieve goals they might not have otherwise been able to achieve, such as buying a home or paying for higher education. However, credit has also been the downfall of many people who have not used it wisely. Understanding both the positive and negative aspects of credit will help you be wise as you pursue your financial goals.

The credit card can become a very destructive financial instrument if not carefully watched and controlled. If credit card debt gets out of control, it can cause not only financial troubles but personal heartache as well. Gordon B. Hinckley said, "Debt can be a terrible thing. It is so easy to incur and so difficult to repay. Borrowed money is had only at a price, and that price can be burdensome."[1]

Objectives

This chapter focuses on the following four objectives to help you better understand credit, credit reports and credit cards:

A. Understand credit bureaus, credit reports, credit scoring and the principles of using credit wisely
B. Understand the correct uses of credit cards
C. Learn how credit cards work and how to manage credit
D. Understand and create your Credit Plan.

Learn About Credit Bureaus, Credit Reports, Credit Scores and the Principles of Using Credit Wisely

Credit reports are files of information that credit bureaus compile about specific individuals. Most individuals who have any type of credit (credit cards, checking accounts, loans, etc.) have a credit report.

The information on your credit report is very detailed. It includes personal demographics, such as your age, social security number, previous addresses, employment history, and criminal convictions. The report also includes information about your credit history, including a list of any inquiries you have made about your credit in the last two years. Factors that determine your credit worthiness include your annual income, how long you have lived at your current

residence, how long you have been employed at your current job, and how many bank accounts and credit cards you have. Other factors that determine your credit worthiness include your age, your employment history, and your credit history.

Although the information gathered by the credit bureaus is about you, it may not always be correct. It is estimated that 70 percent of Americans have at least one negative remark on their credit reports, and almost half of all credit reports contain incorrect or obsolete information.

You have specific rights related to your credit reports. If you are ever denied a line of credit, you can request a free copy of your credit report from each of the credit bureaus. If you would like to review your credit report, you can request a free copy once a year from each of the three major credit reporting agencies (Equifax, Trans Union, and Experian) by going to www.annualcreditreport.com and filling out several forms.

You should review your credit report from each credit bureau once a year to make sure there are no mistakes on it. Even simple mistakes can result in a lower credit score, which may prevent you from getting a mortgage or a consumer loan; these mistakes may even increase the cost of your auto insurance.

When you are reviewing your credit report, look for open lines of credit that you were not aware of and other indications that someone may be committing fraud by using your information. If you think there are mistakes on your credit report, you need to have them investigated. If an investigation does not clear up a mark on your credit report, but you still disagree with it, you can add a personal statement of up to 100 words to your credit report explaining what happened with a specific creditor. When you apply for credit, potential lenders can see your explanation of what happened and consider it when they make their lending decisions.

Credit bureaus are private companies that collect and report information from creditors, public records, and various institutions. There are over 1,000 different credit bureaus; the three major ones are Equifax, Experian, and TransUnion.

Credit evaluation is the process potential creditors use to determine whether or not an individual deserves to be given credit. This is based on an analysis of specific financial information from various sources which results in a credit score. Financial institutions developed credit scores as a way of determining which borrowers are most likely to repay their loans. While for students a GPA is based on grades, for borrowers a credit score is based on factors such as credit history, length of credit, repayment history, and types of credit owed.

Your credit score takes into account specific factors surrounding your debt and debt habits. You are assigned a single score that lending institutions use to base their decisions on whether you qualify for credit. Your credit score also determines what interest rate you will pay on the credit an institution offers you. Generally, the higher your credit score, the lower the interest rate you will have to pay.

One of the most important investments that may be affected by your credit score is a loan for a new home purchase. Your credit score can have a significant impact on whether or not you get this type of loan: nearly 75 percent of all mortgage loans are sorted according to credit scores. Your credit score may also affect the cost of your insurance. For these and many other reasons, understanding credit and maintaining a high credit score are important to your overall financial health.

Research by E-Loan showed the following statistics on how credit scores affected what interest rate consumers paid on loans (see Table 1).

Table 1. Credit Scores and Interest Rates Paid[2]

Credit scores above 760 paid 3.27 percent.
Credit scores from 700 to 759 paid 3.49 percent.
Credit scores from 680 to 699 paid 3.67 percent.
Credit scores from 660 to 679 paid 3.88 percent.
Credit scores from 640 to 659 paid 4.31 percent.
Credit scores from 620 to 639 paid 4.86 percent.

For a $300,000, 30-year loan with monthly payments, the difference in how much someone with a credit score of 760 (3.27 percent) paid in interest compared with how much someone with a credit score between 620 and 639 (4.86 percent) paid was significant; there was an increase in interest payments over the life of the loan of $99,275 on a $300,000 loan. There is a direct correlation between your credit score and the interest rate you pay.

What Is a FICO Score?

The most common type of credit score is the FICO score, which was developed by Fair, Isaac, and Company of San Rafael, California. Fair, Isaac, and Company is not the only credit scoring company, but lending institutions use FICO scores more often than the credit scores provided by other companies. Lenders usually base your interest rate on your FICO score, which can range from 300 to 850. Generally, the higher your FICO score, the lower the interest rate lenders will charge you. There are two main FICO scores, including FICO Score 8 (which is the most widely used) and the FICO Score 2, which is used for mortgage lending.

Before 2001, consumers were not allowed to see their credit scores. However, in March 2001, new legislation allowed the public to access their credit information for a price. You can now purchase a copy of your FICO credit score from www.myfico.com or purchase credit scores from other credit scoring and reporting companies, such as Experian, TransUnion, and Equifax. You may also be able to get it free from your credit card company or other agency. I generally recommend getting your FICO credit score as these are most used in the industry.. Getting a copy of your credit report and credit score does not affect your credit score.

How Is Your Credit Score Determined?

There are a number of different institutions that calculate credit scores. Since the FICO score is the most common, this chapter will discuss how your credit score is determined based on the FICO scoring methodology.

About 35 percent of your credit score is based on your payment record. This is why it is important to pay your bills on time. Do what the scriptures and our leaders have counseled: do not get into debt in the first place, if possible. If you are in debt, make timely payments, and get out of debt as soon as you can.

Another 30 percent of your credit score is based on the total amount you owe as a percent of your available credit or credit limit. Generally, try to keep your usage of credit below about 15 percent of your available credit limit. Keep your balances low, especially on revolving debt. If you are hoping to get a mortgage loan in the future, it may be wise to pay off your revolving credit every week so that the amount you owe is a small percentage of your total available credit.

Around 15 percent of your credit score is based on the length of your credit history. You should keep your oldest accounts open whenever possible to show you have learned to manage credit over a longer period of time. However, you do not want to have too many accounts open at one time.

Approximately 10 percent of your credit score is based on your application history. Do not apply for credit too often. If you are applying for a new credit card every quarter, the question arises as to what you are doing with your available credit. For most people, one to three credit cards is generally sufficient. Realize that each time you apply for credit it is noted on your credit report.

Finally, 10 percent of your credit score is based on a credit mix. You do not want to have too many of the same kind of card. Having a Sear's, Nordstrom's, and Kohl's card may actually bring down your credit score because they are all similar stores. Be cautious of retail stores that offer a 10- to 20-percent discount on your first purchase if you apply for their store credit card. These types of cards can have negative effects on your credit score.

Which Credit Score Should You Get and How Do You Get It

There are a number of credit score providers including FICO, VantageScore, PLUS Score, etc. The most used credit score is from FICO. Most loans are sorted based on FICO scores, and there are different FICO scores. While I recommend a FICO score, any score will fulfill the requirements for your PFP.

You can go four routes for your credit score. I would recommend you do it for free if you can.

1. FICO Scores. Discover offers your FICO score for free, you can check it often as it is updated monthly. Go to https://www.discover.com/free-credit-score/ and you can get a free FICO score. You can also go to Google.com, and search for "Myfico promotional code" (generally 10-30%), then go to www.MyFico.com and order a standard credit report and FICO score for $19.95 less discount.

2. Other Credit Scores. You can use free sites to get your Vantage or other scores and to monitor it regularly. While not FICO scores, it can help you if you see your trending score. Sites include www.CreditKarma.com (with an app) and www.Creditsesame.com.

3. You may be able to get a copy of your credit score from your bank or credit card provider (it may or may not be a FICO score). Contact them and see what they have available.

4. If you go to Mint.com, you can also get a free copy of your credit score from them. You need to have already done your budget to get it.

Regardless of how you get your credit score, you will view and print off your credit report and credit score and put it in your PFP.

What Should You Do Regarding Your Credit Score?

Just as you manage your assets carefully, you should manage your liabilities carefully. You must take an active role in managing your credit score. Ideally, you should review your FICO score every two years and review your credit reports annually; do these things more often if you are planning to take out a loan for a house within the next 12 months. By planning ahead, you can resolve any inaccuracies on your credit report before you apply for a loan; planning ahead can help you get the highest credit score—and the lowest interest rate—possible.

Principles of Using Credit Wisely

Proper understand of the principles of using credit wisely can help us to be wiser consumers of credit. Following are a few principles of using credit wisely which may be helpful as to try to minimize the use of credit.

1. Know what you want out of life. Know yourself, your vision, goals, plans and values. It is important that you have an idea of what you are trying to accomplish so that you can slowly become that vision of yourself. Make sure that everything you do is consistent with the things you are trying to accomplish and the values you hold dear.

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of credit and credit reports. It is critical that you understand how our financial system works in regards to credit. Learn how things work and how you can improve your standing with lenders.

4. Know where you are financially. This is especially important in regards to your budget, assets and liabilities. Hide no bills from your spouse and make sure you understand all assets and liabilities.

5. Keep current on all bills. Pay off all credit cards and other debt monthly—you do not need a balance to build credit. Set a goal to not go into debt except for those things that the prophets and apostles have counseled. Work hard to not spend money you don't have.

6. Make only planned purchases from your budget. Only make purchases that are in your budget and that are planned for, particularly large purchases. Use this planning time each quarter or month to wisely determine your needs and wants, and then to plan accordingly.

7. Be wise in your use of credit and debt. Don't go into debt except for a modest home and modest education. Do not fall for the monthly payments trap that says you can pay a certain amount each month.

8. Review your credit score and credit reports annually. This is to ensure correctness and no identity theft which is becoming more prevalent. Work to improve your credit reports and raise your credit score to above 750 if possible.

Finding Balance

As you work on managing credit, finding balance among doctrines, principles and application is important in helping you become better. We have shared some ideas for principles, although I am sure you can find others that are important to you. Below are a few ideas for doctrines on which the principles are based.

Principles	Doctrines
Know yourself, your vision, goals and budget	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Understand the key areas of credit and reporting	Agency
Know where you are financially	Stewardship
Keep current on all bills, don't go into new debt	Accountability
Make only planned purchases	Stewardship
Be wise in your use of credit	Accountability
Review your score and credit reports quarterly	Stewardship

From Obedience to Consecration

From the principles and doctrines, you can see that you are not just working on being wise with your use of credit, which is an application; rather, from a higher perspective, or increased vision,

> We are children of God (identity), striving to live worthy of the Spirit (obedience), acting on our ability to choose (agency), who understands the benefits and dangers of credit (stewardship) and who uses credit only for those items recommended (accountability). We understand the credit industry (stewardship), use it to our advantage by keeping your

credit score high (accountability), so we can get the lowest cost on needed credit products (stewardship), so we can eliminate our interest costs and save money to accomplish our individual missions and personal and family vision and goals.

Identify Appropriate Uses for Credit Cards

Credit cards are essentially open lines of credit. Credit cards can be either 1. the single most destructive financial instrument in the history of the world, or 2. a tool to help us reach our personal and family goals. It depends on us! If we use them to borrow money and get further into debt, they are destructive. If we use them to achieve our personal and family goals, they can be helpful.

There are five main benefits for using credit cards:

1. **Emergencies:** Credit cards can be useful when you don't have cash on hand and need to pay for something immediately, such as an auto repair or an insurance co-payment.

2. **Reservations*:*** Credit cards can be used to guarantee hotel rooms, rental cars, and other rental items. This is an important use, especially if you travel.

3. **Convenience*:*** With a credit card, you can buy things over the phone or on the Internet. Credit cards make purchasing things very easy. They also provide you with a record of everything you spend, an important bookkeeping benefit.

4. **Cash flow and timing*:*** If something is on sale, and you know you have the cash coming in a week, you can actually buy the item before you pay for it. In this way, you can take advantage of sales (but remember, you do not save money by spending).

5. **Free services*:*** Often, credit cards offer rewards, such as extended warranties, travel insurance, airplane miles, gasoline rebates, and cash rebates—all of which can reduce the overall cost of some items.

While there are benefits to using credit cards, there are drawbacks as well. Credit cards must be used wisely to avoid problems. The following is a list of some of the problems associated with using credit cards:

Increased spending: People don't take as much time to think about how much they're spending when they use a credit card. Research has shown that, on average, people spend 30 percent more with a credit card than they do with cash.

Losing track of spending: It's easy to lose track of what you spend with your credit card. It requires discipline to track the charges you make.

Interest and other costs: Interest charges can range anywhere from 8 percent to 25 percent. In addition to these interest charges, you must take into account compounding periods, annual fees,

and other miscellaneous fees, such as cash advance fees and balance transfer fees. Often, the costs of using credit cards are double or triple the costs of using other types of loans.

Obligations on future income: Most importantly, when you use credit cards, you put obligations on future income. As you take on more debt, you not only obligate future income, but you also limit future flexibility should emergencies arise.

Using a Credit Card Effectively

The following are some important keys to using your credit card effectively:

1. **Know your personal and family vision and goals.** What do you want to accomplish individually and as a family? What do you want to accomplish financially? If you can develop good habits, instead of paying interest you can earn it.

2. **Spend money only on things planned for in your budget.** If you understand your goals, and if your budget is consistent with your goals, you will buy only things you have planned for in your budget. If expenses you hadn't planned for arise and you decide they are necessary expenses, you will have to go back and revise your budget to make them work.

3. **Do not go into debt.** It is wise to not go into debt except for a home or an education. Follow this advice and avoid credit card debt whenever possible.

4. **Use wisdom in deciding what to buy.** Use wisdom in your expenditures. Learn to get away from the "buy now, pay later" mentality, and adopt the "save now, buy later" mentality.

Learn How Credit Cards Work and How to Manage Credit

Companies issue credit cards to earn money. Annual fees can be anywhere from $0 (no fee) to $300 a year. Interest rates are high: some are as high as 25 percent before compounding! Balance transfer fees can also be very high—they can start at 3 percent and increase with each transfer. Cash advance fees usually start at 4 percent and can go higher. Often, these fees can't be paid back until the original, less costly debt is paid back; this results in even higher costs to you. Penalty rates sometimes exceed 25 percent, and late fees are also high. All of these charges are added on top of a 1.5 to 5 percent charge to merchants.

How Credit Cards Work

A credit card is one type of open credit. Open credit is an agreement you make with a financial institution (in this case, a credit card company) that allows you to borrow money up to a specific limit; it is expected that you will pay back the loan at a specific interest rate and pay other attached fees as well. Many factors determine how much open credit will cost you annually: the balance owed, the interest rate, the balance calculation method, the cash advance costs, the

annual fee, and the additional penalty fees.

By understanding how open credit works, you can avoid the pitfalls this type of credit can present. There are several key factors you should understand about open credit before you apply for this type of loan:

Interest rate: Credit card companies state the interest rate as an annual percentage rate, or APR. This is the true, simple interest rate that is charged over the life of the loan. However, the APR does not take into account compounding periods or the time value of money. You should also watch out for teaser rates. Teaser rates are introductory rates used to attract new customers (some are as low as 2.9 percent) but these rates change after a specified period of time. Don't be fooled—read the fine print.

Compounding period: The compounding period is how often interest is charged to your account. Most credit card companies compound interest daily. It's interesting to note that when you save money, interest is compounded monthly, but when you borrow money, interest is compounded daily. Any time you borrow money, remember that you are paying interest, not earning it.

Balance calculation methods: You should understand that credit card companies use three main balance calculation methods: average daily balance, previous balance, and adjusted balance. The most commonly used method of calculating your balance is the average daily balance. This method adds up your average daily balances for each day during the month, divides the total by the number of days in the month, and multiplies the result by your monthly interest rate (your APR divided by 12). The previous balance method is the most expensive method. This method takes the previous balance you owed last month and multiplies it by your monthly interest rate. The last method, the adjusted balance method, is the least expensive. This method takes your previous balance, subtracts your payments, and multiplies the total by your monthly interest rate.

Cash advances: Avoid using cash advances. Cash advances are an extremely expensive way to borrow money. Interest begins to accrue as soon as you get a cash advance because they are not considered normal credit card charges. Generally, the interest rate charged on cash advances is higher than the interest rate charged on purchases. In addition, there is usually a cash advance fee of between two and four percent of the cash amount advanced. Moreover, some cards require you to pay the purchase balance before you can pay the cash advance balance so that the credit card company earns the higher interest rate for a longer period of time.

Grace period: A grace period, or period over which you do not pay interest on new purchases, normally lasts from 20 to 25 days. The grace period excludes cash advances and often doesn't apply if you carry over a balance from a previous month. If you do not owe a balance for the previous month, a grace period means that you could avoid paying for a purchase for nearly two months. However, you need to watch out because not all credit cards offer a grace period.

Credit card philosophy: Before you apply for open credit, you should determine your personal

credit card philosophy. What kind of credit card user will you be? There are three main types of credit card users: credit users, convenience users, and combined convenience and credit users. If you use your credit card to borrow money you don't have, you are a credit user. Credit cards are one of the most expensive ways to borrow. Credit users typically carry a balance from month to month. If you are a credit user (it is not a good idea to be one), look for a card with a low APR.

If you use your credit card only because it's convenient, you are a convenience user. Convenience users generally pay off their credit card balance each month. If you are a convenience user, look for credit cards that offer low annual fees, long interest-free grace periods, and free benefits.

Combined convenience and credit users need to balance the interest rate and the annual fee to obtain the lowest overall cost for the card. Find the card that best matches your needs.

Understand and Create Your Credit Plan

Open credit can be either good or bad, depending on how you use it. There are five keys to managing your open credit.

Managing Open Credit

1. Reduce Your Balance. If you have a balance, commit to reducing it each month. Do not take on any additional debt. You need to set a goal to reduce your balance and then just do it. Commit to remaining debt-free.

2. Protect Yourself against Fraud. You should save your credit card receipts. At the end of the month, compare your receipts to your statement. Once you have done this, you can destroy the receipts. Use caution when giving out your credit card number, especially over the phone. In addition to these precautions, be aware of where your cards are at all times. Never leave a store without your credit card.

If your credit cards are lost or stolen, there are a number of things you must do, and you must do them quickly. First, you should call your credit card company immediately. Make sure you have a photocopy all of your credit cards, front and back, and keep the toll-free numbers for your credit card companies handy so you can report any loss or theft. Put your credit card information in a safe place.

Second, you should immediately file a police report in the jurisdiction of the loss. This shows the credit card company that you are serious, that you are diligent, and that you are trying to find your credit card.

Third, you should call the three national credit-reporting organizations and the Social Security Administration to place a fraud alert on your name and social security number. The phone numbers for all four organizations are listed below:

Equifax:	888-766-0008
Experian:	888-397-3742
TransUnion:	800-680-7289
Social Security Administration fraud line:	800-269-0271

3. Be Aware of Signs of Trouble in Credit Card Spending. Consider the following questions:

- Do you make only the minimum payment each month?
- Have you reached your credit limit on any of your cards?
- When you dine with friends, do you pay the entire bill on your credit card and then have your friends reimburse you with cash?
- Do you wait for your monthly bill to determine how much you have charged?
- Do you get cash advances because you do not have enough in your checking account to pay bills or other expenses?
- Have you been turned down for credit or had a card canceled by a credit card company?
- Have you withdrawn money from savings to pay off credit card bills?
- Do you think it is too much trouble to figure out how much of your credit card bill is interest?
- Does your stomach start churning when you get your credit card bill?

If you answered "yes" to any of these questions, you may be having some trouble managing your credit card spending.

4. Control Your Spending. Part of controlling your spending is committing to always live on less than you earn. If you have problems doing that, do plastic surgery, i.e., cut up your credit cards. If nothing else works, use the envelope method of budgeting. The envelope method involves placing money for each budget category in an envelope. When the cash in the envelope for a particular budget category is gone, you have nothing more to spend in that category.

5. Opt Out. One final option is to "opt out." Do you want to stop receiving credit card applications in the mail? There is a national credit opt-out number you can call to take your name off the mailing lists of all four major credit-reporting agencies. Dial 1-888-567-8688 (1-888-5OPTOUT). You will be asked for your home telephone number, name, and social security number. You will then be sent a form to fill out and sign. After doing this, you will have much less junk mail. You can also opt out on the Internet by going to www.optoutprescreen.com. After you fill out the information on the site, you will be immediately removed from the mailing list for credit card applications for five years. Opting out is easy and painless and can also help eliminate some types of credit card and identity fraud.

Creating Your Credit Plan

How you use credit can have a major impact on how you accomplish your personal and family vision and goals. Not living on a budget, not understanding your needs versus wants, and buying on credit are significant constraints that have derailed many wonderful family visions and goals.

As such, it is important that you develop a Credit Plan for how you will manage credit. It need not be long, but it needs to be thought out. Following are a few ideas.

Vision

- From your " Plan for Life." Other ideas may include."
- We will have the necessary financial resources to be able to accomplish my personal mission and my individual and family vision and goals.
- We will use credit wisely in that we will not pay a dollar of interest for non-mortgage, non-student loan debt.

Goals

- We will watch our Credit Reports and Scores quarterly to ensure no major changes and no fraud.
- We will not go into debt except for those things specified by the prophets: a modest education and home, and perhaps a first car.
- We will use credit wisely and to our advantage, and will not pay interest.
- We will not buy cars on debt after the first car.
- We will pay off all credit cards monthly.
- We will not pay any credit card or auto interest.

Plans and Strategies –

Overall

- We will live on a budget and save 20% (or your amount) and save 15% for retirement.
- We will not buy anything with credit cards unless we have the money to pay it off at the end of the month.
- If we have spending problems, we will perform "plastic surgery" and cut up our credit cards.
- We will save for all auto and toy purchases, and will pay cash for all vehicles and toys.

Credit Cards

- We will maintain our Emergency Fund of 4 (your amount) month's income.
- We will use credit cards, but use them wisely and only for planned items in our budget.
- We will use debit cards carefully as the risk of loss is higher.
- We will pay cash for all our vehicles. We will save $300 each month (your amount) for new vehicles.

Credit Reports

- We will Opt Out of all mailing lists for credit cards.
- We will pull one credit report every four months to make sure there are no changes.
- We will check our Credit Report each time to make sure there are no mistakes or fraud.

Credit Scores

- We will Opt Out of all mailing lists for credit cards.

- We will keep our credit score above 760 so we can get the lowest rates for a mortgage and insurance.
- We will pull our free FICO Credit Score annually to make sure there are no major changes.
- We will watch our VantageScore monthly via the CreditKarma or CreditSesame app to ensure no major changes.

Constraints

- Our biggest hurdles to accomplishing this will be:
    - bot living on a budget and not saving money.
    - being impatient and not saving for our vehicles, toys, and other large purchases.
    - Losing the Spirit and not keeping an eternal perspective by having scripture study each day, FHE each week, and attending the temple regularly.
    - Not watching our spending on the little things so we can do the big things.

Accountability

- From your "Plan for Life." Other ideas may include:
    - I will share my vision, goals and plans with God each morning in prayers.
    - I will share these vision and goals with my spouse and kids so they can keep me accountable.

Summary

We have discussed credit evaluations, credit reports, and credit scores. Understanding how these matters impact you is critical, especially if you are looking to buy a house. Your credit score not only influences how much you will pay for a mortgage (or other types of credit) but it also influences your insurance costs.

We shared the key principles and doctrines of using credit wisely. As we follow the principles and understand the doctrines, it changes our perspective for the better.

There are appropriate uses for credit cards, and they can be useful in helping you attain your personal goals. Credit cards can be used for emergencies, reservations, convenience, cash flow, and free services.

There are several drawbacks to having credit cards. When you have credit cards, you are more likely to spend more, lose track of spending, pay higher interest rates and fees, and obligate future income. You need to be very careful if you use credit cards.

Before you apply for a credit card, consider the interest cost (or APR), compounding period, balance calculation method, costs for cash advances, and grace period. Depending on the reasons behind why you use credit cards, you are either a credit user, one who uses the card for borrowing; a convenience user, one who uses the card only for convenience; or both a credit and

a convenience user.

We shared how to manage your open credit and the importance of having a Credit Plan on how you will use credit during your life. Open credit can be either good or bad, depending on how you use it. The five keys to managing your open credit are

1. Reduce your balance.
2. Protect yourself against fraud.
3. Beware of trouble signs in credit card spending.
4. Control your spending.
5. Opt out.

Understanding credit and using it wisely, and having a Credit Plan are important parts of the modern financial world. We shared concrete ideas on how to put together your credit plan.

Assignments

Financial Plan Assignments

Your assignment is to put together your Credit Plan. I recommend you use PFP Credit Use Template (LT01-07). This will help you evaluate how you are doing in managing credit wisely. Since credit evaluation and credit scoring are important tools in the acquisition of a home and other important purchases, it is important that you understand where you stand.

Vision. What is your vision for Credit? Again, this need not be long.

Goals. What are your goals for using and managing credit wisely?

Plans and Strategies. For Credit Cards, answer the following for each credit card you have (bold items are required--see Chart 1: Credit Card Rates). If you have no credit cards, state that you have no credit cards and complete your action plan on views of future debt and perhaps your plan to obtain a credit card.

Credit Report. Get a copy of your credit report. If you are from the United States, you can, by law, obtain one free copy of your credit report each year from one of the major credit report suppliers (Experian, TransUnion, or Equifax). Go to www.annualcreditreport.com and supply the necessary information. You will select one of the major providers and input the necessary identification information, and the credit reporting agency will provide you a copy of your credit report online.

Once you have your credit report, read it thoroughly and ensure it is accurate. If there are problems, follow the process we discussed to improve your score and remove inaccuracies from your credit reports.

Credit Score. Finally, go and obtain your credit score. This score is used by many industries to determine the type of credit risk you are. While we prefer a FICO score, which is used by 85% of the industry, you are welcome to go to free locations, such as www.creditkarma.com review your credit score (they actually use VantageScore 3.0). it can give you an idea of how others see your credit usage. They generally will use either the TransUnion or Equity credit data to calculate your score.

Read through your credit score report in detail. Write down the things you can do to improve your credit score and work on them as part of your Plans and strategies. Under your Action Plan, what are the things you are going to do to improve your credit usage and to be better at wisely managing credit?

Finish by writing your constraints and accountability.

Chart 1: Credit Card Rates

Annual Percentage Rate for Purchases (fixed or variable)	%
Cash Advance APR (fixed or variable)	%
Balance Transfer APR (fixed or variable)	%
Overdraft Advance APR (fixed or variable)	%
Variable Rate Information (Index is _____)	
Purchase And Balance Transfer APR (Index + ___.__%)	%
Cash Advance APR (Index + ___.__%)	%
Default APR (Index + ___.__%)	%
Grace Period (in days)	
Method of Computing Balance for Purchase	
Annual Fee	
Minimum Finance Charge	
Transaction Fee for Balance Transfers	
Transaction Fee for Cash Advances	
Late Payment Fee	
Over-the-Credit-Limit Fee	
International Fee	
Credit Limit	
Date Opened (if available)	

Learning Tools

The following Learning Tools may be helpful as you prepare your Personal Financial Plan:

Credit Card Repayment Spreadsheet (LT18)

This Excel spreadsheet helps you determine how long it will take you to pay off a specific credit card or loan based on the balance owed, annual percentage rate,

compounding periods, and payments per month.

Debt Amortization and Prepayment Spreadsheet (LT09)
This Excel spreadsheet is a debt amortization and prepayment schedule to help you reduce and eliminate your debt.

Debt Elimination Schedule with Accelerator (LT20)
This spreadsheet allows you to input your different debts and interest rates. It then prioritizes that debt based on interest rates and creates a repayment plan based on the minimum payments due each month. You can choose pay highest interest rates first, consistent with Marvin J. Ashton's plan in the article "One for the Money," or smallest payoff first, consistent with Dave Ramsey. This spreadsheet also allows you to include an accelerator amount and an amount in addition to your normal monthly payments; you will be able to see how long it will take you to pay off your debt.

Review Materials

Review Questions

1. What is the difference between a credit evaluation and a credit report?
2. How can you obtain one free credit report per year from each of the three credit bureaus (Equifax, TransUnion, and Experian)?
3. What should you do if you find an error on your credit report?
4. What are the benefits of having and maintaining a high credit score?
5. What are the five most important factors in determining your credit score?

Case Studies

Case Study 1

Data

Steve and Adrianna Tanner recently graduated from college and started their first jobs. Based on their combined salary of $90,000, the bank pre-approved them for a home loan, and they found the perfect house. However, when they went in to finalize the loan, they were told they did not qualify for the loan because of their low credit scores.

Application

A. What didn't this couple do?
B. What should they have done?
C. What can they do to remedy the situation?

Case Study 1 Answers

A. Steve and Adrian Tanner did not determine their credit score before applying for a

loan. Do not leave things to chance! If you know your credit score, you may be able to get a lower rate for your loan.

B. They should have reviewed their credit reports and tried to resolve any problem areas before applying for a loan. They also should have gotten their credit score to see how they were perceived by the financial community.

C. They can get their annual credit report free from each of the three agencies we discussed, and they can pay to get their credit score. They should then work to improve their credit score so they can get the lowest rate possible for a loan.

Case Study 2

Data

Steve carried an average daily balance of $600 this month. His balance last month was $1,000, and he made a $900 payment on the 15th of this month.

Calculations

Calculate the monthly interest charges for credit card accounts that charge interest rates of 10 percent, 16 percent, 18 percent, and 24 percent.

Fill in the following chart:

	10%	16%	18%	24%
Average daily balance	$5.00	____	____	____

Application

Since the average daily balance is the most commonly used method of calculating balance, how important is it to get a low interest rate?

Case Study 2 Answers

Calculations

The formula for calculating your finance charge is your average daily balance multiplied by the interest rate divided by 12 months.

	10%	16%	18%	24%
Average daily balance	$5.00	$8.00	$9.00	$12.00

Application

If you use credit cards to finance spending (which is not recommended), it is important that you get a low interest rate on your card.

Case Study 3

Data

Bill was reading about the importance of keeping a high credit score and got his FICO score of 690. He heard a rumor that to improve his FICO score, he needed to reduce the number of cards in his name. Bill canceled three of his five credit/bank cards that he had not used in a long time. The next time he got his FICO score he discovered it had dropped by 40 points.

Analysis

A. List three possible reasons why his score may have dropped.

B. What should he have done to make sure the canceled cards helped, and not hurt, his score?

C. What might he do to improve his score?

Case Study 3 Answers

A. There are three possible reasons his score may have dropped:
   1. *History:* One of the cards he canceled had the longest history. His score may have dropped as his time with credit was lessened due to the dropped card.
   2. *Available credit:* Each of the canceled cards had a large amount of available credit. When these were canceled, they decreased his total available credit and increased his percentage usage each month, resulting in a lower score.
   3. *Mix:* Perhaps the cards canceled resulted in a mix of credit that was biased toward one type of card. This may have lowered his score.

B. He should have done the following to make sure his score did not drop:
   1. *History:* He should have made sure the cards he canceled did not have the longest credit history.
   2. *Limit:* Before dropping the cards, he should have gone to his existing credit/bank card companies and requested an increase in credit limit, at least to match the amount he had previously. If they would not increase the limit, he should have kept the old cards.
   3. *Mix:* Even though the cards may not have been used, if they had given a better mix, it may have been wise to keep them. He should have avoided having too many of the same types of cards.

C. The following are things he might do to improve his credit score:
   1. *Payment record:* Tighten his budget and save 20 percent of his income. Pay bills on time and don't miss!
   2. *Amount owed:* Use that 20 percent and any additional money to pay down debt (after he has started his emergency fund). This will reduce his amount owed and his usage of available balances.
   3. *Limits*: Call his credit card companies and request an increase in credit limits. This will help his use of available balances.
   4. *Credit history:* Ask his parents to include him on one of their credit cards (I am not sure I would do this).This will increase his credit history (this is called piggybacking, and it works only for families, not individuals).
   5. *Application history:* Do not apply for new cards. Generally, I recommend between two to four cards for most individuals. Do not get new cards just for store credit.
   6. *Credit mix:* Do not apply for too many of the same type of cards.

<u>Case Study 4</u>

Data

Bethany, a BYU student, was reading about the importance of having a high credit score. She went to www.annualreport.com but found she has no credit history. She pays her bills on time, has a checking account, and has a debit card.

Questions

A. Why might she not have a credit report?

B. What can she do to improve her credit history?

C. Does a debit card help build credit?
D. If banks will not allow her to get a credit card, what could she do?
E. How could she get a secured credit card?

Case Study 4 Answers

A. She may not have credit history because she has not had much credit. Even though she pays her bills on time, the bills may be in other students' names. She may also be an international student without a social security number.
B. She could try to get a credit card. This would be helpful to her in improving her credit history.
C. A debit card does not help build credit.
D. If she cannot get a credit card, she should (carefully) look into a secured credit card. If she can find one with low fees, she will put money into the card and can charge up to the amount of money on the card. Credit reporting agencies cannot tell the difference between a credit card and a secure credit card.

E. She should check with her bank or www.bankrate.com for a card that does not charge an application or insurance fee and that has a low annual fee

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[1] "Thou Shalt Not Covet," *Ensign*, Mar. 1990, 4
[2] http://myfico.com, 2 May 2012

7. Loans: Avoiding Consumer and Minimizing Student/Mortgage Loans

Introduction

For many years, inspired religious leaders have urged their followers to get out of debt and live within their means. Gordon B. Hinckley spoke directly to members of the Church of Jesus Christ of Latter-day Saints in the October 1998 conference when he said:

> I am suggesting that the time has come to get our houses in order. . . I am troubled by the huge consumer installment debt which hangs over the people of the nation, including our own people. I recognize that it may be necessary to borrow for a home, of course. But let us buy a home that we can afford and thus ease the payments which will constantly hang over our heads without mercy or respite for as long as 30 years. . . I urge you to look to the condition of your finances. I urge you to be modest in your expenditures; discipline yourselves in your purchases to avoid debt to the extent possible. Pay off debt as quickly as you can, and free yourselves from bondage.[1]

As Gordon B. Hinckley points out, excessive debt is one of the financial problems that many people struggle with today. This chapter aims to explain exactly what consumer debt is. This chapter also offers tips to help you better manage consumer debt throughout your life.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand consumer loans, principles, characteristics and costs.
B. Understand mortgage loan types, characteristics, and costs.
C. Understand the key relationships for borrowing.
D. Understand and create your Consumer Loans and Debt Plan.

Understand Consumer Loans, Principles, Characteristics and Costs

Consumer loans are loans you obtain to pay for items that are fairly expensive and that you usually don't need (at least not urgently). Such items include electronics, automobiles, furniture, and recreational vehicles. Consumer loans are very expensive and should rarely be used. They encourage you to buy now rather than to save for the future. Committing future earnings to today's consumption may keep you from achieving more important long-term personal goals. Consumer loans also reduce the amount of money you can save for your goals because they require you to pay interest with money you might otherwise have saved and invested. Most importantly,

loans are almost always unnecessary unless their purpose is to pay for an education or a home.

Dangers of Consumer Loans

When should you obtain a consumer loan? The following are a few questions to ask yourself if you are thinking of borrowing suing a consumer loan:

1. Do I really need to make this purchase? Is this a need or a want? Separate these two categories.

2. Is this item in your budget and/or your financial plan? Most items should be saved for, not borrowed for.

3. Can I pay for this item without borrowing? What is the after-tax cost of borrowing versus the after-tax cost of using savings and losing your return on those savings? Compare these two alternatives.

4. What is the total cost of this loan, including interest costs, fees, and its impact on your other goals? Can you maintain sufficient liquidity and still achieve your other goals? Choose wisely.

5. Will this purchase bring you closer to your personal goals or take you further away from them? If the purchase brings you closer to your goals, including your goal of obedience to God's commandments (including the commandment to get out of debt), make the purchase. If the purchase takes you further away from your goals, don't make it.

If you answer these questions honestly, it will be much easier to determine whether you should take out a consumer loan or not.

The principles of effective consumer loan use are the same as the principles of effective loan use:

1. Know yourself, your vision, goals, and plans. What is important to you, not just now, but in the future? What do you want to accomplish with your life? What is the vision of what you want you and your family to become? The key is to have the vision of your bigger "yes" in the future so you can say no to the current temptations to spend. "Where there is no vision, the people perish."[2]

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of debt and know where you are financially. This including your assets, liabilities, spending and income. If married, do not hide any liabilities or assets from each other. How much do you owe, and what are your assets? In

order to be able to get where you want to go, you must know where you are now. Have a realistic idea of your income, spending, debt and investment progress. Get on your budget and plan for the things you want to accomplish.

4. Resolve not to go into debt except for a modest home or education. Decide now the things you will do and what you will not do with debt? Make those decisions now, so you won't have to re-decide time after time. Strive to learn from your experiences, the experiences of your family, and others. Thankfully, we have the teachings of leaders and scriptures who have given us counsel. Resolve to not go into debt except for a modest home and modest education. Be wise in your expenditures.

5. Finally, pay as you go. You cannot spend yourself into financial security. Live within your means, and do not spend that which you do not have, and follow your goals and decisions.

If you are in debt add, let me add a few points which will be discussed in the next chapter.

6. Prioritize your debts. Which are the most important? If you cannot pay them all, give priority to secured debts for house or car. If the time comes that you cannot pay all your debts, determine which are most important, such as a roof over your head and food and transportation.

7. Develop a debt repayment plan. Automate it and follow it closely. A debt repayment plan is how you will pay back your debts. You must be able to continue to meet your current needs for yourself and your family, and have sufficient to repay the debt when it comes due.

8. Do not take on any new debt. Debt stops growth, both physically and spiritually. Do not add to your debt burden as you strive to pay off your debts.

9. Once out of debt, continue paying yourself. This will help to catch up with your savings.

Finding Balance

As you work on managing consumer loans, finding balance among doctrines, principles and application is important in helping you become better. Below are a few ideas.

Principles	Doctrines
Know yourself , your vision, goals and budget	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Know where you are financially	Accountability
Use debt only for a modest home and education	Agency
Live within your means and avoid debt	Stewardship

If you are in debt, add:

Develop a debt repayment plan	Stewardship
Do not take on any new debt	Accountability
Once out of debt, continue paying yourself	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with consumer loans, which is an application. Rather, from a higher perspective, or with increased vision,

> We are children of a King (identity), striving to live worthy of the Spirit (obedience), using our agency wisely (stewardship) as we follow the prophet and scriptures in deferring our wants (agency). We can wait to pay cash for specific consumer items (stewardship) so that we are wiser stewards over the things that we have been blessed with, so we have the resources to accomplish our personal missions and our individual and family vision and goals.

Explain the Characteristics and Costs of Consumer Loans

It is important to understand that different consumer loans have different characteristics—there isn't just one type of consumer loan. Some of the different types of loans, which we will compare and discuss in the following paragraphs, include single-payment and installment loans, secured and unsecured loans, variable-rate and fixed-rate loans, and convertible loans. The following is a list of these different types of consumer loans and their characteristics:

Single-payment loans. These are also known as balloon loans. Normally, these loans are used for short-term lending of one year or less. They may also be used to temporarily finance a purchase until permanent, long-term financing can be arranged; this is why these loans are sometimes called bridge loans or interim loans. This type of loan is repaid in one lump sum, including interest, at the end of the specified term—for example, at the end of one year.

Lending institutions calculate interest on a single-payment loan using the simple-interest method. With the simple-interest method, the principal and interest are due when the loan matures. Simple interest is equal to your average amount borrowed multiplied by your interest rate multiplied by the time (in years) that you hold the loan. Your average amount borrowed for a single payment loan is the same as your principal. If there are no fees, your APR and your simple interest rate are the same. The APR formula is:

APR = [(Interest payments + fees) / number of years] / Average amount borrowed

Suppose you take out a $1,000 loan for one year for 12 percent. Assume you pay fees of $20 for a credit check and $20 for a processing fee. Your interest rate is 12 percent. However, your APR = [($120 in interest + $40 in fees) / 1 year] / $1,000 (your average amount borrowed) = 16

percent. Notice how the imposition of fees raises your APR.

Now suppose this loan was for two years. Would your APR be different? The calculation would be:

APR = [($240 in interest + $40 in fees) / 2 years] / 1,000 = 14 percent. The APR is lower with a two-year loan because you are allocating that $40 in fees between two years instead of only one.

Installment loans. These are loans that are repaid at regular intervals—for example, every month. Each payment includes part of the principal and some interest. An installment loan amortizes over the length of the loan, which means that with each monthly payment you make, more of your payment goes toward paying off the principal and less goes toward paying for interest. The amount of interest you pay each month is calculated based on simple interest. Installment loans are typically used to finance purchases of houses, cars, appliances, and other expensive items.

Because of the complexity of this type of loan, it is best to calculate your payments using either a financial calculator or a spreadsheet program. The Credit Card Repayment Spreadsheet (LT18) can help you determine your payments and interest costs. With this spreadsheet you can also calculate how long it will take to pay off a specific credit card or loan based on the balance owed, annual percentage rate, compounding periods, and payments per month. The Debt Amortization and Prepayment Spreadsheet (LT09) can help you calculate how long it will take to pay off your debt as well.

For example, assume the same $1,000 loan as above, but instead of a single-payment, we will pay for it monthly. How do you calculate the APR for installment loans? The formula is the same. From your spreadsheet, I will build a simple loan amortization table from which you can calculate two different items: average amount borrowed and interest rate paid (see Table 1).

Secured loans. These loans use one of your assets, such as a home or a car, as collateral to guarantee that the lending institution will get the amount of the loan back, even if you fail to make payments. Examples of secured loans include home equity loans and car loans. Because these loans are backed by collateral, they usually have lower interest rates.

Unsecured or signature loans. These loans do not require collateral and are generally offered only to borrowers with excellent credit histories. Unsecured loans typically have higher interest rates, which may range between 12 and 26 percent—sometimes even higher.

Fixed-rate loans. These loans maintain the same interest rate for the duration of the loan. The majority of consumer loans are fixed-rate loans. Normally, lenders charge higher interest rates for fixed-rate loans than they do for variable-rate loans. This is because lenders can lose money if market interest rates increase, leaving the loan rate lower than the current market interest rate.

Variable-rate loans. These loans have an interest rate that is adjusted at different intervals over the life of the loan. There is usually a maximum interest rate, or cap, that can be charged on the

loan as well as a maximum amount that the interest rate can increase each year. The interest rates on these loans may change monthly, semiannually, or annually. The interest rate is adjusted based on an index, such as the prime rate or the six-month Treasury bill, as well as on an interest-rate spread. Lenders usually charge a lower interest rate up front for variable-rate loans because the lender will not lose money if the overall market interest rates increase.

Chart 1. Secured Versus Unsecured Loans

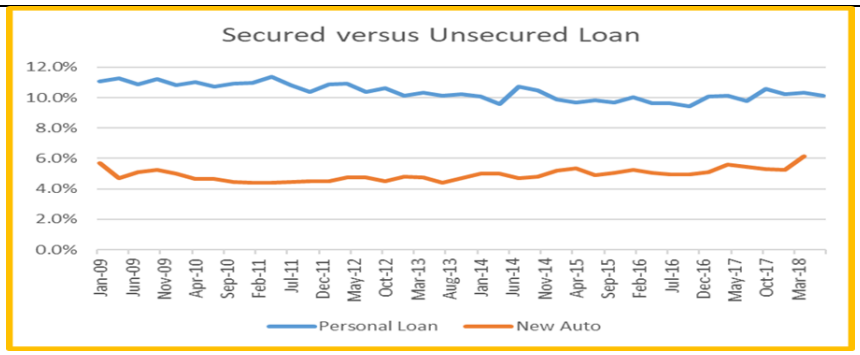

Table 1.Simple Interest Method

	Amount	**$**1,000	**Stated Interest**		12%
	P/Y	12	**PMT Using Excel Function**		
	Years	1	**Payment**	$88.85	
	Amount	**Payment**	**Interest**	**Principal**	**Remaining Principal**
1	$1,000.00	$88.85	10.00	$78.85	$921.15
2	$921.15	$88.85	9.21	$79.64	$841.51
3	$841.51	$88.85	8.42	$80.43	$761.08
4	$761.08	$88.85	7.61	$81.24	$679.84
5	$679.84	$88.85	6.80	$82.05	$597.79
6	$597.79	$88.85	5.98	$82.87	$514.92
7	$514.92	$88.85	5.15	$83.70	$431.22
8	$431.22	$88.85	4.31	$84.54	$346.68
9	$346.68	$88.85	3.47	$85.38	$261.30
10	$261.30	$88.85	2.61	$86.24	$175.07
11	$175.07	$88.85	1.75	$87.10	$87.97
12	$87.97	$88.85	0.88	$87.97	$0.00
Average =		**$551.55**	**Total Interest= $66.19**		**Actual APR = 12.0%**

The total paid is $66.19 interest and $40 in fees. This is divided by one year and then divided by $551.55, the average amount borrowed. This calculation gives us an APR of 19.3 percent.

Convertible loans. These are loans in which the interest-rate structure can change. For example, a convertible loan may start off having a variable interest rate and then switch to having a fixed interest rate at some predetermined time in the future; the opposite process may occur as well.

The Loan Contract

The loan contract is the most critical document of the loan process. It describes what the lender requires of you once you are granted the loan. Whenever you borrow, you put your future into someone else's hands; therefore, you need to know what you are doing. Read the entire contract and make sure you fully understand the details of the loan before you sign the loan agreement.

One of the most important things you should remember about loan contracts is that none of the clauses in the contract are in your favor. Let's talk about four clauses you should be aware of:

1. The insurance clause requires you to purchase life insurance that will pay off your loan in the event of your death. It benefits only the lender and increases the total cost of the loan. This clause is often used in mortgage loans.

2. The acceleration clause requires you to pay for the entire loan in full if you miss just one payment. This clause is often—but not always—disregarded if you make a good-faith effort to catch up on your missed payment, but it is still a risk.

3. The deficiency clause stipulates that if you do not pay back the loan, and the company takes your collateral, you must pay any amount in excess of the collateral's value; this clause takes effect if the money earned through the sale of your collateral does not satisfy the loan. You must also pay any charges incurred by the lender that are associated with the disposal of your collateral.

4. The recourse clause allows the lender to collect any outstanding balance via wage attachments and garnishments. This clause may also allow the lender to put liens on other properties you own (these properties can act as secondary collateral) should you fail to repay your loan.

Special Types of Consumer Loans

There are a number of special types of consumer loans that are different from traditional consumer loans. These include home equity loans, student loans, and automobile loans.

Home equity loans. These loans are also known as second mortgages. In a second mortgage, you use the equity in your house (i.e., the difference between what you paid for the house and what for the house is worth today) to secure your loan.

The benefits of a home equity loan are that you can usually borrow up to 80 percent of the equity in your home, and the interest payments may be tax-deductible. With this type of loan, you can also get a lower interest rate because the house is secure—it can't be moved. One disadvantage of this type of loan is that it limits your future financial flexibility because you can have only one outstanding home equity loan at a time. Moreover, a home equity loan puts your home at risk: if you default on a home equity loan, you can lose not only your high credit score but your home as

well.

Home equity lines of credit (HELOC). This line of credit is also a second mortgage that use the equity in your home to secure your loan. These are generally adjustable rate notes that have an interest-only payment, at least in the first few years of the note. These have lower rates of interest than other consumer loans.

The benefit of these loans is that the interest may be tax-deductible, reducing the cost of borrowing. The problem is that these loans will often keep people from making the hard financial choices to curb their spending. Why worry about spending when you can get a home equity loan or HELOC to pay off your credit cards each year? These loans also sacrifice future financial flexibility and put your home at risk if you default.

Chart 2. Home Equity and HELOC Loans

Current home equity interest rates

3-month trends	Home equity loan	30K HELOC
1/30/2019	5.91%	6.78%
1/23/2019	5.92%	6.73%
1/16/2019	5.89%	6.73%
1/9/2019	5.94%	6.73%
1/2/2019	5.88%	6.52%
12/19/2018	5.91%	6.26%
12/12/2018	5.92%	6.27%
12/5/2018	5.87%	6.28%
11/28/2018	5.91%	6.23%
11/21/2018	5.91%	6.21%
11/14/2018	5.92%	6.21%
11/6/2018	5.90%	6.23%
10/31/2018	5.96%	6.23%
10/24/2018	5.95%	6.20%

Student loans. Student loans have low, federally subsidized interest rates; these loans are often used to pay for higher education. Examples of federal student loans that are available to parents and students include federal-direct loans, plus-direct loans, Stafford loans, and Stafford-plus loans.

One benefit of federal student loans is that some have specific advantages, such as subsidized interest payments and lower interest rates. Also, you can defer payment of federal-direct loans and Stafford loans until six months after you graduate or discontinue full-time enrollment. The disadvantages of these loans are that there is a limit to how much you can borrow, and, like all debts, you must pay these loans back.

Automobile loans. These loans are secured by the automobile the loan is paying for. This type of loan usually has a term of two to six years.

The advantage of an automobile loan is that it usually charges a lower interest rate than an unsecured loan. The disadvantage is that you must make interest payments, and since vehicles depreciate quickly, you are often left with a vehicle that is worth less than what you owe on the loan.

Payday loans. These loans are scary. They are short-term loans of one or two weeks and are secured with a postdated check. The postdated check is held by the payday lender and cashed on the day specified. These loans charge very high interest rates—some payday loans charge more than 500 percent on an annual percentage rate basis (APR). I recommend you avoid using these loans completely.

Chart 3. Auto Loan

Current auto loan interest rates

Dates	60-month new car	48-month new car	36-month used car
1/30/2019	4.77%	4.71%	5.34%
1/23/2019	4.77%	4.71%	5.35%
1/16/2019	4.74%	4.69%	5.33%
1/9/2019	4.77%	4.71%	5.35%
1/2/2019	4.95%	4.90%	5.48%
12/19/2018	4.96%	4.90%	5.53%
12/12/2018	4.93%	4.86%	5.54%
12/5/2018	4.90%	4.84%	5.54%
11/28/2018	4.93%	4.87%	5.58%
11/21/2018	4.94%	4.88%	5.57%
11/14/2018	4.95%	4.89%	5.60%
11/6/2018	4.93%	4.87%	5.57%
10/31/2018	4.93%	4.87%	5.57%
10/24/2018	4.90%	4.83%	5.51%

The APR is equal to the simple interest paid over the life of the loan. The APR takes into account all costs for a year, including the interest rate, the cost of pulling credit reports, and all other fees; the total cost may be significant. To calculate the APR for any loan, multiply the amount of money paid in fees and interest by the number of periods in a year to get the annual cost of the loan; then divide the annual cost by the amount borrowed.

For example, suppose you paid $20 to borrow $100 for two weeks by writing a postdated check for $120. There are 26 two-week periods in a year. Thus the equation for finding your annual payment for this loan would be $20 * 26 = $520. In other words, you would pay $520 dollars in

interest for a $100 loan: Consider that $520/$100 results in 520 percent interest. That is very expensive cash! Do not use payday loans!

Chart 4. Consumer Loan Types 2019

Consumer Loan Comparisons 2019
MBA 620/Fin418/Fin200 Financial Planning (2/14/19)

	Type:		Security:		Rate Type:			Home Related:		Specialty:		
Loan:	**Single Payment**	**Installment**	**Secured**	**Unsecured**	**Fixed Rate**	**Variable Rate**	**Convertible**	**Home Equity**	**HELOC**	**Student**	**Auto**	**Payday**
Description:	Loan paid off in one payment. It may also be a balloon or other loan used to finance a purchase until more permanent financing is available.	Loans that are repaid at regular intervals, i.e., each month. Payment includes interest for the period plus some principal, which increases each period	Loans that are secured by a tangible asset, such as a car or boat, that will be sold if the loan is not repaid. Because it is secured by the asset, interest rates are less.	Loans that are not secured by any asset and are based on the credit worthiness of the borrower.	Loans that maintain a constant interest rate for the entire term of the loan.	Loans that have an interest rate that is tied to an index and that can change depending on market conditions and a spread.	Loans in which the interest rate structure can change, from a fixed or variable rate loan to the opposite.	Second mortgages which use the equity in your home to secure the loan. Borrowers use these for consumer purchases	Loans secured by the equity in a home for a specific amount and term. Generally used like a credit card with a revolving line of credit.	Loans by students to pay for higher education costs and may have Federally subsidized interest rates. **AVOID PRIVATE EDUCATION LOANS**	Loans secured by the vehicle the consumer is purchasing. Because it is secured, interest rates are lower.	Short-term loans of 1-2 weeks secured by a post-dated check, and the worst kind of borrowing. **AVOID THESE LOANS LIKE THE PLAGUE**
Annual Percentage Rate (APR):	5-20% depending on where you borrow, your income and your credit	4-20% depending on where you borrow, your income and your credit	4-12% depending on the secured asset, your income and credit	12-25+% depending on who you borrow from, your income, loan use and your credit	4-20% depending on where you borrow, use of the proceeds and your credit	4-20% depending on where you borrow, use of the proceeds and your credit	4-20% depending on where you borrow, use of the proceeds and your credit	3-6% depending on equity in the home, your income and the your credit	3-6% depending on equity in the home, your income and the your credit	6.8% for subsidized loans, and 10-24% for unsubsidized private loans depending on where you borrow	5-14% depending on the type of auto, who you borrow from, how long, and your income and credit	500-700% APR depending on your credit, income, where you borrow and for how long
Amount owed doubles every "x" Years (at highest rate):	Doubles every 3.5 years	Doubles every 3.5 years	Doubles every 6 years	Doubles every 3 years	Doubles every 3.5 years	Doubles every 3.5 years	Doubles every 3.5 years	Doubles every 12 years	Doubles every 12 years	At 6.8% doubles every 10 years, at 24%, every 3 years	Doubles every 7 years	Doubles every 1 month
Rate Type:	Variable or Fixed	Generally Fixed	Variable or Fixed, generally installment	Variable or Fixed, generally installment	Fixed Rate, can be either installment or single payment	Variable Rate, can be either installment or single payment	Variable or Fixed, generally installment	Variable or Fixed, generally installment	Variable or Fixed, generally installment	Fixed for subsidized and fixed or variable for unsubsidized, installment	Variable or Fixed, generally installment	Fixed, single payment
Cost Calculations:	[(Interest + fees)/years]/avg. borrowed	Amortization table	Amortization table	Amortization table	Can be either installment or single payment	Can be either installment or single payment	Can be either installment or single payment	Amortization table	Amortization table	Amortization table	Amortization table	[(Interest + fees)/years] / avg. borrowed

Understand the Types, Characteristics and Costs of Mortgage Loans

Mortgage loans are used to finance the purchase of a home or investment property. There are a number of different things you should consider when deciding how to finance a home. Your choice of loans should be based on four key concepts:

1. Your time horizon: How long do you expect to have the mortgage, and how certain are you of that time horizon?
2. Your preference (if any) for low required payments: How important are lower payments in the initial years of the loan?
3. Your tolerance for interest-rate risk: Are you willing to assume the interest-rate risk of the loan?

4. Your work status: Are you or have you been a member of the armed forces? If so, you may qualify for special mortgage programs.

Types of Mortgage Loans

There is basic terminology you must understand before we discuss mortgages.

Conventional loans. These loans are neither insured nor guaranteed. They are loans with amounts below the maximum amount set by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddy Mac) for a single family loan (see Table 2). Fannie Mae and Freddy Mac are the major purchasers of mortgages from the loan brokers or originators, so they set the standard as to the type of loans they will purchase. This maximum amount changes over time. Conventional loans require Private Mortgage Insurance (PMI) if the down payment is less than 20 percent. PMI guarantees payment to the lender should you fail to make payments. Borrowers can eliminate PMI by having equity greater than 20 percent.

Jumbo loans. Jumbo loans are loans in excess of the maximum eligible for purchase by the two Federal Agencies. Some lenders also use the term to refer to programs for even larger loans, such as loans in excess of $500,000.

Table 2. Conventional Loan Limits for Fannie Mae and Freddie Mac (Single Family)

Year	Loan Limits
2015	$417,000
2016	$417,000
2017	$424,100
2018	$424,100
2019	$484,350

Loan limits are 50 percent higher in Alaska, Guam, Hawaii, and the U.S. Virgin Islands.

Piggyback loans. These loans are two separate loans, one for 80 percent of the value of the home and one for 20 percent. The second loan has a higher interest rate due to its higher risk; it is used to eliminate the need for Private Mortgage Insurance, the cost of which can be substantial.

There are eight main types of mortgage loans available in the United States: fixed-rate mortgages (FRMs), variable- or adjustable-rate mortgages (ARMs), variable or fixed interest-only mortgages (IO), option adjustable-rate mortgages (Option ARMs), negative-amortization (NegAm), balloon mortgages, reverse mortgages, and special loans.

Fixed-rate mortgages (FRMs). FRMs have a fixed rate of interest for the life of the loan. These are the least risky types of mortgage from the borrower's point of view because the lender assumes the major interest-rate risk. For many years, this was the most common type of mortgage.

The benefits of fixed-rate mortgages include higher initial monthly payments (a greater percentage of each payment goes to pay down principal), no risk of negative amortization, and interest-rate risks that are transferred to the lender. The risks include higher interest rates (lenders must be compensated for increased interest-rate risk) and higher monthly payments that are more difficult to pay, particularly for those not on a regular salary.

Chart 5. Fixed Rate Loans

Today's Mortgage Interest Rate

3-month trend	30-year fixed rate	15-year fixed rate
1/30/2019	4.62%	3.96%
1/23/2019	4.62%	3.99%
1/16/2019	4.59%	3.98%
1/9/2019	4.63%	4.07%
1/2/2019	4.68%	4.11%
12/19/2018	4.75%	4.13%
12/12/2018	4.83%	4.21%
12/5/2018	4.90%	4.33%
11/28/2018	5.01%	4.40%
11/21/2018	5.01%	4.41%
11/14/2018	5.10%	4.47%
11/6/2018	5.10%	4.46%

Variable- or adjustable-rate mortgages (ARMs). ARMs have a rate of interest that is pegged to a specific interest-rate index that changes periodically. Generally, the initial interest rate is lower than that of a fixed-rate loan because the borrower assumes more of the interest-rate risk. However, due to the risk of rising future interest rates, ARMs may result in significantly higher interest rates in the future. ARMs may have a fixed rate for a certain period of time; after this period ends, the interest rate begins to adjust on a periodic basis.

The benefits of variable-rate loans include lower initial interest rates that vary with national interest rates, lower monthly payments (because of the lower interest rates), and no risk of negative amortization. The risks include a possible "payment shock" if interest rates rise, perhaps beyond what borrowers are able to pay, and somewhat higher monthly payments that may be difficult for those not on a regular salary.

Interest-only options on FRM or ARM loans. These loans are FRMs or ARMs with an option that allows the borrower to make interest-only payments for a certain number of years; payments are then reset to amortize the entire loan over the remaining duration of the loan. Some borrowers will take out an interest-only loan to free up principal to pay down other, more expensive debt. However, once the interest-only period has passed, the payment amount resets,

and the increase in payment can be substantial.

Chart 6. Adjustable Rate Mortgages (ARMs)

Bankrate Current Home Mortgage Rates

PRODUCT	INTEREST RATE
30-year fixed mortgage rate	4.41%
15-year fixed mortgage rate	3.72%
5/1 ARM mortgage rate	4.05%
7/1 ARM mortgage rate	4.15%
30-year fixed jumbo mortgage rate	4.44%
30 Year FHA mortgage rate	4.02%
10/1 ARM	4.42%
20-year fixed mortgage rate	4.31%
30-year VA mortgage rate	4.05%

Last update: 02/05/2019 at 6:30 AM

The benefits of fixed or variable interest-only loans include lower initial monthly payments and greater flexibility; these benefits may be helpful if the borrower could better use his or her money elsewhere. Because borrowers only pay interest costs (and not principal), they can afford higher loan amounts to buy more house, with the expectation that they may move before the payments increase. The risks of these kinds of loans include a substantial increase in monthly payments when the interest-only period ends and the fact that there is no amortization of principal during the initial interest-only period. For example, if a borrower takes out a fixed-rate interest-only mortgage with a 10-year interest-only option, the borrower pays interest for the first 10 years. In year 11, however, the borrower must pay substantially higher payments as the loan now must amortize over 20 years instead of the normal 30 years. The borrower must assume appreciation of the house to make money. The main risk of interest-only loans is that many borrowers do not have the discipline to invest savings from principal, so they spend it. In addition, there is the risk of borrowing too much money because of the lower initial payments.

Option adjustable-rate mortgages (option ARMs). Option ARMs have interest rates that adjust monthly and payments that adjust annually. There are “options” on the payment amount, one of which is a minimum payment option, which may be smaller than the interest-only payment. The minimum payment option often results in a growing loan balance (termed negative amortization). The lender specifies a specific maximum balance for the loan, i.e., 110 percent or 125 percent of its original value. Once this maximum is reached, payments are automatically increased. The loan becomes fully amortized after 5 or 10 years, regardless of the increase in the amount of principal and interest payments.

The benefits of option ARMs include lower initial monthly payments and greater flexibility; these benefits are especially appealing if borrowers have better use for their money elsewhere. Borrowers can afford more house, and they may move before the payments increase. The risks of

option ARMs include major "payment shock" when the negative amortization or option period ends and the payment is reset. There is the risk that the borrower will borrow too much money. There is also the risk that the minimum monthly payments will be insufficient to cover principal and interest costs, and the difference, called negative amortization, will be added to the loan principal. This type of loan should be avoided as it is highly risky for borrowers.

Negative-amortization mortgages (NegAms). NegAms are loans in which scheduled monthly payments are insufficient to amortize, or pay off, the loan. Interest expenses that have been incurred, but not paid, are added to the principal amount; this process increases the amount of the debt. Some NegAm loans have a maximum negative amortization that is allowed. Once that limit is reached, payments increase automatically to ensure that interest is sufficient to not exceed the limit.

A benefit of NegAm mortgages is that borrowers do not have to make full payments on the loans, and hence they conserve cash. The risk is that borrowers may find themselves at the negative-amortization limit, where payments are automatically reset to a level higher than the borrowers can afford.

Balloon mortgages. Balloons have scheduled interest and principal payments that will not result in the loan being paid in full at the end of the term. The final payment, or balloon, to pay off the loan can be very large. These loans are often used when the debtor expects to refinance the loan when it approaches maturity.

The benefit of balloon mortgages is that borrowers do not have to make full payments on the loans, and hence they conserve cash. The risk is that borrowers may get to the end of the payment period and not be able to come up with the required balloon payment.

Reverse mortgages. Reverse mortgages have proceeds that are made available against the homeowner's equity. In essence, a financial institution purchases the seller's home and allows the seller to stay in the home until he or she dies. Reverse mortgages are typically used by cash-poor but home-rich homeowners who need to access the equity in their homes to supplement their monthly income at retirement.

The benefit of these mortgages is that the homeowners have an increased income stream to use for retirement, and they can stay in their homes until they die. The disadvantage is that if death occurs soon after the loan is closed, the lender has purchased the house for a very low cost.

Special loans. These loans are insured or guaranteed. Insured loans are issued by others but insured by a United States federal agency. The Federal Housing Administration (FHA) does not originate any loans but insures the loans issued by others based on income and other qualifications. With an FHA loan, there is lower PMI (1.5 percent of the loan), but it is required for the entire life of the loan. While the required down payment is very low, the maximum amount that can be borrowed is also low.

Guaranteed Loans. Guaranteed loans are issued by others but guaranteed by a federal agency. The Veterans Administration (VA) guarantees loans issued by others. These loans are only for ex-servicemen and women as well as those on active duty. These loans may be for 100 percent of the home value.

Chart 7. FHA and VA Loans

30-year fixed jumbo mortgage rate	4.44%
30 Year FHA mortgage rate	4.02%
10/1 ARM	4.42%
20-year fixed mortgage rate	4.31%
30-year VA mortgage rate	4.05%

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Understand the Key Relationships to Reduce Borrowing Costs

If you have consumer loans, the key is keeping your costs low. The least expensive types of consumer loans are obtained from parents or family (generally), home equity lenders, and secured-loan lenders (including mortgage lenders).

More expensive consumer loans are obtained from credit unions, savings and loan institutions, and commercial banks.

The most expensive types of consumer loans are obtained from credit card companies, retail stores, finance companies, and payday lenders.

The key is to only purchase those things you really need and to pay as little for the privilege of borrowing as you can. Ideally, you should save your money first and then purchase what you need with cash.

Reducing Your Borrowing Costs

Listed below are four ways to reduce your borrowing costs:

1. **Understand the key relationships in borrowing.** The total interest cost of your loan is directly related to the interest rate and the maturity length. Keep the interest rate low and the maturity short. The amount of your periodic payment is inversely related to both the maturity and interest rate of your loan. Keep both low. Finally, some sources of lending are cheaper than others. Generally, parents are cheaper lenders than banks.

2. Understand the key clauses for consumer and mortgage loans. Remember, all clauses are in the lender's favor, and very few, if any, are in the borrower's favor. You are putting your future in someone else's hands when you borrow—you are committing future earnings to today's consumption. Use wisdom in your decisions and know what you are doing before you do it. Read documents very carefully and understand them before you sign them.

3. Know the steps to reducing consumer costs. First, if possible, don't get into debt in the first place. Remember what religious leaders have said about managing debt and staying out of debt. In emphasizing how burdensome debt can be, J. Reuben Clark Jr. said the following:

> Once in debt, interest is your companion every minute of the day and night; you cannot shun it or slip away from it; you cannot dismiss it; it yields neither to entreaties, demands, or orders; and whenever you get in its way or cross its course or fail to meet its demands, it crushes you. [3]

Second, remember your goals and budget. Remember that ignorance, carelessness, compulsiveness, pride, and necessity can be offset by wisdom, exactness, discipline, humility, and self-reliance. If you really need something, plan and save for it; don't borrow for it.

Third, compare the after-tax cost of borrowing with the after-tax cost of using savings and losing your return. It makes little sense to borrow at a high interest rate when you have savings earning a lower rate. Use the following formula:

> After-tax lost return = nominal interest rate * (1 – tax rate)
> Tax rate = federal, state, and local marginal tax rates

For example, assume you are looking to purchase a new television set. You have $500 in savings earning 4.0 percent or you can borrow $500 from the television store at an APR of 14.5 percent for two years. If you are in the 25-percent federal marginal tax rate and 7-percent state marginal tax rate, your after-tax lost return is 2.7 percent or .04 from your savings account *(1- (.25 + .07)). Clearly it would be better to take your savings and purchase the television set than to pay 14.5 percent interest.

Finally, maintain a strong credit rating. The more you do to increase your credit score, the more attractive you will be to potential lenders and the lower the interest rate you will have to pay on your loan.

4. Reduce the lender's risk. If you can reduce the risk of the loan to your lender, your lender may be able to offer you a lower interest rate. You can reduce the lender's risk in a number of ways:

- *Use a variable-rate loan.* If you choose to use a variable-rate loan, the lender is not penalized if market interest rates increase. Be aware that by choosing a variable-rate loan, you reduce the risk to the lender but increase the risk for yourself. While I prefer fixed-

rate mortgages, reducing the lender's risk may result in a lower rate (at least initially).

- *Keep the loan term as short as possible.* The shorter the term, the less time the lender is at risk.

- *Provide collateral for the loan.* If a lender has collateral for a loan, there is less risk for the lender because the collateral can be sold if you cannot pay back the loan as promised.

- *Put a large down payment on the item to be financed.* Lenders realize that the greater the amount of money you have already paid for an item, the less likely you are to walk away from your loan. Lending you money becomes less risky for lenders if you are willing to make a large down payment.

Understand and Create your Consumer Loan and Debt Plan

Following are a few ideas as you put together your Consumer Loans and Debt Plan. Be aware that we have yet to discuss some of these areas, so we will have more suggestions in specific areas later in the course.

Vision

- From your Plan for Life. Other ideas may include:
    - We will not pay any interest ever on consumer loans and non-mortgage or non-student loan debt.
    - We will defer our wants and always pay cash for our wants.
    - Debt will not be an option or a concern.

Goals

- We will always live on a budget and save 20%.
- We will shop around for best rates on necessary debt and avoid unnecessary debt like the plague.
- Consumer loans. We will never go into debt for consumer products, including autos.
- Student loans. We will only use subsidized Student loans and will repay them quickly.
- Mortgage loans. We will pay off our home by age 45, and we will not go into retirement with mortgage or other debt.

Plans and Strategies

Consumer Loans

- We will separate needs from wants.
- We pay cash for all consumer purchases.
- We will pay off all credit cards monthly.
- We avoid debt like the plague.
- We keep our emergency fund at 4 months and rebuild it quickly once it is drawn down.
- We defer all wants until we can pay cash for them.

- We may have to borrow for our first car, but after that, we will pay cash for all transportation needs.
- We will never buy toys with debt.

Student Loans

- We will spend loan money only on education.
- We will seek scholarships as much as possible.
- We defer all wants until we can pay cash for them and after we have paid off our student loans.
- We will not buy toys until our student loans are all paid off.
- We will understand our employment options to help pay off our student loan debt.
- We build our emergency fund to 3 months and then use the 20%+ to pay down non-subsidized and then subsidized loans.

Mortgage Loans

- We strive to have a 20% down payment to reduce the need for PMI.
- We ensure all housing payments are within the front- and back-end ratios recommended.
- We avoid debt like the plague.
- We keep our emergency fund at 4 months and rebuild it quickly when it is drawn down.
- We defer all wants until we can pay cash for them, except for student and mortgage loans.
- We will not borrow against the equity in our home.

Debt Reduction

- Once school is out, put enough in the company 401k for the match, then save 20% minimum to build our emergency fund.
- After that, I will use 20-30% to pay of debt as quickly as possible paying the highest interest rate first (LT20). Once debt is paid off, continue to pay 20% into savings.
- Continue to live like a student after college, build my emergency fund, then pay 30% each month against my debt using the debt snowball method until debt is all gone. I will then keep paying myself 20% into saving and investing.

Constraints

- Key is living on a budget and saving 20%.
- One half of all unexpected money (bonuses, tax refunds, etc.) will be put toward paying down principal (after our emergency fund).
- Do all required maintenance and plan on replacing key housing machinery as needed. We will also not skimp on required maintenance.
- Do most of the household work ourselves as a family, and will learn as we go, we will bring in experts in areas outside of our proficiency.
- We will stay strong in the gospel, keeping our covenants, attending the temple and serving.

Accountability

- We will share our vision and goals with our children.
- Children will have daily and weekly indoor jobs, as well as weekly yardwork.
- Home is where we teach our children to work. They will learn to use all landscaping and woodworking tools as we work together on our modest and model home.
- We will rotate the jobs weekly so all children will have the opportunities to work throughout the home and will become proficient on all tools.

Summary

Inspired religious leaders have urged their congregations to get out of debt and live within their means. We need to heed that counsel. In this chapter, we discussed the dangers of consumer loans and how these loans can keep you from achieving your goals. We also identified characteristics of specific types of consumer loans and learned how to calculate the costs of borrowing. Finally, we outlined the types of consumer loans according to their cost and discussed ways you can reduce the costs of borrowing.

Consumer loans pay for items that are fairly expensive; you usually don't need these items (at least not urgently). Such items include electronics, automobiles, furniture, and recreational vehicles.

Consumer loans are very expensive and should rarely be used. They encourage you to buy now rather than to save for the future, a practice that may keep you from achieving more important long-term personal goals. Consumer loans also require you to pay interest with money you might otherwise invest for your goals.

It is important for you to understand that different consumer loans have different characteristics. Know what you are getting into before committing to a loan.

Mortgage loans are used to finance the purchase of a home or investment property. Your choice of mortgage loans should be based on three key factors: time horizon and how certain are you of that time horizon, preferences (if any) for required payments, and tolerance for interest-rate risk.

There are four main ways to reduce your borrowing costs:

1. Understand the key relationships in borrowing.
2. Understand the key clauses for consumer loans and mortgage loans.
3. Know the steps to reduce borrowing costs.
4. Reduce the lender's risk.

Assignments

Financial Plan Assignments

Your assignment is to put together your Consumer Loan and Debt Plan. I recommend you use the PFP Loans Template (LT01-08) as a starting point. Think through the purpose of any consumer, student and other loans you may have. Are they necessary? Could you have gotten by without them? What is your view on loans and debt?

Develop your vision and goals for loans and debt? It need not be long.

Begin working on your plans and strategies as part of your action plan. Start with where you are. If you have consumer loans outstanding, write down the costs of those loans in terms of interest rates, fees, grace period, balance calculation method, and any other fees or expenses.

If you are in debt, what can you do to pay off these loans quickly and get back on the path to debt elimination? Resolve now not to get into debt except for a home or education. What is your debt reduction strategy? How long will it take for you to get out of debt (I recommend you use Debt Elimination Schedule with Accelerator (LT20) as a possible tool). Most importantly, what are your views and goals on future debt?

Learning Tools

The following Learning Tools may be helpful as you prepare your Personal Financial Plan:

Credit Card Repayment Spreadsheet (LT18)
: This Excel spreadsheet helps you determine how long it will take you to pay off a specific credit card or loan based on the balance owed, annual percentage rate, compounding periods, and payments per month.

Debt Amortization and Prepayment Spreadsheet (LT09)
: This Excel spreadsheet is a debt amortization and prepayment schedule to help you reduce and eliminate your debt.

Debt Elimination Schedule with Accelerator (LT20)
: This spreadsheet allows you to input your different debts and interest rates. It then prioritizes that debt based on interest rates and creates a repayment plan based on the minimum payments due each month. This repayment plan is consistent with Marvin J. Ashton's plan in the article "One for the Money." This spreadsheet also allows you to include an accelerator amount and an amount in addition to your normal monthly payments; you will be able to see how long it will take you to pay

off your debt.

Review Materials

Terminology Review

Auto Loans. Auto loans are consumer loans that are secured with an automobile. Because they are secured, they have a lower interest rate than an unsecured loan or credit card. They normally have a maturity length of 2 to 6 years. The risk is that you will often be left with a vehicle that is worth less than what you owe on it.

Balloon Loans. These are loans which payments including interest and principle are not sufficient to pay off the loan at the end of the loan period, but require a large "balloon" payment at some point in the future to fully pay off. This type of loan is not recommended.

Consumer Loans. Consumer loans are loans you obtain to pay for items that are fairly expensive and that you usually don't need (at least not urgently). Such items include electronics, automobiles, furniture, and recreational vehicles. Consumer loans are very expensive and should rarely be used. They encourage you to buy now rather than to save for the future. Consumer loans also reduce the amount of money you can save for your goals because they require you to pay interest with money you might otherwise have saved and invested.

Convertible Loans. These loans begin as a variable-rate loan and can be locked into a fixed-rate loan at the then current interest rate at some predetermined time in the future (for a specific cost).

Fixed-rate Loans. Have the same interest rate for the duration of the loan. Normally have a higher initial interest rate as the lender could lose money if overall interest rates increase. The lender assumes the interest rate risk, so they generally add an interest premium to a variable rate loan

Home Equity Lines of Credit (HELOC). Home equity lines of credit are basically second mortgages which use the equity in your home to secure your loan. These are generally adjustable rate notes that have an interest only payment, at least in the first few years of the note. Interest rates are variable and are generally interest only in the first few years. They have lower rates of interest than other consumer loans.

Home Equity Loans. Home equity loans are basically second mortgages which use the equity in your home to secure your loan. Normally can borrow up to 80% of your equity in your home

Installment Loans. Installment loans are loans which are repaid at regular intervals and where payment includes both principal and interest. These are normally used to finance houses, cars, appliances, and other expensive items. These loans are amortized, which is the process of the payment going more toward principal and less toward interest each subsequent month. These may be secured or unsecured loans, variable-rate or fixed-rate loans.

Payday Loans. These are short-term loans of 1-2 weeks secured with a post-dated check which is "held" by the lender and then cashed later. These have very high interest rates

and fees, APR > 720%. Typical users are those with jobs and checking accounts but who have been unable to manage their finances effectively.

Secured Loans. Secured loans are guaranteed by a specific asset, i.e. a home or a car, and typically have lower interest rates.

Single Payment (or balloon) Loans. These are loans that are repaid in only one payment, including interest. These are generally short-term lending of one year or less, sometimes called bridge or interim loans, often used until permanent financing can be arranged. These may be secured or unsecured.

Student Loans. These are loans with low, federally subsidized interest rates used for higher education. Examples include Federal Direct (S) and PLUS Direct (P) available through the school; Stafford (S) and PLUS loans (P) available through lenders. Some are tax-advantaged and have lower than market rates. Payment on Federal Direct and Stafford loans deferred for 6 months after graduation.

Unsecured Loans. Unsecured loans require no collateral, are generally offered to only borrowers with excellent credit histories, and have higher rates of interest – 12% to 28% (and higher) annually.

Variable-rate Loans. Have an interest rate that is tied to a specific index (e.g., prime rate, 6-month Treasury bill rate) plus some margin or spread, i.e. 5%). Can adjust on different intervals such as monthly, semi-annually, or annually, with a lifetime adjustment cap. Normally have a lower initial interest rate because the borrower assumes the interest rate risk and the lender won't lose money if overall interest rates increase

Mortgage Terminology

Balloon Mortgages. These are mortgage loans whose interest and principal payment won't result in the loan being paid in full at the end of the term. The final payment, or balloon, can be significantly large. These loans are often used when the debtor expects to refinance the loan closer to maturity.

Conventional loans. These are loans that are neither insured or guaranteed. They are below the maximum amount set by Fannie Mae and Freddy Mac. They require Private Mortgage Insurance (PMI) if the down payment is less than 20%.

FHA Loans. These are Federal Housing Administration (FHA) Insured Loans. The FHA does not originate any loans, but insures the loans issued by others based on income and other qualifications. There is lower PMI insurance, but it is required for the entire life of the loan (1.5% of the loan). While the required down payment is very low, the maximum amount that can be borrowed is also low.

Fixed rate mortgages (FRMs). These are mortgage loans with a fixed rate of interest for the life of the loan. These are the least risky from the borrower's point of view, as the lender assumes the major interest rate risk above the loan rate. These are the most-recommended option for new home buyers.

Interest Only Option Loans. These are FRMs or ARMs with an option that allows interest only payments for a certain number of years, and then payments are reset to amortize the entire loan over the remaining years. Some will take out an interest only loan to free up principal to pay down other more expensive debt. Once the interest-only period has passed, the payment amount resets, and the increase in payment can be

substantial. These are generally not recommended.

Jumbo Loans. These are loans in excess of the conventional loan limits and the maximum eligible for purchase by the two Federal Agencies, Fannie Mae and Freddy Mac, of $424,000 in 2018 (some areas have higher amounts). Some lenders also use the term to refer to programs for even larger loans, e.g., loans in excess of $500,000.

Negative Amortization Mortgages (NegAm). These are mortgage loans in which scheduled monthly payments are insufficient to amortize, or pay off the loan. Interest expense that has been incurred, but not paid is added to the principal amount, which increases the amount of the debt. Some NegAm loans have a maximum negative amortization that is allowed. Once that limit is hit, rates adjust to make sure interest is sufficient to not exceed the maximum limit.

Option Adjustable Rate Mortgages (Option ARMs). This is an ARM where interest rate adjusts monthly, and payments annually, with "options" on the payment amount, and a minimum payment which may be less than the interest-only payment. The minimum payment option often results in a growing loan balance, termed negative amortization, which has a specific maximum for the loan. Once this maximum is reached, payments are automatically increased and the loan becomes fully amortizing after 5 or 10 years, regardless of increase in payment and must be repaid within the 30 year limit. These are not recommended.

Piggyback Loans. These are two separate loans, one for 80% of the value of the home and one for 20%. The second loan has a higher interest rate due to its higher risk. The second loan is used to eliminate the need for PM Insurance. With a piggyback loan, PMI is not needed, but these are much harder to get now.

Reverse Mortgages. These are mortgage loans whose proceeds are made available against the homeowner's equity. Financial institutions in essence purchase the home and allow the seller the option to stay in the home until they die. Once they die, the home is sold and the loan repaid, generally with the proceeds. These are typically used by cash-poor but home-rich homeowners who need to access the equity in their homes to supplement their monthly income at retirement.

VA Loans. These are Veterans Administration (VA) Guaranteed Loans. These loans are issued by others and guaranteed by the Veterans Administration. They are only for ex-servicemen and women as well as those on active duty. Loans may be for 100% of the home value.

Variable or Adjustable Rate Mortgages (ARMs). These are mortgage loans with a rate of interest that is pegged to a specific index that changes periodically, plus a margin that is set for the life of the loan. Generally the interest rate is lower compared to a fixed rate loan, as the borrower assumes more of the interest rate risk. The may have a fixed rate for a certain period of time, then afterwards adjust on a periodic basis.

Review Questions

1. What are seven different types of consumer loans?
2. What is the most critical document of the loan process? Why?

3. What are the three concepts that should be considered before obtaining a home mortgage?
4. What are the benefits of getting a fixed-rate mortgage? A variable-rate mortgage?

Case Studies

Case Study 1

Data

Matt is offered a $1,000 single-payment loan for one year at an interest rate of 12 percent. He determines there is a mandatory $20 loan-processing fee, $20 credit check fee, and $60 insurance fee. The calculation for determining your APR is (annual interest + fees) / average amount borrowed.

Calculations

A. What is Matt's APR for the one-year loan, assuming principal and interest are paid at maturity?

B. What is Matt's APR if this was a two-year loan with principal and interest paid only at maturity?

Case Study 1 Answers

Matt's interest cost is calculated as principal * interest rate * time.

A. The APR for the one-year loan is:

Interest = $1,000 * 0.12 * 1 year = $120

Fees are $20 + $20 + $60 = $100

His APR is (120 + 100) / 1,000 = 22.0%

B. The APR for the two-year loan is:

Interest = $1,000 * 0.12 * 2 years = $240

Fees are $20 + $20 + $60 = $100

His APR is

[(240 + 100) / 2] / 1,000 = 17.0%.

Since this is a single-payment loan, the average amount borrowed is the same over both years. Note that Matt's APR is significantly higher than his stated interest rate because of the fees charged. He should be very careful of taking out this loan.

Case Study 2

Data

Matt has another option with the same $1,000 loan at 12 percent for two years. But now he wants to pay it back over 24 months and he has no other fees.

Calculations

Using the simple interest and monthly payments, calculate:

A. The monthly payments

B. The total interest paid

C. The APR of this loan

Note: The simple-interest method for installment loans is simply using your calculator's loan

amortization function.

Case Study 2 Answers

A. To solve for simple interest monthly payments, set your calculator to monthly payments, end mode:

PV = -1,000, I = 12%, P/Y = 12, N = 24, PMT=?

PMT = $47.074

B. Total interest paid = 47.074 x 24 – 1,000 = ?

$129.76

To calculate the APR, it is [(interest + fees) / 2] / average amount borrowed (which changes each year as you pay it down in an amortized or installment loan). The average amount borrowed of $540.68, which is the average of the monthly principle outstanding (see Table 3). The APR is calculated as ($129.76 / 2 years) / $540.68 = 12%.

<u>Case Study 3</u>

Data

You are looking to finance a used car for $9,000 for three years at 12 percent interest.

Calculations

A. What are your monthly payments?

B. How much will you pay in interest over the life of the loan?

C. What percent of the value of the car did you pay in interes

Case Study 3 Answers

A. To solve for your monthly payments, set PV equal to -9,000, I equal to 12, N equal to 36, and solve for PMT.

Your payment is $298.93 per month.

B. To get your total interest paid, multiply your payment by 36 months. $298.92 * 36 = $10,761.44 – 9,000 = ?

$1,761.44

C. To determine what percent of the car you paid in interest, divide interest by the car's cost of $9,000 = $1,761.44 / 9,000 = 19.56%

You paid nearly 1/5 the value of the car in interest. Why not save next time and buy a nicer car (or save some of that money)?

Table 3. APR Calculation

Calculated rate using Excel "Rate" Function:				12.000%
Amount	1,000	**Stated Interest**	12%	
P/Y	12	**Payment**	$47.07	
Years	2	PMT = from loan calculator		
Amount Received:		1,000		**Remaining**
Amount	**Payment**	**Interest**	**Principle**	**Principle**
1,000.00	$47.07	10.00	$37.07	$962.93
$962.93	$47.07	9.63	$37.44	$925.48
$925.48	$47.07	9.25	$37.82	$887.66
$887.66	$47.07	8.88	$38.20	$849.47
$849.47	$47.07	8.49	$38.58	$810.89
$810.89	$47.07	8.11	$38.96	$771.92
$771.92	$47.07	7.72	$39.35	$732.57
$732.57	$47.07	7.33	$39.75	$692.82
$692.82	$47.07	6.93	$40.15	$652.68
$652.68	$47.07	6.53	$40.55	$612.13
$612.13	$47.07	6.12	$40.95	$571.18
$571.18	$47.07	5.71	$41.36	$529.82
$529.82	$47.07	5.30	$41.78	$488.04
$488.04	$47.07	4.88	$42.19	$445.85
$445.85	$47.07	4.46	$42.62	$403.23
$403.23	$47.07	4.03	$43.04	$360.19
$360.19	$47.07	3.60	$43.47	$316.72
$316.72	$47.07	3.17	$43.91	$272.81
$272.81	$47.07	2.73	$44.35	$228.47
$228.47	$47.07	2.28	$44.79	$183.68
$183.68	$47.07	1.84	$45.24	$138.44
$138.44	$47.07	1.38	$45.69	$92.75
$92.75	$47.07	0.93	$46.15	$46.61
$46.61	$47.07	0.47	$46.61	$0.00
$540.68	**Total Int.=**	**129.76**	**Actual APR =**	**12.0%**

Case Study 4

Data

Bill is short on cash for a date this weekend. He found he can give a postdated check to a payday lender who will give him $100 now for a $125 check that the lender can cash in two weeks. The APR equals the total fees divided by the annual amount borrowed. The effective annual rate = $[(1 + \text{APR} / \text{periods})^{\text{periods}}] - 1$.

Calculations

A. What is the APR?

B. What is the effective annual interest rate?

Application

C. Should he take out the loan?

Case Study 4 Answers

A. The APR is the amount paid on an annual basis divided by the average amount you borrow.

APR = ($25 * 26 two-week periods) / $100 = $650 / $100 = 650%

B. To solve for your effective annual interest rate, put it into the equation for determining the impact of compounding.

The effective annual interest rate is

(1 + [6.5 / 26 periods])^26 periods – 1 = 32,987%

This is a very expensive loan.

D. No. It is just too expensive.

Case Study 5

Data

Wayne is concerned about his variable-rate mortgage. Assuming a period of rapidly

rising interest rates, how much could his rate increase over the next four years if he had a 6-percent variable-rate mortgage with a 2-percent annual cap (that he hits each year) and a 6-percent lifetime cap?

Application

How would this affect his monthly payments?

Case Study 5 Answers

Assuming rates increased by the maximum 2 percent each year, at the end of the four years it could have reached its cap of 6 percent, giving a 12 percent rate. Nearly doubling the interest rate would significantly increase Wayne's monthly payment.

Case Study 6

Data

Anne is looking at the mortgage cost of a traditional 6.0 percent 30-year amortizing loan versus a 7.0 percent 30-year/10-year interest-only home mortgage of $300,000.

Calculations

A. What are Anne's monthly payments for each loan for the first 10 years?

B. What is the new monthly payment beginning in year 11 after the interest-only period ends?

Application

C. How much did Anne's monthly payment rise in year 11 in percentage terms?

Case Study 6 Answers

A. Anne's monthly payments are

Traditional: The amortizing loan payment is:

PV = -300,000, I = 6.0%, P/Y = 12, N = 360, PMT = ?

PMT = $1,798.65

Interest-only: The payment would be $300,000 * 7.0% / 12 = $1,750.00

B. After the 10-year interest-only period, her new payment would be (she would have to amortize the 30-year loan over 20 years):

PV = -300,000, I = 7.0%, P/Y = 12, N = 240, PMT = ?

PMT = $2,325.89

C. The new payment is a 33% increase over the interest-only period in year 10.

Case Study 7

Data

Jon took out a $300,000 30-year Option ARM mortgage for purchasing his home, which had a 7 percent mortgage. Each month he could make a minimum payment of $1,317 (which did not even cover the interest payment), an interest-only payment of $1,750, a payment of $1,996 that included both principal and interest, or an additional amount. The loan had a negative-amortization maximum of 125 percent of the value of the loan. Jon was not very financially savvy, and for the first 10 years made the minimum payment only. As a result, at the end of year 10, he was notified that he had hit the negative-

amortization maximum and that his loan had reset.

Calculations

A. What is Jon's new monthly payment beginning in year 11 after he hit the negative amortization limit?

B. How much did Jon's monthly payment rise over the minimum payment he was paying previously?

Case Study 7 Answers

A. After the negative-amortization limit is hit, he must now amortize the loan over 20 years instead of 30. His new loan amount is not $300,000, but $375,000 (300,000 * 125 percent) due to the fact he did not pay enough to even cover interest payments:
PV = -375,000, I = 7.0%, P/Y = 12, N = 240, PMT = ?
PMT = $2,907.37

B. His minimum payment was $1,317, and his new payment is $2,907.
It is a 121-percent increase over the minimum payment period.

Notes

Other good sources of information on mortgages are available at:
www.mtgprofessor.com
www.bankrate.com

[1] *Ensign*, Nov. 1998, 52–54
[2] Proverbs 29:18.
[3] J. Reuben Clark Jr., *Improvement Era*, Jun. 1938, 328

8. Debt: Avoiding Debt Like the Plague

Introduction

Attitudes toward debt have fluctuated dramatically over the last 50 years. Many who lived through the 1930s vowed never to go into debt again. Yet gradually people grew to see debt as a tool to obtain what they wanted now. In the late nineties in particular, the stock market's upward trend encouraged consumers to acquire significant additional debt. Then, when the economy faltered, people realized once again we live in a time of great economic uncertainty. The decline in the stock market and the slowing economy during those years led to a major increase in bankruptcies throughout the United States.

Advertising has been instrumental in promoting the view of debt as a tool, "Get what you want," the advertisements say. "Get it now, and pay only $80 a month!" "Buy a car with zero down and make no payments for the next 12 months!" Get what you want now and pay it off over the next 15 years. Someone said "we borrow money we don't have, to buy things we don't need, to impress people who don't care."[1] Will Rogers summarized the current condition of our nation by saying, "We'll show the world we are prosperous, even if we have to go broke to do it."[2]

People comment on how difficult it is to pay back loans. What they don't realize is for every dollar borrowed, they must earn more than a dollar to pay it back. We are not consistent in our thinking. With debt, we are borrowing an after-tax amount. However, to pay it back, we must earn a before-tax amount. That difference can be significant depending on your taxes, contributions and savings.

Objectives

Once you have completed this chapter, you should be able to do the following:

A. Understand our leader's counsel on debt.
B. Understand the principles of using debt wisely.
C. Understand how to develop and use debt-reduction strategies.
D. Understand plans and strategies for debt reduction.

Understand our Leader's Counsel on Debt

We have been counseled for 6,000 years to "Pay thy debt and live."[3] Debt is a form of bondage, limiting both temporal and spiritual freedom. J. Reuben Clark reminded us:

> It is a rule of our financial and economic life in all the world that interest is to be paid on borrowed money. . . Interest never sleeps nor sickens nor dies; it never goes to the

> hospital; . . it never visits nor travels; it is never laid off work; it never works on reduced hours; it never pays taxes; it buys no food, it wears no clothes. . . Once in debt, interest is your constant companion every minute of the day and night; you cannot shun it or slip away from it; you cannot dismiss it;. . .and whenever you get in its way or cross its course or fail to meet its demands it crushes you. So much for the interest we pay. Whoever borrows should understand what interest is, it is with them every minute of the day and night.[4]

To help people avoid this bondage, Joseph F. Smith advised, "Get out of debt and keep out of debt, and then you will be financially as well as spiritually free."[5]

More recently, James E. Faust stated: "Over the years the wise counsel of our leaders has been to avoid debt except for the purchase of a home or to pay for an education. I have not heard any of the prophets change this counsel."[6]

Some might argue that their financial situation has nothing to do with their spirituality. Marion G. Romney pointed out that self-reliance is essential for spiritual growth to continue. He said:

> Independence and self-reliance are critical keys to our spiritual growth. Whenever we get into a situation which threatens our self-reliance, we will find our freedom threatened as well. If we increase our dependence, we will find an immediate decrease in our freedom to act.[7]

When we are in debt, our freedom to act and our ability to grow spiritually are reduced. Staying out of debt is not just a temporal commandment, as some suppose; it is also a spiritual commandment as well.

Debt is necessary at times when people may need to borrow for some goals that might otherwise be impossible to achieve. Such goals may include gaining an education and purchasing a modest home. Purchasing a second car or a new wardrobe on credit, however, may not be appropriate. Gordon B. Hinckley counseled, "Reasonable debt for the purchase of an affordable home and perhaps for a few other necessary things is acceptable. But from where I sit, I see in a very vivid way the terrible tragedies of many who have unwisely borrowed for things they really do not need."[8]

When going into debt for a home or an education, you should use prayer and wisdom to make good decisions about the amount of money you borrow and the type of loans you take out. If you do go into debt, you should pay your debt off as soon as you can.

Another type of debt that may be necessary is business debt. While we will not cover this in detail, we include some cautions from N. Eldon Tanner regarding business debt:

> Investment debt should be fully secured so as to not encumber a family's security. Don't invest in speculative ventures. The spirit of speculation can become intoxicating. Many

> fortunes have been wiped out by the uncontrolled appetite to accumulate more and more. Let us learn from the sorrow of the past and avoid enslaving our time, energy, and general health to a gluttonous appetite to acquire increased material goods.[9]

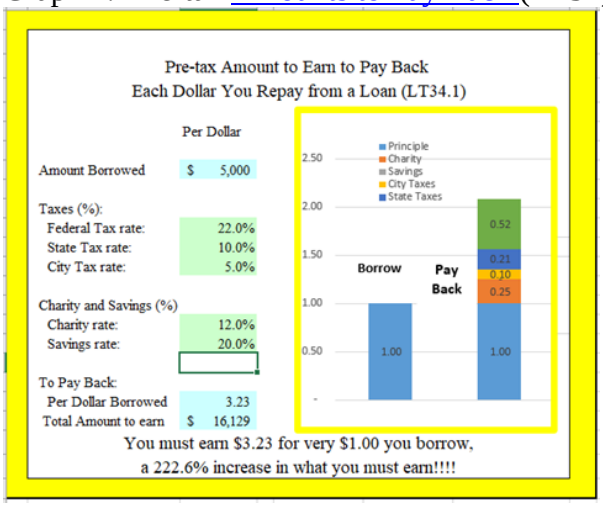
It may be acceptable to incur debt to undertake a business endeavor if (1) the debt does not jeopardize the personal or family finances of the business owners or managers, (2) the debt is used for a valid business purpose or investment opportunity, (3) speculative ventures and consumption under the guise of investment should be avoided. Using debt to finance a speculative venture magnifies the risk of the investment. And (4) business debt must be incurred with full commitment to repay the money. Failure to repay any debt—including business debt—is a form of dishonesty. Keeping these principles in mind will help us determine when debt may or may not be appropriate for a business investment.

Why is Repaying Debt So Hard

Most in debt find it difficult to pay it back. That is because when we borrow money, we are borrowing an after-tax amount, and to pay the debt back, we must earn a before-tax amount. The difference is significant.

For example, let's say you borrowed $1. In order to pay that dollar back, you must not just earn $1, but you must earn enough to pay your taxes, charitable contributions, and any savings you plan. Assuming your federal tax rate was 22%, your state tax of 5%, a city tax of 5%, charity of 12% and you are saving 20%, you would need to earn $3.23 for every dollar you will pay back, and this does not include interest (see Graph 1). For a tool to help you calculate how much you will need to earn, see Amounts to Pay Back (LT34).

Graph 1. Pre-tax Amounts to Pay Back (LT34)



For a $5,000 loan, you must earn $16,129 before tax to pay off the $5,000 debt assuming the percentages above. Borrowing is not cheap.

Understand the Principles of Using Debt Wisely

There are a few important principles of effective loan use. These include:

1. Know yourself. This includes your vision, goals and plans. What is important to you, not just now, but in the future? What do you want to accomplish with your life? What is the vision of what you want you and your family to become? The key is to have the vision of your bigger "yes" in the future so you can say no to the current temptations to spend. "Where there is no vision, the people perish."[10]

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of debt, and know where you are in your spending and your income. If married, do not hide any liabilities or assets from each other. How much do you owe, and what are your assets? In order to be able to get where you want to go, you must know where you are now. Have a realistic idea of your income, spending, debt and investment progress. Get on your budget and plan for the things you want to accomplish.

4. Set your priorities. Decide now the things you will do and what you will not do? Make those decisions now, so you won't have to re-decide time after time. Strive to learn from your experiences, the experiences of your family, and others. Thankfully, we have the teachings of leaders and scriptures who have given us counsel. Resolve to not go into debt except for a modest home and modest education. Be wise in your expenditures.

5. Finally, pay as you go. You cannot spend yourself into financial security. Live within your means, and do not spend that which you do not have, and follow your goals and decisions.

If you are in debt add, let me add a few points which will be discussed in the next chapter.

6. Prioritize your debts. Which are the most important? Give priority to secured debts for house or car. If the time comes that you cannot pay all your debts, determine which are most important, such as a roof over your head and food and transportation.

7. Develop a debt repayment plan. Automate it and follow it closely. A debt repayment plan is how you will pay back your debts. You must be able to continue to meet your current needs for yourself and your family, and have sufficient to repay the debt when it comes due.

8. Do not take on any new debt. Debt stops growth, both physically and spiritually. Do not add to your debt burden as you strive to pay off your debts.

Finding Balance

As you work on avoiding and eliminating debt, finding balance among doctrines, principles and application is important in helping you become better. Below are a few ideas.

Principles	Doctrines
Know yourself , your vision, goals and budget	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Know where you are financially	Accountability
Use debt only for a modest home and education	Agency
Live within your means	Stewardship
If you are in debt, add:	
Develop a debt repayment plan	Stewardship
Do not take on any new debt	Accountability
Once out of debt, continue paying yourself	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with our finances and avoiding debt, which is an application. From a higher perspective, or with increased vision,

> We are children of God (identity), striving to live worthy of the Spirit (obedience), showing what we believe by our actions and choosing to delay gratification (accountability). We are taking responsibility for our actions and using our agency (stewardship) to save for things and not borrow, and learning the lessons God would have us learn through distinguishing between our wants and needs (agency) so we can accomplish our individual missions and achieve our individual and family vision and goals.

Understand How to Develop and Use Debt-Reduction Strategies

What if you are already in debt? Is there a process that can help you get out? The good news is that there is. The following process is essential for debt-reduction:

1. Recognize and accept that you have a debt problem.

2. Stop incurring debt. Don't buy anything else on credit. Be especially careful about using home equity to pay down debts until you have your spending under control. Will Rogers commented, "If you find yourself in a hole, stop digging."[11]

3. Make a list of all your bills.

4. Look for many different ways of reducing debt, not just one. Examples might include consolidating balances to a lower interest rate credit card, having a yard sale to earn money to pay down debt, or using savings to reduce debt.

5. Organize a repayment or debt-reduction strategy and follow it.

6. Follow through on the Plan until total debt elimination.

There are three basic types of debt-reduction strategies:

Personal strategies: These are strategies you can use on your own; they include the use spreadsheets and financial management software, such as Quicken, Mint.com, YNAB or Mvelopes, or other programs to help you organize your financial situation so you can make payments to get out of debt.

Counseling strategies: These strategies require outside help and include debt consolidation and debt negotiation strategies from credit counseling agencies.

Legal strategies: These strategies require professional legal help and may consist of declaring bankruptcy.

Personal Strategies

In this chapter, we will focus on personal strategies to help those in debt organize a plan to get out of debt. Even if you are not in debt, it is still helpful to learn these debt-reduction strategies because you will probably know someone who would benefit from these suggestions.

Debt-elimination Calendar: Most expensive debt first. In his article "One for the Money," Marvin J. Ashton discusses his debt-elimination strategy. His logic is that you should organize your debts and pay off your most expensive ones first.

He recommends that you set up a spreadsheet or ledger with a row for every month you will be making payments on your debts and a column for each creditor (see Table 1). You start by paying off the debt with the highest interest rate; this way you are paying off your most expensive debt first, which will save you the most money. Once your most expensive debt is paid off, continue applying the same total amount of money to other lines of credit until all of your debts are paid off. This is the critical point. After you have paid off one debt, you must keep paying the same amount of money but use that additional money to pay off the next most important debt. Then, once you have paid off your all your debts, you can continue paying yourself consistent with your personal and family goals.

Debt-elimination Calendar: Smallest Balance First. Dave Ramsey, in his book The Total Money Makeover (2003), recommends you pay off your smallest balance first. His logic is that as you see your debt decreasing, it will increase your motivation to continue attacking your debt until you get it paid off.

He recommends that you set up a spreadsheet or ledger with a row for every month you will be making payments on your debts and a column for each creditor (see Table 1). You sort the columns by the debt with the smallest balance first, and the next smallest next. As you pay off

the smallest balance, you see success quickly and it helps keep you motivated. Once the first debt is paid off, continue applying the same total amount of money to other lines of credit until all of your debts are paid off. This is the critical point. After you have paid off one debt, you must keep paying the same amount of money but use that additional money to pay off the next most important debt. Then, once you have paid off your all your debts, you can continue paying yourself consistent with your personal and family goals.

Table 1: Debt-Elimination Calendar

	Credit Card	Consumer Loan	Dentist	Piano Loan	Auto Loan	Student Loan	Total Payments
Interest Rate	16%	13%	10%	8%	6%	5%	
Amount Owed	$215.68	$533.66	$613.61	$1,399.94	$10,006.37	$7,002.64	$ 19,772
Min. Payment	110	70	50	75	235	120	660
March 20xx	110	70	50	75	235	120	660
April	110	70	50	75	235	120	660
May		180	50	75	235	120	660
June		180	50	75	235	120	660
July		52	178	75	235	120	660
August			230	75	235	120	660
September			30	275	235	120	660
October				305	235	120	660
November				305	235	120	660
December				129	411	120	660
January					540	120	660
February					540	120	660
March 20xx					540	120	660
April					540	120	660
May					540	120	660
June					540	120	660
July					540	120	660
August					540	120	660
September					540	120	660
October					540	120	660
November					540	120	660
December					540	120	660
January					540	120	660
February					167	493	660
March 20xx						660	660
April						660	660
May						660	660
June						660	660
July						245	245

Note that with both highest rate and smallest balance, if you have extra money, you can add an accelerator to your payoff. This can allow you to pay off your debt even faster.

While the "most expensive debt first" framework is better from a "total cost" point of view, both methods have the same objective and both can be helpful in eliminating debt. Debt Elimination Spreadsheet with Accelerator (LT20) on this website is a useful tool for determining which method will repay debts the quickest. With this tool, you have the option to pay down either the highest interest rate or smallest principal first. Most times, the difference is not significant and either method will accomplish the same objective. The key is to act now.

Home equity loans: Exchanging for Secured Debt. You have probably heard radio and TV

advertisements for debt consolidation loans. Debt consolidation loans are home equity loans, or loans against the equity in your home. Home equity loans have some benefits: because they are secured loans (credit cards are unsecured loans), they have lower interest rates, which reduces the monthly payment on your debt. In addition, the interest on home equity loans may be tax deductible.

However, there are two drawbacks to this type of loan. First, by taking out a home equity loan, you may not be addressing your real problem: the bad habit of spending money you do not have and living beyond your means. If your spending habits have not changed, your spending will continue even after you take out the home equity loan.

Second, if you take out a home equity loan and do not pay it off, you run the risk of losing not only your credit score but your home as well. Home equity loans put your home at risk because your home is used as collateral for the loan. Experience has shown that over 80 percent of those who take out a home equity loan to pay credit card debt have the same amount of debt they had at the time they took out the loan within three years. No spending changes have occurred, and the people soon find themselves back in debt. As their spending continues, they may now suffer both reductions in their credit ratings and the loss of their homes.

Should you take out a home equity loan to consolidate and pay off your debts? The answer is not straightforward. It's likely that you will get into the same problem again in the near future if you have not changed your spending habits. If you have already addressed the spending problem that got you into debt in the first place, a home equity loan may be a useful option.

If you find yourself too far in debt for personal strategies to work successfully, you have a few choices:

Counseling Strategies

Regarding counseling strategies, you may be able to get help from either nonprofit credit counseling agencies (CCAs), which can help you reduce your monthly interest charges, or for-profit agencies, which can help you consolidate and negotiate your debt. Regardless of your choice, check out the company you select with the Better Business Bureau before you spend any money.

Nonprofit credit counseling agencies. These agencies are set up specifically to help people reduce their credit card debt. These nonprofit agencies have arrangements with many credit card companies, and by working with those credit card companies, you can have your interest payments reduced or even eliminated with specific creditors. The creditors give these nonprofit agencies a rebate that comes from what the creditors are able to collect from you. Creditors are generally willing to work with credit counseling agencies because they would rather get some money back than none at all.

Using these services will cost you about $15 to $20 for setup and about $12 per month after that.

If you work with a credit counseling agency, realize that it will likely show up on your credit reports. However, your goal is to reduce your debt—not to increase it through paying high fees. If you successfully complete the program, your success may be noted on your credit reports as well.

Nonprofit credit counseling agencies can be found by calling the National Foundation for Credit Counseling (1-800-388-2227). The following are a few questions you should ask nonprofit credit counseling agencies before you sign up to work with them:

- Is the agency licensed? (To verify their answer, ask for their tax ID)
- Is the agency a member of the National Foundation of Consumer Credit (NFCC)?
- Is the agency accredited through the Council on Accreditation?
- Are the agency's counselors certified by the NFCC?
- What is the agency's monthly management fee? Is it tax-deductible?
- How long would I be in the program? (It should rarely be longer than five years)
- How much would I be paying on my debts each month? (Payments are usually taken directly from a checking or savings account)
- Will I talk with the same person every time or with many different people?

For-profit credit counseling agencies. These agencies make money by helping people get out of debt. There are two main methods through which they work: debt consolidation and debt negotiation.

Debt consolidation: The goal of this strategy is to consolidate debt into a single loan with a lower interest rate. For-profit agencies make money on *loan-origination charges* and other loan fees as they help homeowners take out an interest-only home loan and use the excess cash that would have gone to pay down principal to pay off debt. Borrowers should realize, however, that interest-only mortgages have an interest-only option for a specific period, i.e., one to seven years. After the interest-only period, the loan becomes fully amortizing and the loan principal must be repaid in a shorter amount of time, increasing monthly payments.

Debt negotiation: Debt negotiators work with creditors to reduce the interest rate and principal on certain types of loans, especially credit card loans. Initially, the consumer makes monthly payments to the debt management company, which may hold those payments until the consumer's accounts are long overdue. At this point, the debt management company attempts to negotiate with the creditors to reduce the consumer's interest rate and principal. They are sometimes able to significantly reduce the amount owed; however, help from these companies is not cheap. They typically charge a two-month retainer fee up front to work with your creditors. In addition, should this strategy backfire, you may have many months of nonpayment history on your credit report even though you made monthly payments as required to the for-profit credit counseling agency.

Before you begin working with a for-profit credit counseling agency, be sure you understand

how the agency makes money. If it doesn't make sense to you, go with another company. The following are a few questions you should ask for-profit credit counseling agencies before you sign up to work with them:

- What types of loans will the agency help consolidate or negotiate?
- How much will the agency's services cost?
- How does the agency get paid? Who pays the agency?
- When does the agency get paid?
- What is the monthly fee? Is it tax deductible?
- How long would I be in their program? (It should never be longer than five years)
- How much would I be paying on my debts each month? (Payments are usually taken directly from a checking or savings account)
- Will I talk with the same person every time or with many different people?

There are benefits to using these types of programs. First, these companies may be able to significantly reduce the interest charges and even the principal of some types of debt. Second, they may be able to help you out of extreme debt if you follow through with them.

There are also drawbacks to working with these organizations. Most importantly, they are very expensive, and there is no guarantee they will be able to help. In addition, these organizations are established mainly to make money, which means you will pay much more for their help than you will pay for the help of nonprofit credit counseling agencies. Remember, these companies stop making payments before they begin to negotiate, so working with them may have a significant negative impact on your credit reports. Watch for the following warning signs, and go elsewhere for help if you notice any of them:

- High, up-front or "voluntary" fees
- Vague contracts that do not explain fees
- Promises that sound too good to be true (for example, a promise that creditors will cut the principal owed by 50 percent)
- Fees for just distributing payments to creditors
- Pressure to sign up for debt-repayment services immediately before fees are disclosed
- Fees for phone consultations

Remember, you are working with your money. Use it wisely, and find a program that can help you resolve your debt issues in a consistent, logical way and within a reasonable time frame.

Legal Strategies—Bankruptcy

Legal help should be your last resort; however, if there is no possible way that you can repay your debts, you may want to consider this option. There are two major types of bankruptcy: Chapter 7 and Chapter 13.

Chapter 7. If you declare *Chapter 7 bankruptcy*, your assets will be liquidated and used to pay creditors according to procedures outlined in the Bankruptcy Code. This is the quickest, simplest, and most frequently selected type of bankruptcy. Under Chapter 7 bankruptcy, certain debts cannot be waived, including child support, student loans, and drunk driving fines.

Chapter 13. If you declare *Chapter 13 bankruptcy*, a repayment plan is set up in which the court binds both you and your creditors to set terms of repayment. You retain your property and make regular payments with future income to a trustee, who pays creditors slowly over the life of the bankruptcy plan.

Research on bankruptcy has shown some interesting trends. The majority of bankruptcies are caused by loss of relationships (divorce, death, or separation); unpaid medical expenses; and loss of the primary source of employment. You can substantially reduce your risk of these events by further developing your relationships, obtaining life and health insurance and continuing your education.

Unfortunately, some have come to see bankruptcy as a way of getting out of paying the obligations they can honestly pay on their own. If you are considering bankruptcy, ask yourself the following questions:

- Is it honest, or is it just a way to get out of debt legally? Remember, things that are legal may not necessarily be honest.
- Is your integrity worth more than money?
- Is it really necessary to declare bankruptcy?

A bankruptcy filing will remain on your credit reports for up to 10 years after you make your last payment. This will hurt your chances of getting the credit necessary to purchase a home or a business. Filing bankruptcy should not be taken lightly; it should be your last resort.

Understand Plans and Strategies for Debt Reduction

If you are out of debt, we are pleased. It is not an easy thing to get and stay out of debt. But it is important. If so, your Consumer Loans and Debt Plan will be short.

For those in debt, your Debt Reduction Plan and Strategies are part of your Consumer Loan and Debt Plan. For your Plan, continue from what you did with your Credit Plan previously on credit, and add your views on debt. Then add you're your debt reduction plans and strategies that may be helpful. Start with your views on debt. What is the place of debt in your life?

Plans and Strategies – Debt
Overall

- I will keep an emergency fund of 3-6 months at all times. When I use these, I will repay them in 6 months

- I will avoid debt except for a home and education, and will pay off my home by age 45
- I will pay cash for all transportation purchases and toys
- I may need to borrow for my first car. If so, I will pay it off within 3 years and pay cash for all future vehicles
- I will save money for my children's education and missions by saving $20 per child per month so I will not need to go into debt for these things
- I will save 20% of my income and will invest wisely. I will get the company match, save 15% of my income for retirement. And not borrow against my 401k

Debt Reduction

- Once school is out, put enough in the company 401k for the match, then save 20% minimum to build our emergency fund.
- After that, use 20-30% of income to pay off debt as quickly as possible paying the highest interest rate first (LT20). Once debt is paid off, continue to pay 20% into savings
- Continue to live like a student after college, build my emergency fund, then pay 20%+ each month against my debt using the debt snowball method until debt is all gone. After that, I will then keep paying myself 20% into saving and investing.

One-off Debt Reduction Strategies

- Bump up your debt repayment percentage. Pay more than the minimum balance, and use 30-50% of income to get out of debt.
- Negotiate a lower interest rate. Call the credit card company and request a lower interest rate which can reduce your interest costs. If they will not do this, move your balances to another card that has a lower interest rate (but make sure transfer fees are low)
- Use savings to pay down debt after you have your Emergency Fund
- Use any salary increase to pay down debt. Live at your previous salary and use increases to pay debt
- Use your tax refund check entirely to pay down debt.
- If possible, exchange consumer debt for mortgage debt. If you have equity in your home and you have changed your spending habits, use your equity to pay down debt.
- Sell assets. Have a yard sale and sell those things you probably should not have bought in the first place to reduce your debt.

Summary

You have studied what the scriptures and other leaders have said concerning debt. Avoiding debt is important for both our temporal and spiritual well-being and growth. Debt stops growth, both temporal and spiritual.

We discussed different personal strategies for debt-reduction as well as counseling and legal strategies for debt-reduction. Personal strategies include using debt-reduction spreadsheets and payoff accelerators. We talked about counseling strategies in terms of both nonprofit and for-

profit credit counseling agencies. Finally, we talked about the legal strategy of bankruptcy, and why it should be filed only as a last resort.

We concluded with ideas for those in debt, of a Debt Reduction Strategy, which is part of your Consumer Loans and Debt Plan. This Plan can be powerful in helping you stay away from and eventually reducing your debt.

Assignments

Financial Plan Assignments

Your assignment is to finish your Consumer Loan and Debt Plan. You have already worked on consumer loans as part of the PFP Loans Template (LT01-08), and now you will add more to the debt and debt reduction portion. Your Consumer Loan and Debt Plan includes four main areas: Consumer Loans, Student Loans, Mortgage Loans, and Debt and Debt Reduction. You will include each of these four areas as you develop your plans for using debt.

If you are in debt, or know others in debt, think through the reasons for that debt. Are there things that could have been done differently or things you could have done without that would have reduced the need for debt?

Review any debt you may have, including consumer, auto, mortgage and student loans. Write out your debt situation for each debt, including the following: creditor, phone number, reason for the loan, principal owed, interest rate, minimum payment, additional costs, fees, and the date by which you expect to have the loan paid off. Once you have written down all your debts, plan how to reduce your debt.

Write down your views on how you will use debt in the future. Will you use it? What type of debt is acceptable? What are your thoughts and what are the reasons you feel the way you do toward both acceptable and unacceptable debt?

If you are in debt, create a Debt Reduction Strategy, and include it as part of your Consumer Loan and Debt Plan.

Learning Tools

The following Learning Tools may also be helpful as you prepare your Personal Financial Plan:

Debt-Elimination Spreadsheet with Accelerator (LT20)

This Excel spreadsheet gives a framework for paying off debt; it encourages you to pay off your debts in order of expense until you have paid off all your debts. You can also choose between paying highest interest or smallest balance first.

Debt Amortization and Prepayment Spreadsheet (LT09)

This Excel spreadsheet gives a debt amortization and prepayment schedule to help you as you reduce and eliminate your debt.

Credit Card Repayment Spreadsheet (LT18)
This Excel spreadsheet gives information on how long it will take to pay off credit cards and other debt.

Review Materials

Terminology Review

Average Daily Balance (ADB). A common way of calculating interest to charge. Computed by adding each day's balance for a billing cycle and then dividing by the number of days in the cycle.
Cash Advance. Using a credit card to obtain cash, such as through an ATM or over the counter at a bank. This is an extremely expensive way to borrow, and carries several pricy fees.
Credit Bureau. Private organizations which maintain credit information on individuals, which it allows subscribers to access for a fee. The three major credit bureaus to know are Equifax, Experian, and Trans Union.
Credit Card. A financial instrument that allows the holder to make purchases through an open line of credit.
Credit Limit. The maximum amount that one can borrow on a single credit card. This amount is often influenced by one's credit score.
Credit Report. Information collected by credit bureaus from subscribers, creditors, public court records, and the consumer.
Credit Score. A numerical evaluation of your credit based on specific criteria determined by the credit scoring company.
Debit Card. Unlike credit cards, debit cards act like a personal check. When used, money is taken straight from the connected account to pay for the purchased item.
FICO Score. This is the most commonly used credit score. It ranges from 300 to 850.
Grace Period. The amount of time given by a credit card company to pay a due balance before interest starts to accrue. Normally 20 to 25 days, excluding cash advances. It does not apply if the card already carries a balance.
Secured Credit Card. Similar to a standard credit card, but is tied to a checking or savings account. The card cannot be used once the money in the account is gone, until more funds are added. Useful for building credit.
Smart Card. Similar to a debit card, but rather than being connected to a certain bank account, they magnetically store a certain amount of money linked to the card itself.
Teaser Rates. Very low introductory interest rates used to attract new customers to a certain credit card. They increase soon after the card is in the user's hands.

Review Questions

1. What are two debts that, according to leaders, are okay to incur?
2. What are principles of avoiding debt and why are they important?
3. What key doctrines, if understood better, would help you avoid debt?

Case Studies

Case Study 1

Data

A family friend has asked you to help one of his children, who is having some financial problems. The son gave you the following information: They have four children, ages three months to 18 years. Their bills include a mortgage of $150,000 at 6 percent, a second mortgage of $20,000 at 7.5 percent (because they were too far in credit card debt), debts to various financial institutions of $10,000 at between 12 percent and 28 percent (she lost her job due to the latest pregnancy), a lease on a new truck of $18,000, a loan on her car for $5,000, and miscellaneous Christmas bills totaling $3,000. After some work using Debt-Elimination Spreadsheet with Accelerator (LT20), you determine that debt payments represent 83 percent of their income for living expenses.

Application

What suggestions do you have to help them get out of debt?

Case Study 1 Answers

The above was a real case that occurred a few years ago. I have included below my suggested process to help (there are likely other ways to help as well).

1. Help them determine what is important to them—their personal vision of where they want to be.
   - I shared with them the importance of perspective and that personal finance is just part of the gospel of Jesus Christ.
   - I share with them doctrines, principles and application, the "why's", "whats'" and "how's" of personal finance and why the Lord wants us to be financially secure.
   - They recognized that they had a debt problem. They were finally sick and tired of being sick and tired.
2. Help them realize where they are financially, and that their habits were not taking them to their goals.
   - I helped them develop a balance sheet for the family.
   - We worked together to determine what assets were available and how much was owed. We developed an income statement and ratios
   - We worked at finding out where the money was going so we could put it to the best use.
   - We put them on a very strict income and expense plan, and we worked on both areas.
3. Determine individual ways of reducing debt, the more the better.

- I had them fill out their income taxes quickly so they could receive their income tax return.
- They borrowed money against their cash-value insurance policy to reduce their debt.
- I had them sell assets that they could do without (i.e., truck, old vehicles, etc.).

4. Help them determine a course of action and debt reduction plan, and committed them to that course.

- We worked together to make a debt reduction plan, and then we all worked together to follow that plan.
- I enlisted other people as part of a team approach to help them with talking to creditors and paying off their debts.
- We met together every week and I held them accountable for their plan.

5. Help them follow through with their plan (until total debt elimination*)

- We worked together on their debt reduction plan (not our plan) and held them accountable for it
- We met with them weekly to see how they were doing and to encourage them to stick with the Plan

We continued to offer encouragement and support in a non-judgmental manner
Now, many years later, they are still in debt, but their debts have become much more manageable and they are working to pay them off completely. Has it been easy? No. Is it worthwhile? Yes. The wife commented recently, "I just didn't realize that it would be so hard for so long. You run into debt, but you crawl out of it."

Case Study #2

Data

Emilee has been thinking about how much she has to earn to pay back her loans once she leaves school. Assume she will be in the 25% Federal tax bracket after school, living in New York (10% state tax rate) and New York City (5% city tax rate), and she pays 12% gross of her income to charity.

Calculations

How much must she earn to pay back $1.00 in student loans (this assumes 0% interest)?

Case Study #2 Answer

Calculations

To pay back $1.00 in student loans will require:

- Taxes:
- Federal tax rate: 25%
- State tax rate: 10%
- City tax rate: 5%
- Charitable contributions: 12%

The formula is:

- $x - .25x - .10x - .05x - .12x = 1$. Solve for x?

- X = 2.08 (1/(.25+.10+.05+.12)

Emilee must earn $2.08 for every dollar she borrows (and that assumes a 0% interest rate). That's expensive (see Loan Amount to Pay Back (LT34).

Pre-tax Amount to Earn to Pay Back
Each Dollar You Repay from a Loan (LT34.1)

	Per Dollar	Specific Amount
Amount Borrowed	1.00	$ 3,500.00
Taxes (%):		
Federal Tax rate:	25.0%	25.0%
State Tax rate:	10.0%	10.0%
City Tax rate:	5.0%	5.0%
Charity and Savings (%)		
Charity rate:	12.0%	12.0%
Savings rate:		0.0%
Amount Necessary to pay Back	2.08	$ 7,291.67

You must earn $2.08 for very $1.00 you borrow, a 108.3% increase in what you must earn!!!!

Amount Necessary to Pay Back Student Loans
ling Principle, Interest, Taxes and Contributions (LT

	Loan 1		Total
Loan Information:			
Amount Borrowed:	$5,000.00	*Total Amount Borrowed*	$ 5,000.00
Interest Rate (APR):	12.0%	*Weighted Interest Rate*	12.0%
Education Information:			
Months Until Education is done?	24		
Subsidized? (1 = yes, 0 = no)		*Total amount due:*	
Amount due at end of education	$6,348.67	*at end of education:*	$6,348.67
Repayment Information:			
How Many Months to Pay off?	60	*Average months to pay off*	60
Payment per Month	$141.22	*Total Payments per month*	$141.22
Total Amount to Pay off	$8,473.36	*Total Amount to Pay*	$8,473.36
Ratio of Earned (P&I) to Borrowed:	1.69		1.69
Taxes:			
Federal Tax Rate:	25.0%	*Average Federal Tax Rate*	25.0%
State Tax Rate:	10.0%	*Average State Tax Rate*	10.0%
City Tax Rate:	5.0%	*Average City Tax Rate*	5.0%
Charity and Savings:			
Charity rate (%):	12.0%	*Average Charity Rate*	12.0%
Savings rate (%):			
Ratio of Earned (PITSC) to Borrowed:	2.08		2.08
Total Amount Needed to Pay Back	17,652.84	*Total Amount to Pay Back*	$17,652.84
Ratio:	3.53	*Ratio of amount borrowed to amount earned to pay back*	3.53
Annual Percentage Rate	68.0%		

You must earn $3.53 on average to pay back every $1.00 you borrow!!!!!

* APR is calculated from graduation until the time the loan is paid off. I haven't figured out how to calculate the i

Case Study #3

Data

Use the tax and charity information from the previous case. Emilee is in her second to last year in school (24 months till graduation) and is considering a $5,000 alternative loan at 12% and plans to pay it back in 60 months after she graduates.

Calculations

How much must she earn to pay back that alternative loan of $5,000 (which is not subsidized and accrues interest while she is in school) at 12% interest over 60 months and including taxes and charitable contributions?

Case Study #3 Answers

To pay back $5,000 in student loans requires:

- At 12% interest and in her second to last year of school, she will add 24 months of interest or $1,349
  - PV for 60 months will require a payment of $141.22 per month
  - PV=5,000, rate = 12%/12, Periods = 60 months, Solve for her Pmt = ?
  - Payment = $141.22
  - Her total payments will be $141.22 * 60 months or
- Total Payments = $8,474 or 68% more than borrowed

To determine how much she needs to earn to pay back this $8,474, we determine:

- Taxes:
  - Federal tax rate: 25%
  - State tax rate: 10%
  - City tax rate: 5%
  - Charitable contributions: 12%
- The formula is:

- x-.25x-.10x-.05x-.12x = 1. X = 2.08
- To pay back this $8,474, Emilee must earn 2.08 * $8,474 or $17,653
  - Emilee must earn $3.53 for every $1.00 she borrows ($17,653/$5,000=3.53). Again, very expensive.

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[1] Anonymous.
[2] Will Rogers Legacy, California Department of Parks and Recreation at http://www.parks.ca.gov/?page_id=23998.
[3] 2 Kings 4:7.
[4] J. Reuben Clark, Conference Address, April 6, 1938.
[5] Conference Report, Oct. 1903, 5
[6] "Doing the Best Things in the Worst Times," Ensign, August 1984, 41.
[7] "The Celestial Nature of Self-Reliance," *Ensign*, Jun. 1984, 3
[8] "I Believe," *Ensign*, Aug. 1992, 6
[9] "Constancy Amid Change," *Ensign*, Nov. 1979, 80
[10] Proverbs 29:18.
[11] Nina Coleman, "The Manly Wisdom of Will Rogers," in *The Friars Club Bible of Jokes, Pokes, Roasts, and Toasts* (2001), p. 316

9. Time Value of Money 1: Understanding the Language of Finance

Introduction

The language of finance has unique terms and concepts that are based on mathematics. It is critical that you understand this language, because it can help you develop, analyze, and monitor your personal financial goals and objectives so you can get your personal financial house in order.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand the term *investment.*
B. Understand the importance of compound interest and time.
C. Understand basic financial terminology (the language of finance).
D. Solve problems related to present value (PV) and future value (FV).

I strongly recommend that you borrow or purchase a financial calculator to help you complete this chapter. Although you can do many of the calculations discussed in this chapter on a standard calculator, the calculations are much easier to do on a financial calculator. Calculators like the Texas Instruments (TI) Business Analyst II, TI 35 Solar, or Hewlett-Packard 10BII can be purchased for under $35. The functions you will need for calculations are also available in many spreadsheet programs, such as Microsoft Excel. If you have a computer with Excel, you can use our Excel Financial Calculator (LT12), which is a spreadsheet-based financial calculator available on the website. We also have a Financial Calculator Tutorial (LT3A) which shares how to use 9 different financial calculators.

Understand the Term Investment

An investment is a current commitment of money or other resources with the expectation of reaping future benefits.

For the most part, we will be working with financial investments in this course—stocks (or equities), bonds, mutual funds, cash, treasury bills and notes, options, futures, and so on. However, we will make reference to other important investments such as education and relationships. It is important that we have a broader view of what an investment is so that we recognize those investments that are of most worth—those that bring true joy in this life and in the life to come. You should have priorities when it comes to investments, and the most important investments you will make involve your family, your religion, and your relationship with God. The Book of Mormon prophet Jacob wisely counseled, "Wherefore, do not spend

money for that which is of no worth, nor your labor for that which cannot satisfy."[1]

Understand the Importance of Compound Interest and Time

Interest is similar to rent. Just as tenants pay rent to landlords in exchange for the use of an apartment or house, people will pay you interest in exchange for the use of your money. You can either invest your money yourself or you can lend it to others who will then invest your money and pay you an agreed upon rate.

With simple interest, you only earn interest on your original principal. However, with compound interest, interest is calculated not only on the initial principal but also on the accumulated interest earned in prior periods. The magic of compound interest is that you earn interest on money earned in previous periods, hence the importance of time. Time is the only tool that everyone has an equal amount of each day. However, you must have the discipline and foresight to use time to your advantage by investing early and not stopping for "diversions" in your spending and your goals.

The key investing principle states that a dollar in hand is worth more than a dollar received in the future. This principle is true because you can invest that dollar today and begin earning interest on it. The sooner your money can earn interest, the faster your interest can earn interest, and the more money you will have.

Understand Basic Financial Terminology (i.e., the Language of Finance)

For you to understand the language of finance, you must understand thirteen key terms:

Amortized loan: A loan paid off in equal installments composed of both principal and interest. It may also be called an installment loan.

Annuity: A series of equal payments; these payments are made at the end of a specific time period for a specified number of time periods (generally months or years).

Compound annuity: An investment that involves depositing the same amount of money at the end of each period for a certain number of years.

Compounding (annually, quarterly, daily, etc.): The number of periods during the year where interest is calculated. Compound interest is where interest is paid on previously earned interest as well as on the principal. The shorter the compounding period, the higher the effective annual rate of interest.

Effective interest rate: The actual rate (as opposed to the stated or nominal rate) that is received after the effects of compounding are taken into account.

Future value (FV): The value of an investment at some point in the future.

Interest or discount rate: The stated rate you will receive for investing at a specified compounding period for a specified period of time.

Nominal return: The return on your investment before the impact of inflation and taxes is taken into account.

Present value (PV): The current value (today's value) of a future sum of money.

Principal: The money you have available to invest or save, or the stated amount on a bond or deposit instrument.

Real return: The rate of return on an investment after the impact of inflation is accounted for. The formula for approximating the real return is the nominal return minus inflation. The exact formula for the real return is= [(1+ nominal return) / (1 + inflation)] – 1.

Tax-adjusted (or after-tax) return: The return on your investment after the impact of federal and state taxes has been taken into account.

Compounding

How will different compounding periods impact your investment and investment returns?

Compounding periods refer to the frequency with which interest is applied to your investment. Interest may be compounded daily, weekly, monthly, semiannually, or annually. A key relationship exists between time and interest rate. The shorter the compounding period, the higher the effective annual interest rate (the actual rate you are earning on your investment after taking the effect of compounding into account). For example, if interest is compounded daily, the investment will grow faster than if the interest is compounded monthly or annually.

The formula for calculating the effective interest rate (EIR) is as follows:

$$EIR = [(1 + (\text{nominal return or APR} / \text{periods}))]^{\text{periods}} - 1$$

Problem 1: Impact of Compounding

Let's illustrate the effect of compounding and the effective interest rate. The following are examples of four investments with four different nominal returns. Which of these investments would you rather own?

Investment A earns 12.0 percent annually.
Investment B earns 11.9 percent semiannually.
Investment C earns 11.8 percent quarterly.
Investment D earns 11.7 percent daily.

To figure out which investment is best for you, you must determine the effective interest rate of each investment.

For Investment A, the effective rate would be $(1 + .12 / 1)^1 – 1$, or 12.00 percent.
For Investment B, the effective rate would be $(1 + .119 / 2)^2 – 1$, or 12.25 percent.
For Investment C, the effective rate would be $(1 + .118 / 4)^4 – 1$, or 12.33 percent.
For Investment D, the effective rate would be $(1 + .117 / 365)^{365} – 1$, or 12.41 percent.

Even though Investment D has the lowest nominal return, because of compounding, it has the highest effective interest rate. Investment D would be the best vehicle, assuming you were lending money at this rate. Compounding makes an important difference!

Solve Problems Related to Present Value (PV) and Future Value (FV)

Present Value (PV)

Let's suppose you want to determine the current value of the ultimate earnings on an investment. This question could be restated in the following manner: What is the present value of my investment that will mature in N years at I percent interest (or discount rate)?

To solve this problem, you will need to know the future value of your investment, how many years are required for the investment to reach maturity, and what interest or discount rate your investment has. The result of the equation will be a dollar amount that is smaller than the future amount of principal and interest you will have earned; it is the amount the investment is worth at the present time.

The present value (PV) equation is as follows:

$$PV = FV / (1 + I)^N$$

The key inputs in the PV equation are as follows:

- FV = the future value of the investment at the end of N years
- N = the number of years in the future
- I = the interest rate, or the annual interest rate or discount rate
- PV = the present value, in today's dollars, of a sum of money you have invested or plan to invest

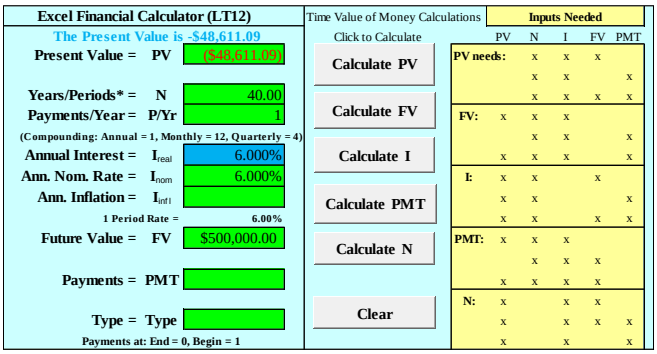
After you find these inputs, you can solve for the present value (PV).

Problem 2: Determining Present Value

Let's suppose your rich uncle promises to give you $500,000 in 40 years. Assuming a six percent interest rate, what is the present value of the amount your uncle is promising to give you in 40 years?

To solve this problem, use the equation given above, which would appear as follows: PV = 500,000 / $(1 + .06)^{40}$, or $48,611. You can also use a financial calculator. Set your calculator to end mode, meaning payments are at the end of each period, and clear the memory registers to make sure you have no old data in the calculator memories. Set $500,000 as your future value (FV), 40 as your number of years (N), and 6 as your interest rate (I); then solve for the present value (PV). You should get the same result as you did when you used the PV equation.

Using our Excel Financial Calculator (LT12), it is:



Future Value (FV)

Let's suppose you want to determine what an investment will be worth at some point in the future, i.e., what will the value of my investment be in N years if my interest rate is I percent?

You will need to know how many years it will be until you have the investment, the interest rate, and the amount of the investment (the present value of the investment).

The result of the equation will be a dollar amount that is larger than the original investment, since your money will earn interest and will then earn interest on that interest. For an approximation, remember the rule of 72, which states that an investment will double approximately each time you multiply the number of years of investment by the interest rate (in percentage terms) and get a number that is greater than 72. For example, if your investment is earning 8 percent interest, it will take nine years for it to double (72 divided by 8 = 9).

The future value (FV) equation is as follows:

$$FV_N = PV * (1 + I)^N$$

The key inputs in the FV equation are as follows:

FV = future value of the investment at the end of N periods (years)
N = number of years in the future
I = interest rate, or the annual interest (or discount) rate
PV = present value, in today's dollars, of a sum of money you have already invested or plan to invest

Problem 3: Determining Future Value

Let's look at two similar problems:

A. Calculate the future value (in 15 years) of $5,000 that is earning 8 percent; assume an

annual compounding period.

B. Calculate the future value (in 15 years) of $5,000 that is earning 8 percent; assume simple interest (the interest earned does not earn interest).

C. How much did interest on interest earn in the first problem?

A. To solve this problem, we must consider compound interest. On your calculator, clear your registers and your memory. Set –$5,000 as the present value (PV), 8 percent as the interest rate (I), and 15 as the number of years in the future (N); then solve for the future value (FV), which is $15,861. With a standard calculator, the result is $5,000 * (1 +.08)^{15}$, or the same sum of $15,861.

B. To solve for simple interest, which does not accrue interest on interest, it is easiest to use a standard calculator. First, calculate your annual interest, which is $5,000 times 8 percent (5,000 * .10), or $400. Multiply $400 by 15 years; the result should be $6,000. Then add the amount of the original investment of $5,000 to get $11,000.

C. The difference between $15,861 and $11,000 is $4,861, which is the amount of interest that your interest has earned. This concept is the key to financial success—earn interest on your interest.

Summary

In this chapter, we have become familiar with the language of finance. The language of finance comprises many different concepts and terms, and understanding these concepts and terms is can help you to develop, analyze, and monitor your personal and financial goals successfully.

An *investment* is the current commitment of money or other resources with the expectation of reaping future benefits. We make investments in many areas of our lives; key investments can involve education and skills, knowledge and friendships, food storage and emergency funds, and finances.

Compounding is an important principle to understand. Compounding periods are the frequency with which interest is applied to your investment. Interest may be compounded daily, weekly, monthly, semiannually, or annually. The sooner your money can earn interest, the faster your interest can earn interest, and the more money you will have.

Present value (PV) is another key term. The present value of an investment refers to the current value of a future sum of money. You must remember, however, that money you will earn in the future is less valuable to you than money you have right now; you cannot use future money to earn interest today. You can only earn interest on money you have in hand.

Future value (FV) is the value an investment will have at some point in the future. The result of a future value equation will be a dollar amount that is larger than the original investment

(assuming a positive rate of interest or return) because your money will earn interest and earn interest on that interest.

Assignments

Financial Plan Assignments

There are no financial plan assignments for this section, although understanding the language of finance is critical to all other sections. As you read through this chapter, think about the purpose of each financial concept. Use either a calculator, your own spreadsheets, or the Excel Financial Calculator (LT12) to make sure you understand how to solve problems of present value and future value.

Learning Tools

The following Learning Tools may also be helpful as you prepare your Personal Financial Plan:

Financial Calculator Tutorial (LT03)
This document is a financial calculator tutorial about most of the major financial calculators. It also includes the financial formulas if you would prefer to program your own calculator.

Excel Financial Calculator (LT12)
This Excel spreadsheet is a simple financial calculator for those who prefer to use spreadsheets. This tool can perform most of the functions of a financial calculator, including present value, future value, payments, interest rates, and number of periods.

Review Materials

Terminology Review

Amortized Loan. A loan paid off in equal installments composed of both principal and interest. It may also be called an installment loan.
Annuity. A series of equal payments; these payments are made at the end of a specific time period for a specified number of time periods (generally months or years).
Compounding (annually, quarterly, daily, etc.): The number of periods during the year where interest is calculated. Compound interest is where interest is paid on previously earned interest as well as on the principal. The shorter the compounding period, the higher the effective annual rate of interest.
Compound Annuity. An investment that involves depositing the same amount of money at the end of each year for a certain number of years.
Compound Interest. Compound interest is where interest is calculated not only on the initial principal but also on the accumulated interest earned in prior periods. The magic of

compound interest is that you earn interest on money earned in previous periods.
Effective Interest Rate. The actual rate (as opposed to the stated or nominal rate) that is received after the effects of compounding are taken into account.
Effective Interest Rate. The actual rate (as opposed to the stated or nominal rate) that is received after the effects of compounding are taken into account.
Financial Investments. These are equity or debt investments including stocks (or equities), bonds, mutual funds, cash, treasury bills and notes, options, futures, and so on.
Future Value (FV). The value of an investment at some point in the future.
Inflation. An increase in the volume of available money in relation to the volume of available goods and services; inflation results in a continual rise in the price of various goods and services. In other words, because of increased inflation, your money can buy fewer goods and services today than it could have bought in the past.
Interest or Discount Rate. The stated rate you will receive for investing at a specified compounding period for a specified period of time.
Investment. The current commitment of money or other resources with the expectation of reaping future benefits.
Minimum Payment. The minimum amount of payment required by credit card companies each month. The credit card companies purposefully keep these as low as possible, in order to maximize the amount that they earn in interest.
Nominal Return. The return on your investment before the impact of inflation and taxes is taken into account.
Present Value (PV). The current value (today's value) of a future sum of money.
Principal. The money you have available to invest or save, or the stated amount on a bond or deposit instrument.
Real Return. The rate of return on an investment after the impact of inflation is accounted for. The formula for approximating the real return is the nominal return minus inflation. The exact formula for the real return is= [(1+ nominal return) / (1 + inflation)] – 1.
Simple Interest. Interest is paid only on your original principal.
Tax-adjusted (or after-tax) return. The return on your investment after the impact of federal and state taxes has been taken into account.

Review Questions

1. What is compound interest?

2. What are the four variables of the present value equation?
3. What are the 13 financial terms mentioned in the chapter? What do they mean?
4. What is the relationship between the compounding period and the effective interest rate?

Case Studies

Case Study 1

Data

Brian has a goal to have $500,000 saved by the time he turns 65, which is 40 years from now.

Calculation

Assuming he can make 6 percent on his money, what is the value of that money now (this indicates present value)? The math formula is as follows:

$PV = FV/ (1 + I)^N$

Case Study 1 Answer

The formula is $PV = FV/ (1 + I)^N$, or $PV = 500{,}000 / (1.06)^{40}$, or $48,611.10. This formula shows you how this equation would be calculated on a standard calculator. Using a financial calculator, you would clear the memories and then enter the following information:

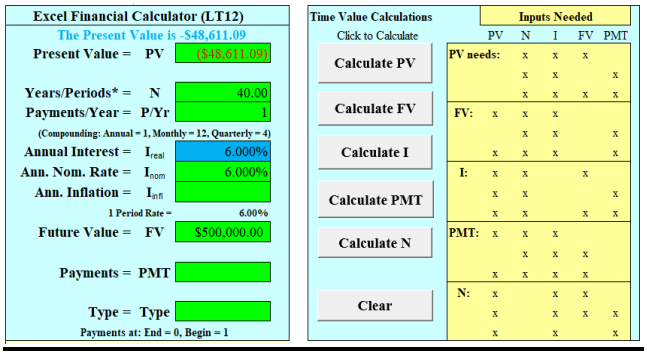
$500,000 = FV

6% = I, which is the interest rate (the annual interest, or discount, rate)

40 = N, or the number of years

You would then solve for PV:

PV = the present value, in today's dollars, of a sum of money you have invested or plan to invest. If you use a financial calculator for this equation, the present value should come out as $48,611.10.



Case Study 2

Data

Ron has $2,500 saved.

Calculation

If his investment earns 8 percent per year for 20 years, how much will his investment be worth in 20 years (the investment's future value)? The formula is as follows:

$FV = PV (1 + I)^N$

Case Study 2 Answer

The equation would be $FV = \$2{,}500 * (1 +.08)^{20}$ or $11,652.39

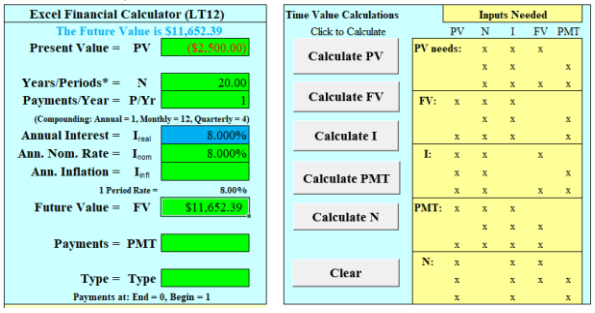
If you were using a financial calculator, you would clear the memories and then enter the following:

$2,500 = PV

8% = I, which is the interest rate (the annual interest, or discount, rate)
40 = N, or the number of years

You would then solve for FV:

FV = $11,652.39



[1] 2 Nephi 9:51

10. Time Value of Money 2: Understanding Inflation, Annuities, and Amortized Loans

Introduction

This chapter continues the discussion on the time value of money. In this chapter, you will learn how inflation impacts your investments; you will also learn how to calculate real returns after inflation as well as annuities and payments on amortized loans.

Objectives

Once you have completed this chapter, you should be able to do the following:

1. Explain how inflation impacts your investments.
2. Understand how to calculate real returns (returns after inflation).
3. Solve problems related to annuities.
4. Solve problems related to amortized loans.

Explain How Inflation Impacts Your Investments

Inflation is an increase in the volume of available money in relation to the volume of available goods and services; inflation results in a continual rise in the price of various goods and services. In other words, because of increased inflation, your money can buy fewer goods and services today than it could have bought in the past.

Inflation negatively impacts your investments. Although the amount of money you are saving now will be the same amount in the future, you will not be able to buy as much with that money in the future (the purchasing power of your money erodes). Inflation makes it necessary to save more because your currency will be worth less in the future.

Problem 1: Inflation

Forty years ago, gum cost five cents a pack. Today it costs 99 cents a pack. Assume that the increase in the price of gum is completely related to inflation and not to other factors. At what rate has inflation increased over the last 40 years?

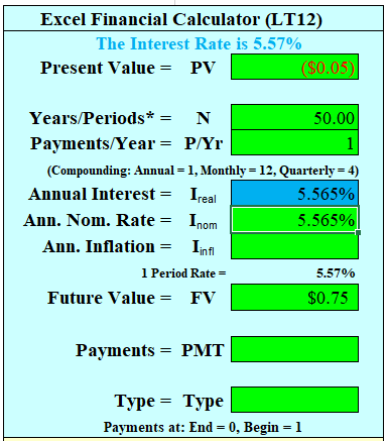
Before solving this problem, clear your calculator's memory, and set your calculator to one annual payment. Then input the following information to solve this problem:

PV = –$0.05 (the price of gum forty years ago)

FV = $0.75 (the price of gum today)
N = 40 (The cost has increased every year for forty years.)
I = ?

The formula is: $((FV/PF)^{(1/N)}))-1$

On average, the inflation rate has been 5.56 percent each year for the last 40 years. So, the average price of gum has increased by 5.56 percent each year for the last 40 years.



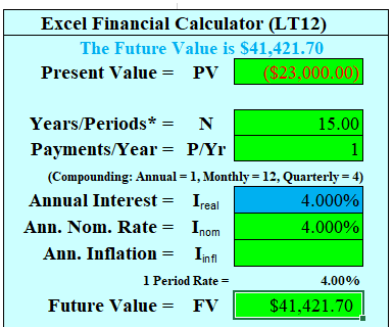
Problem 2: Inflation—The Future Value of a Wedding

I have six daughters and one son. It is estimated that an average wedding cost $23,000. Assuming four-percent inflation, what would it cost me to pay for all six of my daughters' weddings in 15 years? (Hopefully not all six weddings will take place in the same year.)

Before you begin, clear your calculator's memory and set your calculator to one annual payment. Input the following information to solve for the cost of a single wedding in 15 years:

PV = $23,000 (Assume that on average a wedding still costs $23,000.)
N = 15 (The cost will increase every year for 15 years.)
I = 4 (The inflation rate is four percent.)
FV = ?

The formula is: $PV*((1+I)^{(N)})$.



In 15 years, the value of a single wedding will be $41,422. This means six weddings will cost $248,530. Inflation will raise my costs by 80 percent (($41,422 / 23,000) – 1) over the next 15 years, so I need to plan now.

Understand How to Calculate Real Returns

A real return is the rate of return you receive after the impact of inflation. As discussed earlier, inflation has a negative impact on your investments because your money will buy less in the future. For example, 40 years ago a gallon of gas cost 25 cents per gallon; currently, gas costs $4.00 per gallon. While the gas itself hasn't changed (much), the price has increased. To keep your real return constant (in other words, to maintain your buying power), you must actually earn more money in nominal (not inflation adjusted) terms.

Excel Financial Calculator (LT12)		
The Future Value is $51,808.55		
Present Value =	PV	($35,000.00)
Years/Periods* =	N	10.00
Payments/Year =	P/Yr	1
(Compounding: Annual = 1, Monthly = 12, Quarterly = 4)		
Annual Interest =	I_{real}	4.000%
Ann. Nom. Rate =	I_{nom}	4.000%
Ann. Inflation =	I_{infl}	
1 Period Rate =		4.00%
Future Value =	FV	$51,808.55

Traditionally, investors have calculated the real return (r_r) as simply the nominal return (r_n), or the return you receive, minus the inflation rate (π). This method is incorrect. It is preferable to use the following formula:

(1 + nominal return (r_n)) = (1 + real return (r_r)) * (1 + inflation (π))

To solve for the real return, divide both sides of the equation by (1 + inflation (π)). Once you've divided, the equation looks like this:

(1 + nominal return (r_n)) / (1 + inflation (π)) = (1 + real return (r_r))

Then, subtract one from both sides and reverse the equation to get the following:

Real return (r_r) = [(1 + nominal return (r_n)) / (1 + inflation (π))] – 1

<u>Problem 3: Real Return (i.e., the Return after Inflation)</u>

Paul just graduated from college and landed a job that pays $35,000 per year. Assume that inflation averages 1.96 percent per year.

A. What nominal rate will Paul need to earn in the future to maintain a 2-percent real return rate?

B. In nominal terms, what will Paul's salary be in 10 years? Assume that his salary keeps up with inflation and that inflation averages the same 1.96 percent per year.

a. To determine the nominal rate of return, remember the formula for real return: $r_r = ((1 + r_n) / (1 + \pi)) – 1$. Now plug in the values you know: 0.02 = (1 + x) / (1 + 0.0196) –1. Solving for x results in a nominal return of 4.00 percent. Thus, Paul's nominal return must be 4.00 percent in the future to maintain a real return of 2 percent. The formula for the nominal rate of return is NR = (1 + RR)*(1+I) -1.

b. To maintain his current purchasing power 10 years from now, Paul will have to make $51,809 in real terms.

This problem is very similar to the Future Value we have already discussed. Use the following values to solve this problem:

PV = –$35,000 (This is Paul's current salary.)
I = 2 (Interest is replaced by inflation.)

N = 10 (This is the number of years in the future.)
Solve for FV = ?

Excel Financial Calculator (LT12)		
The Future Value is $42,664.80		
Present Value =	PV	($35,000.00)
Years/Periods* =	N	10.00
Payments/Year =	P/Yr	1
(Compounding: Annual = 1, Monthly = 12, Quarterly = 4)		
Annual Interest =	I_{real}	2.000%
Ann. Nom. Rate =	I_{nom}	2.000%
Ann. Inflation =	I_{infl}	
1 Period Rate =		2.00%
Future Value =	FV	$42,664.80

The formula is FV = PV * $(1+I)^{N.}$

Understand How to Solve Problems Related to Annuities

An annuity is a series of equal payments that a financial institution makes to an investor; these payments are made at the end of each period (usually a month or a year) for a specific number of years. To set up an annuity, an investor and a financial institution (for example, an insurance company) sign a contract in which the investor agrees to transfer a specific amount of money to the financial institution, and the financial institution, in turn, agrees to pay the investor a set amount of money at the end of each period for a specific number of years.

To determine the set amount of each equal payment for a certain investment, you must know the amount of the investment (PV), the interest rate (I), and the number of years the annuity will last (N).

Problem 4: Annuities

{XE "Annuities" }When you retire at age 60, you have $750,000 in your retirement fund. The financial institution you have invested your money with will pay you an interest rate of 7 percent. Assuming you live to age 90, you will need to receive payments for 30 years after you retire. How much can you expect to receive each year for your $750,000 investment with a 7 percent interest rate?

To solve this problem, input the following information into your financial calculator:

Set –$750,000 as your present value (PV). Your present value is negative because it is considered an outflow. You pay this amount to the financial institution, and the financial institution pays you back with annual payments.

Set 30 as the number of years (N).

Set 7 percent as your interest rate (I). Remember that you may need to convert this percentage to the decimal 0.07 in some calculators.

Now solve for the payment (PMT). The present value of this annuity is $60,439.80. This means you should receive 30 annual payments of $60,439.80 each.

Without a financial calculator, solving this problem is a bit trickier. The formula is as follows:

$$PMT = PV_{N,I} / ((1 – (1 / (1 + I)^{N})] / I)$$

$$PMT = \$750{,}000 / ((1 – (1 / (1.07)^{30})] / 0.07) = \$60{,}439.80.$$

Excel Financial Calculator (LT12)		
The Payment is $60,439.80		
Present Value =	PV	($750,000.00)
Years/Periods* =	N	30.00
Payments/Year =	P/Yr	1
(Compounding: Annual = 1, Monthly = 12, Quarterly = 4)		
Annual Interest =	I_{real}	7.000%
Ann. Nom. Rate =	I_{nom}	7.000%
Ann. Inflation =	I_{infl}	
1 Period Rate =		7.00%
Future Value =	FV	
Payments =	PMT	$60,439.80

The key is to start saving for retirement as soon as you can. Starting to save early will make a big difference in what you are able to retire with.

Problem 5: Compound Annuities

{XE "Compound Annuities" }With a compound annuity, you deposit a set sum of money into an investment vehicle at the end of each year; you deposit this amount for a specific number of years and allow that money to grow.

Suppose you are looking to buy a new four-wheeler to remove snow from your driveway. Instead of borrowing the $7,000 you would need to pay for the four-wheeler, you want to save for the purchase. You need to ask yourself two questions:

A. How much will I need to save each month if I want to buy the four-wheeler in 50 months if I can earn 7 percent interest on my investment?

B. How much will I have to save each month if I want to buy the four-wheeler in 24 months if I can earn 7 percent interest on my investment?

Note: The method you use to calculate the monthly payments will depend on the type of financial calculator you have. Some calculators require you to set the number of payments to 12 (for monthly payments) and also divide the interest rate by 12 months. Other calculators only require you to set the number of payments to 12. Determine what your calculator requires before solving problems requiring monthly data.

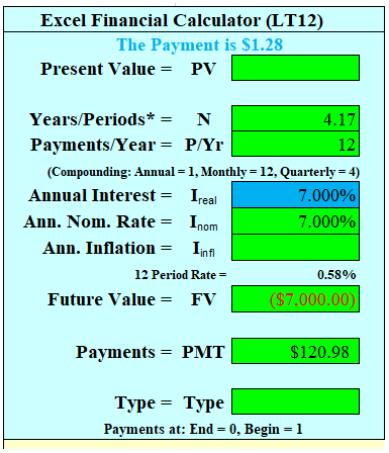
Before solving for the monthly payment, follow these steps: (1) clear your calculator's memory, (2) set your number of payments to 12 so that your calculator will calculate monthly payments instead of annual payments, and (3) make sure your calculator is operating in "end mode," since the payments are received at the end of each period.

To solve the first question, input the following information:

FV = –$7,000
N = 50/12
I = 7
PMT = ?

If you earn 7 percent interest on your investment, you will need to save $120.98 each month to save $7,000 in 50 months. If you do not have a financial calculator, use the following to solve this problem:

The formula is $PMT = FV_{N,I} / ((((1 + (I / 12))^{N}) - 1) / (I / 12))$



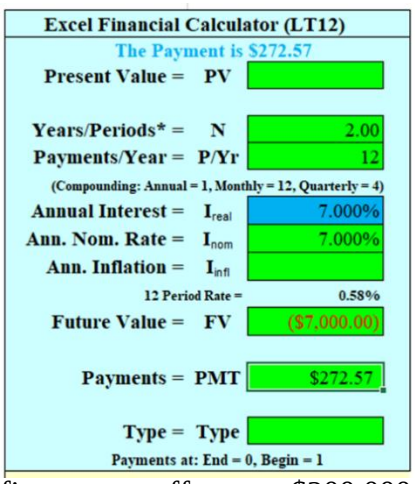
$PMT = \$7{,}000 / ((((1 + (0.07 / 12))^{50}) - 1] / (0.07 / 12)) = \$120.98$

To solve the second question, input the following information:

FV = –$7,000
N = 24
I = 7
PMT = ?

After solving for the payment, you will discover that you need to save $272.57 each month to save $7,000 in 24 months. If you do not have a financial calculator, use the following to solve this problem:

$PMT = \$7{,}000 / ((((1 + (0.07 / 12))^{24}) - 1] / (0.07 / 12)) = \$272.57$



As a general rule, it is better to save for a purchase than to borrow money for it because when you borrow you will have to pay interest instead of earning interest.

Problem 6: Present Value of Annuities

Let's try another sample problem using annuities; this time, we will be calculating the present value instead of the set payment amount.

There are two people who each want to buy your house. The first person offers you $200,000 today, while the second person offers you 25 annual payments of $15,000. Assume a 5 percent interest or discount rate. What is the present value of each offer? If you could take either offer, which person would you sell your house to?

1. First offer: The present value of this offer is $200,000 because the buyer can pay you all of the money today.

2. Second offer: This offer is a little different because you will not receive all of the money today; therefore, you must calculate the present value.

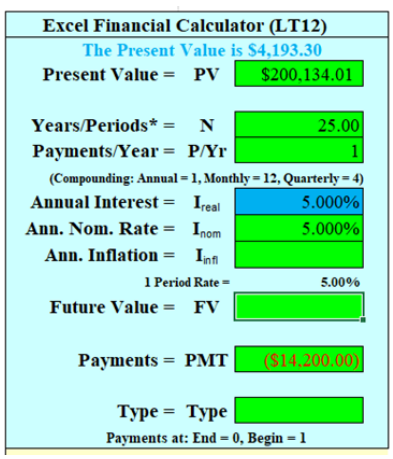
To calculate the present value of the first offer using a financial calculator, clear your calculator's memory, set the number of payments to one annual payment, and make sure your calculator is set to "end mode." Then, input the following information:

PMT = –$15,000
N = 25
I = 5
PV = ?

The present value of the second offer is $211,409. If you do not have a financial calculator, use the following formula to solve for the present value:

$$PV_{N,I} = PMT * (1 – (1 / (1 + I)^N)) / I$$

$$PV_{N,I} = \$14,200 * [1 – (1 / (1.05)^{25}] / 0.05 = \$200,134$$



Which is the better offer? The second offer has a higher present value: if we can assume that you don't need the money right away and that you are willing to wait for payments and confident the buyer will pay you on schedule, you should accept the second offer. As you can see from this example, it is very important that you know how to evaluate different cash flows.

Problem 7: Future Value of Annuities

Just as it is possible to calculate the present value of an annuity, it is also possible to calculate the future value of an annuity.

Josephine, age 22, started working full time and plans to deposit $3,000 annually into an IRA that earns 6 percent interest. How much will be in her IRA in 20 years? 30 years? 40 years?

To solve this problem, clear your calculator's memory and set the number of payments to one (for an annual payment). Set I equal to 6 and the PMT equal to $3,000. The formula is: $PMT * (((1 + I)^N)-1) / I$.

For 20 years: Set N equal to 20 and solve for FV. FV = $110,357
For 30 years: Set N equal to 30 and solve for FV. FV = $237,175
For 40 years: Set N equal to 40 and solve for FV. FV = $464,286

If Josephine increased her return rate to 8 percent, how much money would she have after each of the three time periods? How does this interest rate compare to the 6 percent interest rate over time?

Do the previous problems at 8 percent interest. Begin by clearing the calculator's memory. Set I equal to 8 and the PMT equal to $3,000.

For 20 years: Set N equal to 20 and solve for FV. FV = $137,286 ($26,929 more than she would earn at the 6 percent interest rate)
For 30 years: Set N equal to 30 and solve for FV. FV = $339,850 ($102,675 more than at the 6 percent rate)
For 40 years: Set N equal to 40 and solve for FV. FV = $777,170 ($312,884 more than at the 6 percent rate)

Your rate of return and the length of time you invest make a big difference when you retire.

Solve Problems Related to Amortized Loans

An amortized loan is paid off in equal installments (payments) made up of both principal and interest. With an amortized loan, the interest payments decrease as your outstanding principal decreases; therefore, with each payment a greater amount of money goes toward the principal of the loan. Examples of amortized loans include car loans and home mortgages.

To determine the amount of a payment, you must know the amount borrowed (PV), the number of periods during the life of the loan (N), and the interest rate on the loan (I).

Problem 8: Buying a Car

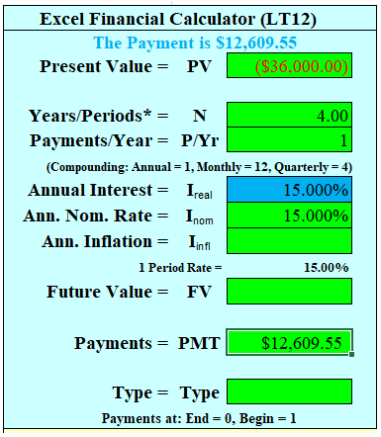
You take out a loan for $36,000 to purchase a new car. If the interest rate on this loan is 15 percent, and you want to repay the loan in four annual payments, how much will each annual payment be? How much interest will you have paid for the car loan at the end of four years?

Before solving this problem, clear your calculator's memory and set your calculator to one annual payment. Input the following information into your financial calculator:

PV = –$36,000
N = 4
I = 15
Solve for PMT = ? to get $12,609.55.
The formula is: $PMT = PV_{N,I} / ((1 – (1 / (1 + I)^N)] / I)$

The amount of interest you will have paid after four years is equal to the total amount of the

payments ($12,609.55 * 4 = $50,438.20) minus the cost of your automobile ($36,000); the total comes to $14,438.21. That is one expensive loan! In fact, the interest alone is more than the cost of another less-expensive car. If you want to buy this car, go ahead, but don't buy it on credit—save for it!



Problem 9: Buying a House

What are the *monthly* payments on each of the following mortgage loans? Which loan is the best option for a homeowner who can afford payments of $1,550 per month? What is the total amount that will be paid for each loan? Assume each mortgage is $250,000.

Loan A: 30-year loan with a fixed interest rate of 4.5 percent

Loan B: 15-year loan with a fixed interest rate of 5.75 percent
Loan C: 20-year loan with a fixed interest rate of 4.125 percent

Loan A. To determine the monthly payment for a 30-year loan with an 8.5-percent fixed interest rate, clear your calculator's memory, then set your calculator to 12 monthly payments and "end mode." Input the following to solve this equation:

PV = –$250,000
N = 360 (Calculate the number of monthly periods by multiplying the length of the loan by the number of months in a year: 30 * 12 = 360.)
I = 8.5/12
Solve for PMT = ?

Your monthly payment for this loan would be $1,266.71, and the total amount of all payments would be $1,266.71 * 360, or $456,017. Interest is $206,017.

The formula is: PV/((1-(1/(1+(I/P))^(N*P)))/(I/P))

Loan B. For a 15-year loan at 3.75 percent interest, follow the same steps explained above. This time, input the information listed below:

PV = –$250,000
N = 15 * 12 = 180
I = 3.75

PMT = ?

The monthly payment for this loan would be $1,818.06, the total amount of all payments would be $327,250 and the interest would be $77,250.10.

Loan C. For a 20-year loan at 4.125 percent interest, the calculations are still the same. Input the following in your financial calculator:

PV = –$250,000
N = 20 * 12 = 240
I = 4.125
Solve for PMT = ?

The monthly payment for this loan would be $1,531.47, the total amount of all payments would be $367,552 and the interest paid will be $117,552.

Considering the mortgage payment the homeowner can afford, the best financial option is Loan C—the 20-year fixed-rate mortgage at 4.125 percent interest. This loan would allow the homeowner to pay off the home in 10 fewer years than if he or she had the 30-year loan and to pay $77,250 less.

Problem 10: Becoming a Millionaire

Your friend thinks becoming millionaire is totally beyond her earning abilities. You, financial wizard that you are, plan to show her otherwise. Assuming your friend is 25 years old and will retire at age 65, and assuming a 6 percent interest rate, how much will she have to save each month to reach her goal of becoming a millionaire when she retires? How much each month if she earns 9 percent on her investments?

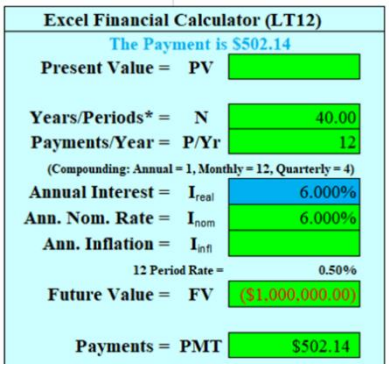
Clear your memory and set payments to monthly. FV = 1,000,000 N = (40 * 12) I = 6%, Solve for Payment (PMT).

PMT = $502.14. She will need to save $502 per month.

The formula is: $FV/(((1+(I/P))^{(N*P)} -1)/(I/P))$

At 89 percent interest:

Clear your memory and set payments to monthly. FV = 1,000,000, N = (40 * 12), I = 89%, Solve for Payment (PMT)
PMT = $286.4513.62. She will need to save only $28614 per month.



It's not that hard to become a millionaire if you invest a specific amount every month and can earn a modest interest rate.

Summary

The major goal of this chapter was to help you better understand the time value of money. This chapter also helped you understand how inflation impacts your investments.

Real return is the rate of return you receive after the impact of inflation. As discussed earlier, inflation has a negative impact on your investments because you will not be able to buy as much with your money in the future. Traditionally, investors have calculated real returns with the approximation method by simply using the nominal return minus the inflation rate. Although the approximation method is fairly accurate, it can give incorrect answers when it is used for precise financial calculations. Because of the possibility of error, it is preferable to use the exact formula: (1 + nominal return (r_n)) = (1 + real return (r_r)) * (1 + inflation (π)) = (1 + nominal return (r_n)) / (1 + inflation (π)) – 1.

Inflation is an increase in the volume of available money in relation to the volume of available goods and services; inflation results in a continual rise in the price of various goods and services. Because of inflation, you can buy fewer goods and services with your money today than you could have bought in the past.

An amortized loan is paid off in equal installments (payments) that are made up of both principal and interest. With an amortized loan, the interest payments decrease as your outstanding principal decreases; therefore, with each payment, you pay a larger amount on the principal of the loan. Examples of amortized loans include car loans and home mortgages.

An annuity is a series of equal payments that a financial institution makes to an investor at the end of each period (usually a month or a year) for a specific number of years. A compound annuity is a type of investment in which a set sum of money is deposited into an investment vehicle at the end of each year for a specific number of years and allowed to grow. Annuities are important because they can help you prepare for retirement and allow you to receive a specific payment every period for a number of years.

Assignments

Financial Plan Assignments

There is no specific part of your PFP on the Language of Finance. However, it is an integral part

of your work and analysis. As you read through this chapter, think about the purpose of each new financial idea: annuities, present value of an annuity, and future value of an annuity. Also review the uses of amortized loans and the calculations that concern them. Using either your financial calculator or the Excel financial calculator from the Learning Tools section, make sure you understand how to solve problems of amortized loans and annuities, including the present and the future value of an annuity. It is also critical that you understand the impact of inflation on returns. Make sure you understand the correct method for calculating real returns (the return after the impact of inflation).

Learning Tools

The following Learning Tools may also be helpful as you prepare your Personal Financial Plan:

Financial Calculator Tutorial (LT03)
This document is a financial calculator tutorial about most of the major financial calculators. It also includes the financial formulas if you would prefer to program your own calculator.

Excel Financial Calculator (LT12)
This Excel spreadsheet is a simple financial calculator for those who prefer to use spreadsheets. This tool can perform most of the functions of a financial calculator, including present value, future value, payments, interest rates, and number of periods.

Review Materials

Terminology Review

Amortized Loan. An amortized loan is a loan paid off in equal installments (payments) made up of both principal and interest. With an amortized loan, the interest payments decrease as your outstanding principal decreases; therefore, with each payment a greater amount of money goes toward the principal of the loan.

Annuity. An annuity is a series of equal payments that a financial institution makes to an investor; these payments can be made at either the beginning or end of each period (usually a month or a year) for an individual's lifetime or for a specific number of years. To set up an annuity, an investor and a financial institution (for example, an insurance company) sign a contract in which the investor agrees to transfer a specific amount of money to the financial institution, and the financial institution, in turn, agrees to pay the investor a set amount of money at the end of each period for a specific number of years.

Compound Annuities. With a compound annuity, you deposit a set sum of money into an investment vehicle at the end of each year; you deposit this amount for a specific number of years and allow that money to grow.

Future Value of an Annuity. The future value of an annuity is the value of a set of

recurring payments at specific dates in the future. It measures how much you will have in the future given a specific return or interest rate.

Inflation. An increase in the volume of available money in relation to the volume of available goods and services. Inflation results in a continual rise in the price of various goods and services. In other words, because of increased inflation, your money can buy fewer goods and services today than it could have bought in the past.

Present Value of Annuity. The present value of an annuity is the current value of a set of recurring payments at specific dates in the future, given a specified rate of return or interest rate.

Real Returns. A real return is the rate of return you receive after the impact of inflation. Traditionally, investors have calculated the real return (r_r) as simply the nominal return (r_n), or the return you receive, minus the inflation rate (π). This method is incorrect. It is preferable to use the following formula: (1 + nominal return (r_n)) = (1 + real return (r_r)) * (1 + inflation (π)). To solve for the real return, divide both sides of the equation by (1 + inflation (π)). Once you've divided, the equation looks like this: (1 + nominal return (r_n)) / (1 + inflation (π)) = (1 + real return (r_r)). Then, subtract one from both sides and reverse the equation to get the following: Real return (r_r) = [(1 + nominal return (r_n)) / (1 + inflation (π))] – 1.

Review Questions

1. What is an annuity?
2. How do you set up an annuity?
3. What is a compound annuity?
4. What is the relationship between interest rate and present value?
5. What is inflation? How does it impact investments?

Case Studies

<u>Case Study 1</u>

Data

Lee is 35 years old and makes a $4,000 payment *every year* into a Roth Individual Retirement Account (IRA) (this is an annuity) for 30 years.

Calculations

Assuming the discount, or interest, rate Lee will earn is 6 percent, what will be the value of his Roth IRA investment when he retires in 30 years (this is future value)?

Note: The formula is a bit tricky. It is:

FV_N = Payment * $(((1 + I)^N) – 1)/I$ (This is the future value of an annuity factor $_{N,I}$)

Case Study 1 Answer

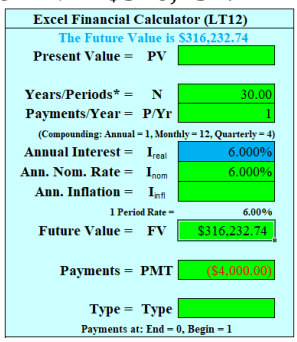
There are two ways for Lee to solve the problem. Using the formula, the problem is solved this way:

$FV_{N,I}$ = Payment * $(((1 + I)^N) – 1) / I$ = FV = $4,000 * $[(1.06)^{30} – 1] / .06$ =

$316,232.74

If you are using a financial calculator, clear the calculator's memory and solve:

1 = P/Y (payments per year)
4,000 = PMT (payment)
6 = I (interest rate)
30 = N (number of years)
Solve for FV = $316,232.74



Case Study 2

Data

Janice will make a *yearly* $2,000 payment for 40 years into a traditional IRA account.

Calculations

Given that the discount, or interest, rate is 6 percent, what is the current value of Janice's investment in today's dollars? The formula is:

$PV_{N,I}$ = Payment * $[1 – (1 / (1 + I)^N)] / I$ (the present value of an annuity factor $_{N,I}$)

Case Study 2 Answer

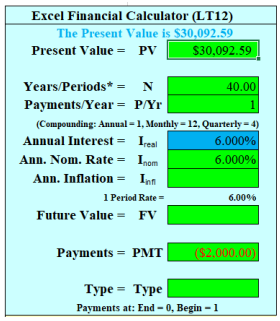
Using the formula, the calculation is:

$PV_{N,I}$ = Payment * $[1 – (1 / (1 + I)^N)] / I$ = PV = 2,000 * $[1 – (1 / (1.06)^{40})] / .06$ = $30,092.59

Using the financial calculator:

Clear memories and use the following:

1 = P/Y
2,000 = PMT
6 = I
40 = N
Solve for PV = $30,092.59



Case Study 3

Data

Brady wants to borrow $20,000 dollars for a new car at 13 percent interest.

Calculations

He wants to repay the loan in five *annual* payments . How much will he have to pay *each year* (this indicates present value)? The formula is the same formula that was used in the previous problem:

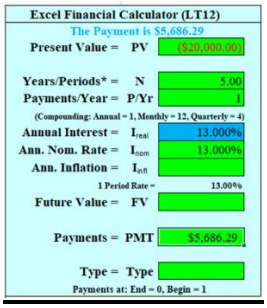
PV_N = Payment * ($PVIFA_{I,N}$)

Case Study 3 Answer

Using the formula, put Brady's borrowed amount into the equation and solve for your payment. $PV_{N,I}$ = Payment * $[1 – (1 / (1 + I)^N)] / I$ = PV = 20,000 = Payment * $[1 – (1 / (1.13)^5)] / .13$ = $5,686.29 per year.

Using a financial calculator, clear the calculator's memory and use the following:

1 = P/Y
20000 = PV
13 = I
5 = N
Solve for PMT = $5,686.29



Case Study 4

Data

Kaili has reviewed the impact of inflation in the late 1970s. She reviewed one of her parent's investments during that time period and discovered that inflation was 20 percent and that her parent's investment made a 30 percent return.

Calculations

What was her parent's real return on this investment during that period?

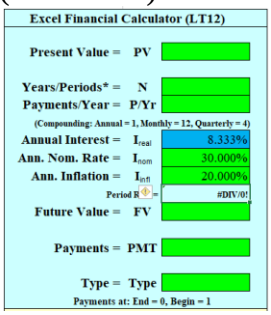
Case Study 4 Answers

The traditional (and incorrect) method for calculating real returns is

Nominal return – inflation = real return. This formula would give you a real return of 10%: 30% – 20% = 10%.

The correct method is (1 + nominal return) / (1 + inflation) – 1 = real return

(1.30 / 1.20) – 1 = 8.33%.



In this example, the traditional method overstates return by 20 percent ((10% / 8.33%) – 1). Be very careful of inflation, especially high inflation!

11. Insurance 1: The Basics of Insurance Protection

Introduction

The purpose of insurance—and financial planning in general—is to make our lives more predictable from a financial standpoint. All people face the risk of certain types of loss every day: these risks pertain to our health, automobiles, homes, and many other aspects of our lives. Through the appropriate use of insurance products, you can make the risks of loss more manageable and predictable; managing your risks can bring you more peace of mind as you go about your daily activities and as you seek to achieve your personal and family goals.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Recognize the importance of insurance.
B. Understand what leaders have said regarding insurance and the key principles of insurance.
C. Understand and create your Insurance Plan.

Recognize the Importance of Insurance

Insurance is a legal contract between you and an insurance firm. The insurance firm agrees that if you pay a specified amount, known as a premium, the firm will compensate you for certain kinds of losses or events, such as death, sickness, accident, loss of ability to work, and legal expenses.

There are many types of insurance, and because of the different natures of various types of risk, we have divided our discussion of insurance into sections about life insurance, health insurance, auto insurance, homeowner's/renter's insurance, and liability insurance.

The Importance of Insurance

The concept of insurance was sparked by the idea of pooling risk. People with families and valuable property have always faced the possibility of loss; the possibility of such loss has caused individuals so much concern that they have pursued options for the replacement of their loss. Thus, the practice of insuring property for its replacement value evolved. Life insurance, the practice of replacing the economic value of a human life, has also grown out of this same thought process.

Insurance allows you to transfer the financial risk of certain types of losses to another entity, usually an insurance company, which is organized according to stringent federal and state

regulations specifically for the purpose of protecting you against losses. By transferring the financial risk to such an entity and paying the required premiums, you can receive compensation for loss in the form of either a lump sum or an annual amount of money. This compensation can maintain or replace your income stream. In this way, insurance helps you and/or your family maintain financial stability if you get sick or become unable to work because of disability, injury, or death.

If you have insurance but do not incur a loss for which you had coverage, you lose only the premium you paid, although some insurance policies do have a return-of-premium feature. Even though a particular loss may not occur, you still receive value from the premium paid in the form of peace of mind and the knowledge that you are taking care of your family. If you do not have insurance and you are sued, get sick, or die, you and your family may suffer serious consequences: your family may have to rely on only one income or a reduced income to get by, and your children may not be able to achieve important goals. Insurance allows you to transfer the financial responsibility for risks like illness, disability, and death to an institution capable of handling these risks.

Managing Risk

An important part of determining the right level of insurance you should have is understanding risk. Risk, in terms of insurance, is uncertainty concerning the occurrence of a specified loss.

There is risk in all areas of life, including your lifestyle, your career, your environment, and so on. You can manage risk in four ways: you can avoid it, reduce it, assume it, or transfer it.

> You can **avoid** some risks. For example, you can avoid some health risks by taking care of yourself, eating well, exercising, and avoiding high-risk activities where you might be hurt, such as skydiving. You can avoid some financial risks by diversifying your investments.
>
> You can **reduce** some risks by adding fire extinguishers and burglar alarms to your home, adding airbags to your car, using seat belts, and getting regular medical checkups. By taking these precautions, you can reduce the potential damage of some risks.
>
> You can **assume** some types of risk through self-insurance. For example, I used to own a 1973 Ford Pinto. Instead of carrying full-coverage insurance, which would have allowed me to get the car fixed if it were in an accident, I carried only liability insurance. If I had been in an accident, I would have had to pay to have the car fixed myself (in other words, I assumed the risk of repair and collision costs). If the costs are not too high, you can assume some risks by assuming the potential for additional costs, i.e., a higher deductible, and keeping a slightly larger emergency fund.
>
> You can **transfer** risk to others by purchasing insurance and thus transfer financial responsibility for a specific risk—death, disability, liability, and so on—from yourself to

an insurance company.

Once you understand how to manage risk, you can determine which risks you can avoid, reduce, or assume, and which risks you should transfer to an insurance company or other entity.

The Key to Insurance

The key to insurance is balancing the cost of reducing risk with the potential severity of a loss. Should you insure against all losses? While this may be possible for some people, it is not possible for most—the costs would be too high.

The key is to realize that some losses are not as critical as others. You should insure yourself against high-severity losses that rarely occur—those that would have a major impact on the financial condition of you and your family—such as death, illness, auto or home accidents, and accompanying liability issues. And you should avoid, reduce, or assume the other risks.

You can analyze and classify risk by looking at two important areas. The first area is the frequency of the potential loss: how often could the loss happen? Could it happen every month, every year, or just once in a lifetime? The second area is the severity of the loss: how severe would the implications be for you and your family if the loss occurred? These factors can be charted in Table 1.

Understand What Leaders Have Said Regarding Insurance and Key Principles

Acquiring insurance is an important step toward becoming financially self-reliant. We have been counseled by our leaders to live within our means, to put our lives in order, to provide for our future, and to obtain adequate insurance to meet our responsibilities as parents. We have also been commanded by the Lord to take care of our families.[1] Marvin J. Ashton offered the following counsel on insurance:

> It is most important to have sufficient medical, automobile, and homeowner's insurance and an adequate life insurance program. Costs associated with illness, accident, and death may be so large that uninsured families can be financially burdened for many years.[2]

N. Eldon Tanner also commented on this topic, saying "Every family should make provision for proper health and life insurance."[3]

Understand the Key Principles of Insurance Planning

Insurance should be an important part of your Personal Financial Plan. There are several different approaches to building an effective insurance plan. One approach is to focus on specific products; however, insurance products will and do change over time as new products are developed. A better method is a principles-based approach. While products may change over time, the principles regarding effective insurance planning do not change.

Table 1. Risk Matrix for Understanding Insurance

		Frequency of Loss	
		High	Low
Severity of Loss	High	Avoid Reduce	Transfer
	Low	Reduce Assume	Reduce Assume

The key to insurance is to balance the cost of reducing risk with the severity of the potential loss. Insure against high-severity losses that rarely occur—those events that could have a major impact on your financial situation. Reduce and avoid other risks to the extent that you can. Finally, self-insure against smaller risks that will have limited impact on your financial situation. Use insurance for what insurance does best. Be careful in using insurance products as an investment, or investment products as insurance.

So what are the key principles of insurance planning that we can apply to help us manage our various insurance products wisely? The following are a few ideas to help you understand the key principles of insurance planning:

1. Know Yourself, Your Vision, Goals, and Plans. Insurance is a tool that can help you plan for the future while living in the present. However, before you can develop an insurance plan, you must know what is important to you and what you want from life. Insurance is not an end in itself: it is a tool to help you achieve your vision and personal goals. What are your goals? One goal may include replacing your salary should you die.

Once you determine your goals, the challenge becomes figuring out which insurance products can help you reach your goals the fastest. You should understand each insurance product well. While it will take a significant amount of time to understand insurance products individually, your understanding of the main insurance products will increase with a general overview. Recognize that your insurance needs will change over time. Plan for the future, but live in the present.

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of insurance, and know your budget and how much you can afford. Before you can determine which insurance products you need, you must set a budget. How much can you afford to spend on insurance needs? It is important to be cost-effective in your insurance planning. Insurance is a long-term product, and certain insurance products have higher premiums than others; it makes no sense to begin an insurance program you cannot continue. As you think about your goals and insurance needs, recognize the potential for change in your income—or even loss of income—and the possible impact of such changes on your budget.

However, you need insurance to help you face risks that are beyond your control. You will face financial responsibility if certain adverse events occur. In making insurance decisions it is important to purchase all insurance that is necessary to allow you to survive the foreseeable adverse events of life. If your current consumption does not leave enough money in your budget to purchase necessary insurance, then you may need to reevaluate your priorities.

4. Understand in Detail the Costs and Benefits of Each Insurance Product. Knowledge is power. If you are to make wise decisions in your insurance planning, it is critical for you to understand in detail the costs, benefits, and risks of insurance products and their providers. Do your homework early and you will better understand what various insurance products can and cannot do. Weigh the costs and benefits carefully before you purchase a particular insurance product. Many insurance products have high beginning or up-front expenses and are very expensive to modify or change after the policy is in force.

Also, compare products across companies, and make sure you understand the differences between competing products. Ask for help from your insurance agent or potential insurance agent if you don’t understand the differences.

5. Insure Against High-Cost, High-Severity Losses Only. Insure yourself against events that would have a major economic impact on you or your family. Self-insure against events that would have a smaller economic impact. Balance your need for insurance with the cost of the insurance. The goal is to use insurance to provide funds in those most adverse circumstances where your personal resources would not be sufficient.

6. Work Only with High-Quality Individuals and Institutions. Trust is a critical component of your insurance relationship. Since insurance is a long-term commitment, you want a relationship with an institution that will be willing and able to help you now and in the future. Work with individuals and institutions that make you comfortable. If you feel pressure in any way to purchase a product, find another insurance agent; you do not want an insurance agent who is there just for the sale. The key is to find an agent who will work in your best interests and help you achieve your goals, while at the same time finding an insurance agency that pays up when agreed so you don’t have to dispute every charge.

Know how insurance agents are paid. Minimize the potential for conflicts of interest by understanding the costs of insurance products and how insurance agents are paid for selling these products. For example, the commission paid on cash-value life insurance policies to insurance agents can be *10 to 20 times higher* than commissions paid on term life insurance policies with the same face or policy amount. While the former are much more complex products and may have additional benefits over the alternatives, it is important to understand the potential for conflicts of interest.

Evaluate the insurance company carefully. You want to make sure that your insurance agent and the company will be around for a long time. Make sure the company is financially sound before you purchase their products. Getting your insurance products from the firm with the lowest prices will do you little good if the insurance company goes out of business. You can also evaluate the insurance company by checking the company's rating with various insurance-rating firms.

7. Review Your Insurance Needs Annually. Remember, your insurance needs may change over time as your family situation, investment portfolio, and work situation change. Use wisdom in planning your insurance coverage and in making changes to your policies. Be especially careful of the costs of making changes—many insurance products have higher up-front or beginning costs. Be an informed consumer of insurance products.

Finding Balance

As you work on managing consumer loans, finding balance among doctrines, principles and application is important in helping you become better at managing insurance. Below are a few ideas.

Principles	Doctrines
Know yourself, your vision, goals and plans	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Know your budget and what you can afford	Accountability
Understand the tools of insurance and use carefully	Stewardship
Insure against high-cost high-severity events	Agency
Work with good people and institutions	Stewardship
Review your insurance needs annually	Stewardship

From Obedience to Consecration

As we work on understanding and managing our insurance needs, finding balance among doctrines, principles and application is important. We are not just insurance consumers,

> We are children of a King (identity), striving to live worthy of the Spirit (obedience), learning the critical areas of insurance (stewardship), so we can make wise choices in our use of insurance products (agency). Our goal is to maximize our protection and minimize

costs in each of the five key areas of insurance (stewardship), so we can get the protection we need at a cost that we can afford (stewardship), so that we can accomplish our individual missions and our individual and family vision and goals.

Understand and Create Your Insurance Plan

As you work on making insurance work, you can see the importance of following the principles. Becoming a wise insurance consumer is important to helping you achieve your personal and family vision and goals. Following are ideas as you put your Insurance Plan together. Being a knowledgeable and wise consumer of insurance products will allow you to get the coverage you need at the lowest possible costs.

Vision

- Likely from your Plan for Life. It may also include:
  - Insurance will be used for what it does best; providing security for myself and family.
  - We will not mix insurance and investments.
  - Insurance will help us with financial security.

Goals

- We will always have adequate auto, homeowners/renters, and health insurances.
- We will always have an Emergency Fund large enough to hold us over until government. disability is available. That way we can reduce the need for private disability insurance.
- We will not mix insurance and investments as each do their respective elements well.

Plans and Strategies

Life Insurance: Students and young marrieds

- If married, buy a small $250k - 20 year annual renewable term product with the convertibility option. Once children come, ladder on additional renewable convertible term products.

Married with families

- If term insurance rates have decreased, you can purchase a new product then cancel the old.

Empty nesters

- As your investment assets increase and children leave the home, you can allow some of the policies to terminate without renewing as the need for income replacement is diminished.

Health Strategies: Students and young marrieds

- If married without kids, compare your group plans to a Health Savings Account to see which plan has the best coverage for the costs

Married with families

- Once children come, switch to a traditional group plan to meet your family needs.
- Use a flexible spending plan if offered by your employer to reduce your medical expenses.

Empty nesters

- As children leave home, make adjustments to your health insurance to be cost effective with your coverage.

Disability

- Keep my Emergency Fund at 4 months so if I am disable, I will have sufficient to live on until Social Security or Workers Compensation is available.
- Live health and keep running.

Asset Protection: Students and young marrieds

- Have adequate renters insurance.—it is cheap.
- Have adequate auto insurance, with a minimum 100/300/100 split coverage initially.

Married with families

- Raise your split coverage to 250/500/100 to offer more protection when you have teenage drivers.
- Make sure teenage drivers take "safe-drivers courses" to reduce their insurance costs.

Empty nesters

- Consider an umbrella policy to reduce the risk of future litigation expense as assets increase.

Constraints

- Not living on a budget will make it difficult to save and to have adequate insurance.
- Getting caught up in the things of the world will make it difficult to save.

Accountability

- You will share your vision and goals with your spouse and children.
- You will remember these things in prayer with Heavenly Father each week.

Summary

The insurance industry is always changing, and it can be a challenge to understand the many insurance products available. Each of the many products the insurance industry offers has unique benefits and costs. Understanding what Church leaders have said regarding insurance will help you realize the importance of insurance as part of your Personal Financial Plan and your family's

financial plan. If you understand how insurance can help you, you will be better prepared for the challenges you may encounter in your life. Finally, by understanding and applying the principles of insurance planning as they are outlined in this chapter to create your Insurance Plan, you can make sure the products you choose are the products that will most likely help you achieve your personal goals.

Assignments

Financial Plan Assignments

In this section you will complete your Insurance Plan. I recommend you use the PFP Insurance Template (LT01-09) as a starting point. As you learn about the different types of insurance in this course, think about the different ways to manage risk and the key principles and doctrines of insurance planning. These principles are important because they provide a structure to help you evaluate the different types of insurance and the uses of different insurance products.

Think about these principles as you read through the succeeding chapters on health insurance, life insurance, auto insurance, property insurance, and liability insurance and as you develop vision, goals, and plans and strategies for each of these types of insurance. Think about how you can apply the principles of risk management and insurance planning to the different types of insurance. You will incorporate these principles in the assignments for the succeeding chapters.

Review Materials

Terminology Review

Earnings Multiple Approach. This is one approach for determining the amount of life insurance required. The goal is earnings replacement. The earnings multiple approach seeks to replace the annual salary stream of a bread winner for X years, normally 10 – 15 times gross salary.

Insurance. Insurance is a tool help you achieve your personal and family goals. It is a product that transfers the risk of certain types of losses or events from an individual to another institution. By transferring risk, it can help the individuals achieve specific goals if they die, get sick or become unable to work. But it is a tool that needs to be understood and used wisely.

Investment Risk. This is the risk of who takes responsibility for the investment outcome, the insurance company or the insured.

Life Insurance. This is insurance that provides compensation to your beneficiaries should you die prematurely. It transfers the economic loss of death from an individual to an insurance company by way of a life insurance contract. It can help us take care of our own and extended families should we die.

Mortality Risk. This is the risk that the insured dies outside the contract period and is therefore not covered by insurance.
Needs Approach. This is an approach for determining the amount of life insurance that is required. It determines the total needs of the beneficiaries which includes immediate, debt elimination, transitional, dependency, spousal life income, education, and retirement needs. It is the most detailed of the approaches.
Permanent Insurance. Permanent insurance is an insurance contract that is purchased for the entire life of the policy holder with premiums divided between death protection and savings. Provides insurance that cannot be cancelled, may be used for estate retirement, and savings. It is complex, expensive, and not transparent, and unless premiums are paid, it can expire worthless. Please note that certain permanent products are not permanent, i.e. they can lose money.
Risk Pooling. It is the process where individuals transfer or share their risks with others to reduce catastrophic losses from health problems, accidents, lawsuits, etc.
Term Insurance. Term insurance is insurance protection for the insured over a specific term or time period. They may be renewable or non-renewable policies. It is the least expensive form of insurance and the death benefit coverage is only for a specific term.

Review Questions

1. What is insurance?
2. What is the purpose of insurance?
3. In regard to insurance, what is risk? What are the four ways to manage risk?
4. In Table 1, what are the two ways in which you can analyze risk?
5. What is the key to insurance?

Case Studies

<u>Case Study 1</u>

Data

Bill is 25, married with one child, and does not have any life or health insurance. He has a friend that sells insurance. His friend wants to talk to him about his insurance needs.

Application

What questions should Bill ask as he considers whether to work with this friend for his insurance needs?

Case Study Answers

The answers for these questions are based on information from Arthur J. Keown's *Personal Finance, Turning Money into Wealth Student Workbook*. [4]

1. Are you a full-time insurance agent?

   Work with agents who work full-time as insurance agents. This gives greater assurance that your agent is knowledgeable about the products you need and the products he or she represents.

2. How long have you been a full-time insurance agent?

Work with someone who is experienced and has been established for a number of years. While a new agent may be competent, an experienced agent will be more likely to be competent.

3. Which life insurance companies do you represent?

Generally, it is better to work with someone who represents at least one company with a top rating from A.M. Best for 10 consecutive years (see www.ambest.com/ratings for information. You can register for free and view the financial strength and issuer credit ratings on the different insurance companies you are considering). If the agent works with multiple companies, he or she may be able to offer more competitive products than captive agents (agents who only work for a single insurance company).

4. Are you a CLU (a Chartered Life Underwriter)?

A CLU is preferred, especially if you are seeking advice or considering insurance other than term. Realize that an insurance agent is only able to sell things he or she is licensed to sell.

5. Will I be allowed to keep the insurance proposal you prepare for me?

You should not consider an agent who won't allow you to keep the insurance proposal. You should be able to take the proposal home and review it on your time.

6. Would you be willing to inform me of the commission you'll receive on any policies you recommend?

You want to make sure the agent is working on your behalf. Knowing the agent's commission on various policies may help you avoid policies that benefit the agent more than you. If the agent is not willing to share the amount of his or her commission on each product with you, go with another agent who will.

7. Do you have any clients who are willing to recommend you?

Your agent should either supply you with names of satisfied clients or share testimonial letters from others. You should not consider an agent without recommendations.

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[1] 1 Timothy 5:8
[2] "Guide to Family Finance," *Liahona,* Apr. 2000, 42.
[3] "Constancy Amid Change," *Ensign,* Nov. 1979, 80.
[4] Prentice Hall, New Jersey, 2007, p. W47

12. Insurance 2: Life Planning with Life Insurance

Introduction

Once you understand the basics of insurance, your understanding of the importance of life insurance increases greatly. Much of what is written on the subject of life insurance is confusing and difficult to grasp. The purpose of this chapter is to help you to more clearly understand the benefits and costs of the different types of life insurance.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand the benefits of life insurance and the five key questions.
B. Understand the different types of term life insurance.
C. Understand the different types of permanent life insurance.
D. Determine which type of insurance is best for you and know the steps to buying life insurance.
E. Understand plans and strategies for life insurance.

Understand the Benefits of Life Insurance and the Five Key Questions

Life insurance provides your beneficiaries compensation in the event of your death. Death is a low-frequency (you can only die once) but high-severity risk. Life insurance is essentially contingent financing: it will help support your family in the event of your death. The financial loss due to death is significant. Life insurance can help us take care of our nuclear and extended families financially even beyond death.

Life insurance contracts are designed to help consumers achieve a variety of individual and family goals. Life insurance marketing may be confusing, and recommendations and policy language differ from company to company. It is critical to understand the benefits of life insurance so you can make wise choices regarding it.

Benefits of Life Insurance

The greatest benefit of life insurance is insuring your beneficiaries against the economic loss caused by death. While the payments can never replace the person lost, they can replace his or her ability to pay for living expenses, home mortgages and taxes, education expenses, and other costs. At a critical time, the payments may make it possible for the surviving spouse to remain in the home and concentrate on raising the surviving children. However, life insurance offers four

additional benefits that may be of interest to you as you develop your Personal Financial Plan: life insurance can benefit you with estate planning, insurability, retirement planning, and saving.

Life insurance proceeds may be used in estate planning to ensure that sufficient funds are available to pay estate settlement costs after death (debts, taxes, legal costs, burial expenses, etc.). Proceeds may help heirs receive as large a share of inheritance assets as legally possible. In addition, proceeds can be used to ensure that inheritance assets, such as businesses, do not have to be sold at discounted prices to raise funds for estate taxes or other liabilities.

Permanent life insurance products offer guaranteed insurability. Once you have a contract with the insurance company, your insurance contract cannot be canceled unless you fail to make payments. Once you have this contract, regardless of your medical condition, you cannot be denied the life insurance agreed upon.

Life insurance may also be used for retirement planning. When retirement income is taken from the cash value of an insurance policy, it can be received on a tax-favored basis. The cash-value portion of life insurance, after mortality costs and fees, may gain interest or capital gains that are exempt from taxes. This extra interest or capital gains may be saved for retirement. Life insurance also allows you to borrow against the cash-value portion of your policy and, in essence, receive a low-cost loan. Moreover, when you borrow against the cash-value portion of your policy, you don’t have to sell the permanent assets as you would with a normal investment account (resulting in capital gains or losses). Instead, the insurance company actually makes a loan to you against the cash-value portion of the policy.

Finally, life insurance can be a type of forced savings account. For those without the discipline to make monthly payments into a savings or investment program, life insurance can be a part of an overall savings strategy. The individual can purchase certain types of permanent life insurance products with low fees and mortality expenses, and can direct, to a degree, where the investment portion of the monthly premiums are invested. When needed, the individual can borrow against the cash value of the policy for a tax-free loan.

Remember, insurance is never your best investment, and investment is never your best insurance. The goal is to use insurance for what it does best and investment for what it does best. Be careful when combining the two.

Five Key Questions about Life Insurance

You should understand the following important terms as you learn about life insurance:

> **Beneficiary:** The recipient of benefits in the event of the death of the insured.
>
> **Cash value:** The total account value that is available to the policy owner while he or she is alive. Most policies have both guaranteed and non-guaranteed elements of the cash value. This means that some elements, such as a minimum return each year, may be

guaranteed, and other elements, such as may vary with the instrument in which the cash value is invested, may not be guaranteed. The cash value is reduced by any loans or applicable surrender charges.

Face value: The basic benefit the insurance company is to pay the beneficiaries; the face value is due upon the death of the insured. Total benefits may be higher if there have been policy additions.

Insured: The person whose life is covered by the insurance policy.

Policy owner: The individual or business that pays for and owns the insurance policy.

Premium: The payment for an insurance policy. Premiums can be paid monthly, quarterly, semiannually, or annually. Premiums may build cash value in certain insurance products; this cash value may be used to pay costs.

There are five important questions you should ask yourself about life insurance:

1. Why Should You Have Life Insurance?

Life insurance provides financial compensation to your beneficiaries in the event of your death. This type of insurance can help you prepare for major catastrophes and accidents; life insurance also yields some living benefits, or benefits that are available before death. Paul wrote, "But if any provide not for his own, and especially for those of his own house, he hath denied the faith, and is worse than an infidel."[1] Having adequate life insurance can help us fulfill this commandment even after we die.

2. How Does Life Insurance Work?

Life insurance is an example of risk pooling, which means that individuals transfer or share their financial risks with others to reduce potential catastrophic losses due to death, accidents, or health problems. While everyone pays into this insurance pool, because there are several participants and hopefully few recipients, the cost per participant is small because expenses are shared among the large number of participants.

There are two main risks that life insurance can share or transfer: mortality risk and investment risk. Mortality risk is the risk that the insured dies outside of the contract period and is therefore not covered by insurance. Some insurance contracts must be renewed each year and are therefore very risky because health problems or other concerns may make an individual unable to obtain coverage. Other products cannot be canceled by the insurance company (except in the case of nonpayment by the policy owner) and therefore ensure mortality coverage.

Investment risk has to do with who takes responsibility for the investment outcome; with some policies it is the individual who takes responsibility and with others it is the insurance company.

3. Who Needs Life Insurance?

Any individual whose death would create financial hardship for his or her dependents or business should have life insurance. This includes the following types of individuals:

- Single or married parents with children or other dependents.
- Married, single-income couples where the nonworking spouse has insufficient work skills or savings to survive should the breadwinner die.
- Business owners who want the value of their businesses to be passed on to their heirs or who want to preserve the value of their businesses if a key person is lost.
- Those whose estates exceed the tax-free transfer threshold for estates or who need additional liquidity at the time of death to avoid discount sales of estate assets.

While life insurance may offer benefits for other people in addition to those listed above, those benefits are not necessary for every individual.

4. How Much Life Insurance Is Necessary?

The decision regarding how much life insurance you need should be made individually. An earlier edition of the *Handbook for Families* recommends,

> Insure the family's breadwinner first, then others, if desired, as income permits. At a minimum, get enough life insurance to pay for such things as a funeral, taxes, mortgage on the home, car payments, and other debts. The next priority should be to get enough insurance that, supplemented by any government retirement benefits the surviving spouse may be entitled to, there will be sufficient to provide for the family and to make provisions for the children's education and missions. [2]

I like the framework that recommends minimum insurance first, then additional priorities. There are two different methods of determining how much life insurance you need: the earnings multiple approach and the needs approach.

With the **earnings multiple approach** the goal of having life insurance is earnings replacement. This approach has the goal of replacing the annual salary stream of a breadwinner for a certain number of years, or until the children are raised and the surviving spouse is financially stable and retired. Normally, an amount of 5 to 15 times your gross salary is recommended. Generally, most insurance companies will not insure an individual for more than 20 times his or her annual income. There is a three-step process for using the earnings multiple approach:

> *1. Adjust the pre-incident salary down to compensate for the reduction in household expenses.* Generally, a family's expenses decline in a predictable manner in the event of the death of an adult family member. The larger the family size, the less the percentage of total family expenses will drop (see Table 1).
>
> *2. Choose the appropriate interest rate to match the assumed after-tax and after-inflation*

earnings on a policy settlement. Interest rates affect insurance policies in that the higher the market interest rates, the more can be earned on investments, including money paid by an insurance company. If you think future market interest rates will be higher, your beneficiaries will not need as large an insurance settlement as would be necessary if market interest rates were lower.

Table 1. Percent Reduction in Living Expenses for Families

Family members after death	Reduction in living expenses
1	30%
2	26%
3	22%
4	20%
5	18%

To get an idea of how interest rates and the amount needed each year are related, see Table 2. If you needed $50,000 at the beginning of each year for the next 40 years and market interest rates were five percent, you would need to invest $857,954 in an annuity which would give you that $50,000 each year. If market interest rates were three percent, you would need to invest over $1 million in life insurance proceeds. Clearly, interest rates have an impact on insurance needs.

Table 2. Amount Needed for a $50,000 Annual Annuity

Years in Retirement	3%	4%	5%	6%
40	$1,155,739	$989,639	$857,954	$752,315
30	$980,022	$864,602	$768,623	$688,242
20	$743,874	$679,516	$623,111	$573,496
10	$426,510	$405,545	$386,087	$368,004

This table shows the amounts you need to invest to obtain a $50,000 annual payment or annuity for the following years in retirement at the indicated market interest rates.

Once life insurance proceeds are paid to the beneficiaries, the proceeds should be invested with the goal of providing a specific amount of money each year, or an annuity, to meet the beneficiaries' needs and expenses. Additionally, an annuity could be purchased or an annuity settlement option in the policy elected, which would guarantee a specific payment each period for a specific number of periods. Investing these funds will ensure that funds are available to pay expenses in a timely manner.

3. Determine the income stream replacement and annuity. The income stream replacement is how much money the beneficiaries will need each period or year and how long they will need that income stream. Once you have determined how much you need each period and for how

long, you can calculate the amount of money needed to provide the required income stream.

The **needs approach** for determining the amount of life insurance needed has a different goal from that of the earnings multiple approach. The goal is to meet the total financial needs of the household after the death of a breadwinner, both at the time of death and in the future. To calculate the necessary amount of life insurance according to this approach, add up all of your funding needs to determine the total needs of your beneficiaries. Include immediate needs, debt elimination, transitional funds, dependency funds, spousal life income funds, spousal education funds, children's education funds, and retirement income funds. Subtract current insurance coverage and other available assets from this total. There is a four-step process for calculating the needs approach:

1. *Add up all funding needs.* This inventory of funding needs is a very detailed description of the total needs of the family. The total needs of the beneficiaries include the following: immediate needs, such as needs for a funeral and other expenses; debt elimination needs, such as paying off credit card debts and mortgages; transitional needs, which include helping the spouse gain needed skills for better employment if necessary; dependency needs, such as taking care of and educating children; spousal life income needs, such as taking care of the spouse so he or she does not have to work; and education and retirement needs, such as taking care of the surviving spouse in retirement.

2. *Subtract current insurance coverage and other available assets.* The result gives you the amount of additional coverage you will need.

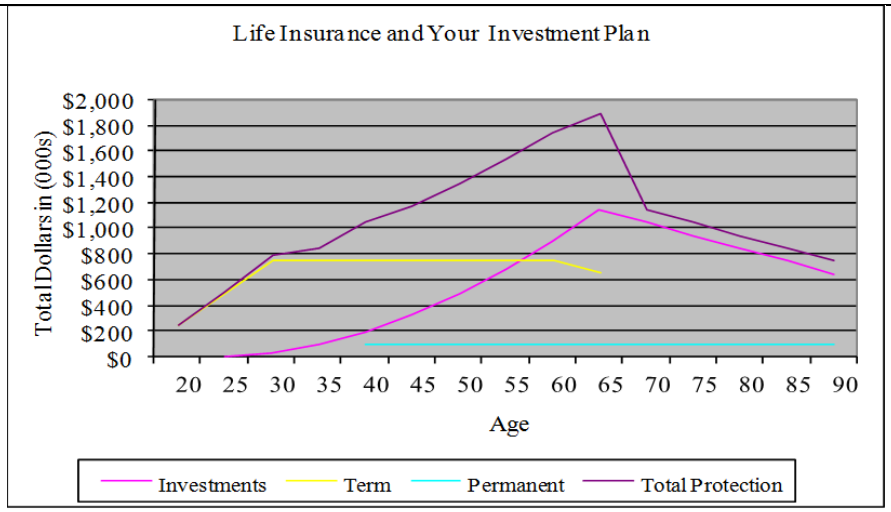
3. *Determine the income stream that would be needed to meet the family needs, and then calculate the amount of money required to provide the needed annuity* (see Figure 2). The difference between your total needs and your current coverage and available assets determines the amount of additional insurance coverage that will be necessary to meet the needs of dependents in the event that the breadwinner dies. Some couples find it essential to have two breadwinners, in which case couples should consider having life insurance for both spouses.

If your goal for having life insurance is income replacement, recognize that your income needs will change over time. Depending on your salary, the size of your family, and the growth of your investment assets, the amount of income that will need to be replaced varies throughout your life: it will increase significantly as children are born and raised and then decline as your children finish college. Therefore, instead of using a single product to meet all of your needs, it may be advantageous for you to utilize multiple products to give you maximum protection at the most cost-effective rate. These products should take into account your goals, budget, and growth in investment assets (see Chart 4).

Finally, you must determine the type of insurance you need. There are two main types of life insurance: term, or insurance for a specific period, and permanent (also known as endowment or cash-value insurance), which is term insurance with a savings component. The type of insurance

you choose will depend on four factors: your priorities and preferences, the amount of insurance needed, your ability and willingness to pay premiums, and the duration of need.

Chart 4. Life Insurance and Your Investment Plan



Permanent: with guaranteed insurability option paid up till age 65. Term: Five-year guaranteed renewable term in $50,000 and $100,000 increments; can add and drop as necessary. Investment: Includes individual and employer sponsored retirement plans [17]

5. What Type of Life Insurance?

Your priorities and preferences refer to your goals and objectives. What do you want the life insurance product to do? What are your personal goals? Your preferences are what you generally like to do. Do you prefer to "own" or "lease"? What are your "biases" for insurance? Are you willing to take the risk of re-insurability or not?

The amount of insurance needed is also an important consideration. Buy term insurance when there is no way to satisfy the financial needs should you die without it. The term protection may be converted to another form of protection at a later date, if available (i.e., convertible term). Buy a combination of term and permanent when you can cover the financial needs should you die and when you are able and willing to allocate additional dollars to appropriate permanent coverage.

Your ability and willingness to pay premiums should also be considered. Pay on installment basis (term, or low-outlay whole life) if your mortality risk is higher than average. Prepay coverage if you expect to live longer than average (vanishing premium or limited-payment whole life) or if you want payments to stop at a specific age. Purchase a yearly renewable term if you want minimal payments initially that increase year to year. Consider permanent coverage if your cash flows are sufficient to cover the higher premiums and you are committed to paying for it for the rest of your life.

The duration of need is your final consideration. Buy a term policy if your need is 10 to 30 years. If the need will last longer than 20 years, buy a permanent policy or a guaranteed renewable term

policy with your required duration (of 10, 20, or even 40 years). Finally, you should buy a permanent policy if the coverage will be continued beyond age 55 or if the policy will be used for estate taxes and charitable giving.

Understand the Types of Term Life Insurance

How Term Insurance Works

Term insurance provides life insurance protection that is valid over a specific term or time period. After the specified period of time is over, the life insurance company is not required to continue coverage. The main advantage of this type of insurance is that it is the least expensive coverage over the short term, since insurance costs rise with age. However, this type of insurance may be disadvantageous because it is valid only if the insured dies during the term of coverage. Another disadvantage is that the cost of the insurance will increase with each new contract period because term insurance is basically the pure cost of mortality insurance at a specific age. Older individuals typically pay more for life insurance because the probability of death increases with age. The insurance contract might not be renewed once the current term expires (at the insurance company's discretion) unless it contains a guaranteed renewable feature.

Figure 4. Term Life Insurance Characteristics

Term Insurance Characteristics					
Type of Policy	Description	Mortality Risk	Policy Cost	Payouts Based on	Biggest Risks
Annual Renewable Term*	Lowest cost term policy with premiums increasing each year aligned with probability of dying; however you must re-qualify and re-apply each year for the policy	Must be renewed each year so risk is high, but policies may be in force well into retirement years	Lowest cost term insurance initially, then costs rise exponentially as probability of dying increases	Payouts based on guarantees	Insured is unable to qualify for renewal and cannot get new insurance. Costs may become prohibitive in later years
Level Term Option*	Lower cost term policy with option for a level price each year of the period	May be renewed for multiple years at the same price so lower risk	Lower cost term insurance	Payouts based on guarantees	Insured is unable to qualify for renewal and cannot get new insurance.
*** Convertible Rider** (included with most policies above)	Insured can convert to a permanent if within a certain number of years or before a certain age	As term, higher risk; but as permanent, risk is lowest as cannot be declined if premiums paid	Most term policies include some form of convertible rider. Check policies for details	Payouts based on guarantees	Insured does not convert within the conversion period and cannot get new insurance

Figure 4 shows term life insurance characteristics for the different types of term policies. Premium payments are made that cover mortality costs and other fees. There is no buildup of cash—all premiums go to pay the costs and fees. As long as you continue making payments, you are covered for the contracted amount of time.

There are many different types of term insurance, the most common being annual term, renewable term, and convertible term.

Annual term. With annual term insurance, the face or death benefit amount is constant throughout the selected term of coverage. Premiums increase each time the contract is renewed,

even though the face amount remains the same. Coverage terminates after the specified time period.

Renewable term. Renewable term insurance policies can be renewed for a specific number of years. Even if health problems become apparent after coverage has begun, you can continue the coverage until the end of the specified period. Premiums will increase considerably at each renewal period, unless you demonstrate to the company that your health and circumstances merit a continued favorable rate.

Convertible term. Convertible term insurance is a policy that can be exchanged for a permanent policy within a specific number of years after issuance, without evidence of insurability. Many term policies contain this specific guarantee. These convertible term insurance policies allow you to convert your term policy to a permanent one at your discretion, regardless of your medical history; you also do not have to get a medical exam to convert your policy.

Premiums on term policies are much lower than on permanent policies with similar death benefits for three main reasons. First, with term policies, you are only paying for insurance for a specific period, which means that the risk is priced one period at a time. Roughly 98 percent of all term policies lapse without payment. Second, term insurance is generally priced for shorter time periods, from one to 20 years. The longer the time period, the higher the fees the insurance companies must charge in the early years to offset the more expensive mortality charges and fees in the later years. Finally, term insurance policies are less complex than permanent products and are cheaper and easier to administer.

There are a number of important questions that should be answered before you purchase term insurance. These questions include the following:

- What is the premium?
- How long can I keep this policy?
- What are the renewal terms of the contract?
- When will my premiums increase?
- Can I convert my term policy to a permanent policy?
- Can I convert it without getting a medical exam? What are the details?
- How strong is the insurance company financially?

Understand the Types of Permanent Life Insurance

Permanent life insurance is a contract in which the premiums are divided between death protection and savings. A portion of the premium pays for the mortality or death benefit component, and a portion goes toward paying the insurance fees. The remainder of the premium is put into an account that earns tax-deferred interest, dividends, or investment gains. Permanent insurance is often called endowment or cash-value insurance. This type of insurance is intended to provide the policy holder benefits over a lifetime. However, the policy will not be permanent if it does not have enough cash value, if the insured is not able to keep paying the premiums, or if

the investment value declines substantially.

Although permanent insurance is permanent under most circumstances, it is still possible to lose money with certain types of these products. The length of time in which payments must be made is sometimes a factor in permanent life insurance policies. You should determine if you can or want to pay premiums for the required length of time before you enter into a contract. If you do not wish to pay premiums throughout your entire life, fewer payment periods with fewer benefits can be arranged, or you may have an option of paying higher premiums over fewer payment periods.

How Permanent Insurance Works

There are three sources of cash that increase the value of a permanent life insurance policy. The first source is the premium payments you make on a regular basis. The second is the investment yield (also known as the dividend or investment earnings) from the cash-value portion of the policy. The third source of cash is available only on policies that allow you the option of receiving tax-free dividends from the insurance company as a legal return of premium. Dividends that exceed the premium are taxable, however. You can typically receive tax-free dividends on your insurance if you own insurance from a mutual company. This is because you own part of the company and receive a dividend as an inflow to your account each year based on your ownership of the company's earnings. However, should insurance company profits decline, these dividends are likely to decline as well. If your insurance policy comes from a stock company, then you have no ownership; however, the credits and costs of your policy will still be affected by the company's performance.

Permanent insurance cannot be canceled and therefore can be maintained for as long as you live. It provides a death benefit similar to that of term insurance as well as an opportunity to accumulate tax-deferred savings, which can be used for retirement and estate planning. Also, as the cash value of the insurance policy accumulates, it becomes a valuable asset that can be borrowed against—enabling you to get a loan that is very inexpensive and possibly tax-free. If you fail to pay back the loan, the face value of your policy is decreased by the value of the loan at payment to your beneficiaries.

Because permanent insurance is designed to maintain a constant premium throughout your life and to build cash value, the premium is naturally higher. To put this concept in perspective, the premium for a permanent policy may be 5 to 10 times higher than the premium on the same amount of term insurance; the premium is much higher because a portion of your premium goes toward creating cash value. Unless you maintain the policy by continuing to pay insurance premiums to cover costs and build cash value, the policy can expire, and you may lose much of what you have already put into the policy. With some of the newer products, like variable life insurance, your investments could *potentially lose money*, which would likely increase the amount of money you would have to contribute each year. Also, depending on the type of permanent insurance you have, there *may not be a guaranteed return* each year.

Expenses are another important aspect of buying a life insurance policy. Expenses can be divided into two categories. The first type of expense is the mortality cost, or the cost of the insurance. The second type of expense is the fees that accompany the purchasing process. These fees include sales commissions (often substantial), state insurance costs, deferred acquisition taxes, administrative fees, and investment fees (if applicable). These costs vary depending on the type of contract you have, so you should ask your agent to disclose these issues to you during the decision-making process. For a representation of the process of understanding permanent insurance, see Figure 5.

After you have paid the premiums on your permanent insurance for many years, the investment yield and dividends on your insurance may be sufficient to fund the policy (after expenses); when this happens, you will no longer need to continue paying the premiums. However, there is a risk that you will have to continue paying the premiums depending on the type of account, the investments chosen, and the economic environment.

Types of Permanent Insurance

There are a number of different types of permanent life insurance products, and these products differ according to five investment criteria: mortality risk, investment risk, policy costs, investment choice (i.e., assets), and investment flexibility. For a comparison of various term and permanent life insurance policies, see Tables 7 and 8.

Mortality risk refers to the risk that the insured dies within the contract period and is covered by insurance.

Investment risk refers to who takes responsibility for the investment outcome.

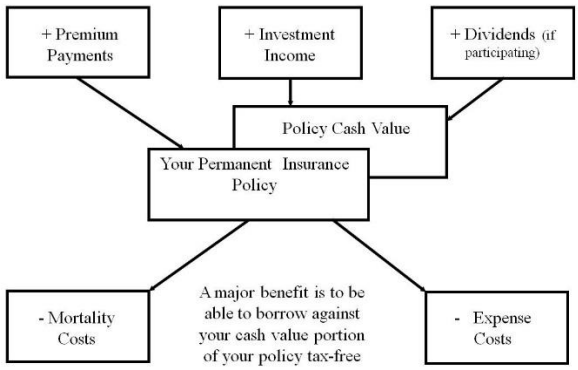
Policy cost compares the costs of the policy to other life insurance products.

Investment choice refers to the types of vehicles or assets the insured chooses to use to build his or her tax-deferred savings.

Policy flexibility refers to the degree of flexibility the insured has regarding insurance products—for example, account options, flexibility to change the face amount or death benefit over time, and flexibility to change premium payments depending on the insured's current situation. In the following chart, account flexibility, premium flexibility, and face value flexibility refer to the flexibility to change the investments, premium payment amounts, and face amount during the life of the contract (see Table 7).

It is important to understand why you want permanent life insurance. Understand your needs. Understand the individual polices of competing life insurance companies, such as the charges and deductions of the insurance company and the fees and expenses of the mutual funds or assets invested in. Finally, select the policy that gives you maximum benefit at the lowest possible cost to you.

Figure 5. Your Permanent Insurance Policy



Whole life. Whole life insurance gives lifelong coverage; this type of insurance has a fixed premium based on your age at the time of purchase. It is also called "straight life" or "ordinary life." Although the risk of death increases with age, most insurance companies keep the premium and face amount of an insurance policy constant by charging more in the early years of your policy and less in the later years of your policy than you would be charged for term insurance. Whole life insurance is ideal for those who want and can afford permanent life insurance protection with a savings element. Mortality risk and investment risk are both eliminated with this product. This type of insurance provides a transition from income replacement goals to goals regarding retirement and estate planning. This type of insurance may also be attractive for those who have low self-discipline or low tolerance for risk in saving and investing.

Other advantages of whole life insurance include a fixed death benefit, a growing cash value, and potential growth from tax-deferred dividends. The disadvantages include the fact that it requires a much higher premium for the same amount of coverage. Moreover, the yield on the cash value portion of whole life insurance may not be competitive with yields on alternative investments because whole-life policies are generally invested in an insurance company's long-term bonds and mortgages.

Universal life. Universal life insurance is a type of permanent life insurance that is a mix between term insurance and savings. Mortality risk is eliminated. This type of insurance earns interest at current money market or bond rates, so when interest rates are high, this type of policy will typically earn a better return. Thus, investment risk, while not eliminated, is low. This type of insurance also has a guaranteed minimum interest rate that is set for the life of the insured. The policy deducts a monthly fee for insurance coverage: the fee includes the mortality cost and the cost of managing the policy. Contributed funds that do not go toward paying for mortality insurance and costs earn tax-deferred interest.

In a universal life policy, the premium and face amounts are flexible. You can pay premiums in excess of costs in order to build cash value that is subject to federal tax limits. You can change the face amount of the policy and the amount and frequency of premium payments. Universal life insurance is ideal for those who want a flexible policy that combines term protection and tax-

deferred savings; this type of insurance is also appropriate for those who have sufficient knowledge of financial matters and are somewhat flexible and self-directed.

An advantage of universal life insurance is that it provides permanent protection that is similar to that of whole life insurance, and it has flexible premiums and death benefits. The cash value earns tax-deferred interest and can be borrowed against if the need should arise. One disadvantage is that universal life insurance typically requires a much higher premium than term life insurance requires for the same amount of coverage. Also, the cash value of the policy fluctuates depending on the amount paid into the policy and the current market interest rates. The cash value can quickly be depleted by insurance charges if sufficient premiums are not paid. The newest form of universal life insurance is similar to whole life insurance in that it guarantees payment for the full face amount of the policy in exchange for a fixed premium.

Variable life. Variable life insurance allows you to direct the investment portion of your premium into one or more separate investment accounts (such as stocks, bonds, or money market accounts). For this reason, investment risk for this type of product is substantial. Depending on company policy, you can change where the investment portion of your premium will go two to five times per year. While this type of policy gives added flexibility of investment, it is also risky because you, rather than the insurance company, decide where your money is invested; therefore, you assume the risk of the cash-value component. Variable life insurance often costs more in the long run than other types of permanent life insurance because of the added expenses and risks. This type of insurance is appropriate for those who want to take risks, manage their own investments, and have an opportunity (but no guarantee) for tax-deferred growth. If you need a tax shelter and are an experienced, risk-tolerant investor, variable life insurance may be a viable option.

Variable life insurance has the advantages of permanent protection and potential for building cash value. Returns are earned on a tax-deferred basis, and variable life insurance allows for either a fixed (straight variable) or flexible (variable universal) premium. Because you determine where the cash value will be invested, there is a potential for higher returns; these returns reflect the performance of the separate investment accounts. However, variable life insurance has the disadvantage of generally having higher costs. Premiums for variable life insurance are much higher than premiums for term life insurance and other permanent products with the same amount of coverage. This type of investment is also riskier than others because your investment can lose money, and, as in all permanent products, policies may lapse if you don’t make payments.

Variable universal life. Variable universal life insurance combines the flexible features of universal life insurance with the investment options (and risks) of variable life insurance. You choose where to invest your premiums, and you assume all the investment risks associated with your choice, as with variable life insurance. Investment risk with this type of permanent insurance is substantial. You can raise or lower your premiums in a single policy, as with universal life insurance. The insurance company makes no guarantee on your cash value.

When you change investment vehicles, no capital gains are acquired, and any investment gains are tax-deferred. You have great flexibility regarding the frequency and amount of premium payments, and you are able to make partial withdrawals in the form of loans. If you furnish proof of insurability, you can increase or reduce the amount of coverage. Variable universal life insurance may be the best life insurance option for you if you need a tax shelter and if you are comfortable with high-risk/high-reward investing.

Table 8. Permanent Insurance Policies

Permanent Insurance Characteristics*								
Type of Policy	Description	Mortality Risk	Policy Cost	Payouts Based on	Biggest Risks	Policy Flexibility (for Permanent Insurance Only): Investment	Premium	Face Amount
Whole Life	Lowest fixed cost permanent policy with premiums and payouts based on guarantees	Low as the policy will remain in force for life based on fixed premiums	Lowest cost permanent, but much higher than term	Payouts based on guarantees	Higher fixed premiums and conservative returns on guaranteed insurance instruments may limit upside	No ability to change, managed by general account of the insurance company	Fixed with no ability to change premiums	Generally no ability to change contract face value
Universal Life	Lower cost flexible permanent policy with cash value invested in short-term and money market investments	Low as the policy will remain in force as long as premiums are paid	Lower cost permanent, but more expensive than Whole Life	Payouts based on assumptions ONLY	Improper funding or very conservative money market returns may require additional contributions	No ability to change, can invest only in shprt-term fixed money market investments	Maximum ability to change premiums	Options to add cash value to the face amount for the total death benefit
Variable Universal Life	Higher cost flexible permanent policy with cash value invested in stocks, bonds, money market, etc. at insured's discretion	Low as the policy will remain in force as long as premiums are paid	Higher costs as there is more flexibility in investments	Payouts based on assumptions ONLY	Expensive and risk remains that low subaccount returns may require additional contributions making it prohibitively expensive	Maximum ability to change, between stocks, bonds, money market etc.	Maximum ability to change premiums	Options to add cash value to the face amount for the total death benefit
Equity Indexed Universal Life	Highest cost flexible permanent policy with cash value appreciation tied to a stock market index with no return downside but capped upside the company can change	Low as the policy will remain in force as long as premiums are paid	Highest costs and expenses which gives limited upside	Payouts based on assumptions ONLY	Very expensive and low stock market caps (which company can change after signing) and high fees offer limited market upside of 3-6% after fees	Choice among a few different invesetment indices with caps	Maximum ability to change premiums	Options to add cash value to the face amount for the total death benefit
Column Descriptions:	Key points of the policy most relevant to consumers	The risk that the insured dies outside the contract period and is not covered by the policy	The cost of the policy in relation to other life policies, both term and permanent	What the payout amounts are based on. If assumptions, the insured's risk is much greater	The insured's key risks of the chosen insurance policy	The insured's ability to change the investments during the life of the contract	The insured's ability to modify the premium payments for certain periods and ranges	The insured's ability to change the face amount of the policy within the contract period
Note: * With permanent products, if insurance company profits are insufficient, they can change the contract after signing to increase profits. ** These are general comments and may not apply in every situation.								

The advantages of variable universal life insurance include permanent protection, returns that are earned on a tax-deferred basis, the choice of either a fixed premium (straight variable) or flexible (variable universal) premium, and the potential for higher returns on your cash value (based on the mutual fund's performance). This type of insurance also gives you the ability to choose different types of investments and to change investment vehicles free of charge a certain number of times per year. The disadvantages include higher costs—variable universal premiums are higher than premiums for term insurance for the same coverage. This type of insurance is also much riskier because your investments can lose money.

Equity indexed universal. Equity indexed universal life insurance combines the flexible features of universal life insurance with the investment options (and risks) of an equity index mutual fund (without dividends) which offers a capped exposure to the major equity markets for the cash value portion of the policy. By using this product, you assume all the investment risks associated with options on the major equity market and index mutual funds. The major selling point of this product is you gain the capped upside of the equity markets should markets advance, and none of the downside risk of a negative equity return.

The advantages are they offer capped upside exposure to the equity markets, without the risk of losing principle should the equity markets decline below zero return which sounds attractive. The downside is the huge commissions on these products—the fee structure is very high. There are caps on returns from the equity markets that limit your upside, usually to 4–8% per year maximum. Finally, because of the high fees on these products, unless they are aggressively funded, the cash value is often insufficient to keep the policy in force later in life due to the very high fees.

Permanent Insurance Cautions

Students who are looking at permanent insurance need to ask themselves several important questions:

> **Can I commit to the premiums over the long-term?** Many students have no prospective job opportunities and will likely be in school for many more years. With permanent insurance, you are committing to make payments, regardless of whether you are in school and whether you have a job. Can you really commit to these payments now?
>
> **Do I need the tax benefits now?** Once you get out of school, purchasing term insurance and investing the remainder (the difference between what you would have paid with a permanent product and what you pay with the term product) in a Roth IRA or 401(k) may be cheaper and better for you in the long run because you will not have to pay high insurance charges and you can therefore invest more for retirement. Qualified savings plans and retirement plans do not provide life insurance, but you may still want to consider putting your investment dollars into these plans before you get the more expensive life insurance products.
>
> **Are the rates of return on these insurance products guaranteed?** Except for whole life, the answer is no. The rates they give on amounts they will pay are assumptions. In addition, be aware that the insurance companies can change the contracts after you have signed them, changing terms, conditions, and amounts paid if they are not making enough profit. Because of this, be careful of people who are selling products they do not understand. Because the commissions on these products are very high, some people may be selling products they don’t understand to clients who don’t need them.
>
> **Do I have a history of medical problems that would preclude my ability to get life insurance?** If this is the case, you might want to look into permanent insurance.

For most students, “buy term and invest the rest” is an appropriate insurance strategy. Most students would do well to buy a term policy that is level term for 10 to 30 years with a convertibility option to permanent insurance and take the additional money they might have spent for permanent insurance and invest that in either a Roth or traditional IRA or a qualified retirement plan.

There is a place for permanent insurance for some individuals. However, think about this:

> Commissions: If permanent insurance is such a good product, why pay such high commissions for sales? First year commissions to agents can be 50-120% of first year sales, often with recurring commissions for each year the policy is in place.
>
> Annual Sub-account fees/expenses: Why must fees be so high on investment sub-accounts? These investments are not complex products, and are often just index funds. Why are the fees on these products so high compared to products not offered by insurance companies?
>
> Assumptions: Why can the company change the insurance contracts even after the product is sold? In addition, payments on cash value products (except whole life) are based on assumptions which the company can change any time even after the contract is sold.
>
> Transparency: Why is anecdotal return evidence so poor, which shows that 20 year returns on permanent products have generally been only slightly above inflation? Why is performance data so very difficult to find for these products?

Typical Expenses for a Permanent Life Insurance Policy

While permanent insurance has many benefits, it also has many more charges and deductions than term life insurance. This is because permanent contracts are designed to meet very specialized goals and needs. Because it would be impossible to describe every possible variation in detail, I will highlight a few of the main expenses of a variable universal life insurance policy (the most complex and flexible policy with the highest premium) as an example. These expenses may include the following:

Investment Account–Level Fees

Sales charges or front-end load: These are deductions for salesman distribution expenses. These charges can consume anywhere from zero to 10 percent of new money or premiums invested in the policy.

State premium taxes: These taxes vary by state and range from zero percent in Oregon to five percent in the Virgin Islands.[3]

Deferred acquisition (DAC) taxes: The DAC tax is a corporate federal income tax that is imposed on insurance companies. Previously, insurance companies wrote off all their acquisition expenses in the first year, thereby reducing taxable income. Now companies must spread out these acquisition expenses over the life of the acquisitions. This means that income is generated in the early years and income taxes are incurred. These taxes on the insurance companies are passed on to the insured.

First-year expenses: First-year administration fees include the cost of setting up the policy.

Monthly administrative fees: These fees enable the insurance company to provide services such as mailing confirmation notices and providing periodic reports.

Mortality and expense charges: These fees compensate the insurance company for certain mortality and expense risks and can range from 0.4 to 1.3 percent annually.

Sub-Account Fees

Sub-account fees are fees paid to the managers of the mutual funds in which the cash value of life insurance policies are invested. These fees include management and 12b-1 fees.

Investment management fees: These are charged for the overall management of the investment accounts, or in other words, the fees paid for professional management. These fees are taken daily from the underlying net assets or value of the sub-accounts.

12b-1 fees: These are used to pay financial advisors and brokerage firms for marketing the account's funds.

Overall expense ratio: This ratio finds the combined cost of all the asset-based charges discussed in this chapter. This is an important number that can be used to compare the costs of managing your money both inside and outside of a life insurance contract.

Figure 6. Charges for Permanent Insurance

Account-level expenses:	**Minimum**	**Average**	**Maximum**
Sales charges	0.0%	8.0%	10.0%
State premium taxes	0.75%	2.0%	5.0%
DAC tax	0.0%	1.5%	2.0%
First-year expense	$200	$350	$700
Administration fees/month	$4	$6	$15
Policy loans as % contract surrender value,			
Interest spread	75%, 4%	90%, 2%	100%, 0%
Asset charges			
Mortality and expense	0.4%	0.7%	1.3%
Sub-account fees			
Investment management	0.4%	0.8%	2.8%
12b-1 fees	0.0%	0.0%	0.5%
Overall expense ratio	1.0%	1.5%	4.4%
Other charges			
Surrender charges (these can be significant)			

Other Fees

Policy loans: A major benefit of permanent insurance is the ability to borrow money against the contract's surrender value (the value the policy would have if you decided to take the cash rather than the death benefit). If you die before the policy loan is paid back, the beneficiary of the loan will receive the face value of the contract minus what is still owed.

Surrender charges: Surrender charges, back-end loads, and contingent deferred sales charges refer to the amount of the policy's account value that you forfeit if you cancel or terminate your policy within a specified period. These fees reimburse the insurance company for expenses that have not yet been recovered. Surrender charges can be significant.

Other fees: There are a number of other fees and expenses that should also be taken into account. These include partial withdrawal processing fees, which are assessed for taking money out of the insurance policy; transfer charges, which are assessed for making asset transfers that are over the limit specified in your policy; and other charges that may be assessed for additional annual reports, increases in principal sums, additional riders, and so on. Not all companies assess all of these charges; be sure that all charges are disclosed when you are in the process of deciding what type of insurance to purchase.

When the charges, fees, and expenses are totaled, it is not uncommon for the total to be between 5 and 15 percent of every dollar you put into permanent insurance. Because of this, the cash-value portion of this type of insurance will grow more slowly than the cash value of a less expensive term policy. However, the term life policy requires you to pay income taxes (capital gains taxes) each year on your investment returns, which can reduce the advantage of a term life policy.

Permanent insurance is not for everyone. It is a very complex financial instrument and will help only those who need the specific benefits of this type of insurance. By understanding your needs and the different aspects of competing life insurance company policies—the charges, deductions, fees, and expenses of the invested assets—you can select a policy that will give you the maximum benefit at the lowest possible cost.

The following are some important questions to ask yourself about permanent insurance before you decide to invest:

- Are the premiums within my budget? Are the costs reasonable?
- Can I commit to these premiums on a long-term basis?
- On a variable life policy, what is the assumed interest rate in the example, or illustration, given you by the insurance agent?
- Is the classification shown in the illustration appropriate for me (i.e., smoker/nonsmoker, male/female)?
- Which figures are guaranteed and which are not?
- Will I be notified if the non-guaranteed amounts change?
- Is the death benefit guaranteed?

- Will the premiums always be the same, even if interest rates are lower than in the illustration?
- Is the illustrated premium sufficient to guarantee protection for my entire life?
- Is the "current rate" illustrated actually the rate paid recently? What was the current rate in each of the last five years?
- What assumptions have been used regarding company expenses, dividends, and policy lapse rates?
- Does all my cash value earn the current rate?
- Is the illustration based on the "cash surrender value" or "cash value"? (The cash surrender value is usually lower and reflects what will be paid if the policy is canceled.)

Understand Which Type of Life Insurance is Best for You

Determining which type of life insurance is right for you can be a challenge. For most people, especially students, convertible renewable term life insurance, which can be converted to a permanent policy without a new medical exam and is renewable for up to 30 years, is the cheapest and best alternative. If your goal is income replacement, term insurance is relatively inexpensive and has the most affordable coverage when life insurance is needed the most; it is possible to carry the coverage only for the amount of time insurance is needed. Although term life insurance becomes more expensive with age, it may become less necessary as your other assets, such as your investment portfolio, grow, so your dependents would need fewer benefits from life insurance in the event of your death. However, if taxes or other liabilities are due at death or if one desires to leave an estate, insurance may still be necessary.

Permanent insurance may be the best choice if you meet very specific criteria. If your goal is medical insurability (that is, if you have a history of medical problems and you already have convertible term insurance), you can't be denied life insurance should you decide to convert policies.

If the value of your assets is very great and you plan to leave an estate, and if you have estate-planning issues (i.e., you need to shield some of your assets), you should consider permanent insurance.

If your goal is retirement savings and you have already invested substantial amounts of money in your tax-deferred retirement accounts and have already invested the maximum in your tax-deferred accounts and annuities, you may want additional tax-deferred savings; consider permanent insurance as an additional investment vehicle.

If you are still unsure about what type of insurance is best for you, consider a renewable convertible term policy. This type of insurance provides the low cost of term insurance while giving you the ability to convert to a cash policy in the future (within a specific number of years).

Steps to Buying Life Insurance

Selecting an insurance agent is your responsibility—choose wisely. You are not just buying insurance: you are building an insurance structure that will shelter you and your dependents for many years. Following are some important tips for buying insurance:

1. Understand what you want. Understand yourself, your goals, and your budget. Consider how much insurance you need versus how much insurance you want. What kind of insurance policy will best meet your needs given your current family situation and cash flow? How much money do you want to spend? Do you have any pre-existing health conditions? Do you need the insurance for your whole life, or only for a specific period? Can you accept the significantly higher costs of permanent policies?

2. Compare the costs of competing policies. Do your homework and shop around, not just based on price but also based on benefits, coverage, and exclusions. Some possible ways of comparing policies are listed as follows:

- What are the annual premiums versus the amount of the coverage?
- Is the policy renewable, and for how many years?
- Do I have to get a new medical to renew the policy?
- Is the policy convertible? Into what type of policy?
- Is the insurance policy participating (offers tax-free dividends) or nonparticipating?
- If participating, what is the five-year dividend history?
- If participating, what is this year's expected dividend?
- What is the total premium cost over the next 10 years (excluding dividends)?
- In 10 years, what will your cash value be?
- What will the total premium cost be over 20 years?
- At what interest rate can you borrow against the policy? Is the spread guaranteed?

3. Select only a high-quality insurance company; base your choice on company ratings. Price is not the only criteria you should look at when selecting an insurance company. You also want the company to be around to pay the benefits years down the road. Remember, you are looking for a long-term insurance relationship. Check with A.M. Best at www.ambest.com or Standard & Poor's at www.standardandpoors.com for ratings of your company.

4. Select an insurance agent with whom you feel comfortable and who does not pressure you. Study the agent's recommendations and ask for a point-by-point explanation if there are items you don't understand. If the agent can't explain all the costs and benefits, go to someone who can. While it is not necessary to have an insurance agent, it can be helpful because an agent can explain the many options and details of the life insurance contract. Remember to ask about the insurance agent's commission on any recommended product.

5. Use wisdom in your decisions. Make sure you check out the insurance company; read your policy when you receive it to ensure it is correct. Consider alternative approaches to finding life insurance: use the Internet or an advisor to help you. Make sure you feel good about the decision

before you sign anything or send any money.

Before you purchase life insurance, consider a few final thoughts:

- Be careful if your only source of life insurance is from your company. Consider having part of your insurance from outside your company's plan. Realize that if you get sick and lose your job, your insurance may terminate with your employment. It will be difficult to get new life insurance if you are very sick.

- Don't rush into a decision just because you are feeling pressured. Wait a few days and then decide. This is not a short-term decision. Take your time and choose wisely—but choose!

- Make your check payable to the insurance company, not the agent. The insurance company will pay the agent. Be sure the insurance agent gives you a receipt for all payments. Make sure there is an adequate paper trail in case there are questions or problems later on.

- Read your policy carefully during your "free-look" period. You are given a specific amount of time in which you have the option to cancel the policy. Make sure you understand your policy completely at the beginning and then review your policy annually. Your life situation may change, so make sure your policy is sufficient to meet your needs as they change.

- If you are changing policies, especially permanent policies, make sure you clearly understand the consequences. Surrendering one permanent insurance policy to buy another insurance policy could be very, very, very (get the hint?) costly. Understand all the costs of making a change before you make it.

- Finally, if you have a complaint, contact your insurance agent first. If you don't get an adequate response from your agent, contact your state insurance department; they can help.

Understand Plans and Strategies for Life Insurance

Following are a few ideas of life insurance plans and strategies over different time periods.

Life Insurance Plans and Strategies

Students and Young Marrieds

- If married, buy a small $250k - 20 year annual renewable term product with the convertibility option. In case things happen to your health, you can convert to a (generally) whole life policy without a medical exam.
- Once children come, ladder on additional renewable convertible term products, extending out the life to the time that children leave home.

- If term insurance rates have decreased, you can purchase a new product then cancel the old.

Married with Families

- Make sure you have sufficient term policies consistent with LT 29 to protect those you love.
- Continue to ladder in additional policies and keeping their maturities longer consistent with the time children leave home.
- If you have filled your Roth/traditional 401k and Roth/traditional IRA investments and are looking for additional tax-deferred investments, you may want to look into permanent products. Be careful.
- If term insurance rates have decreased, you can purchase a new product then cancel the old.

Empty Nesters

- As your investment assets increase and children leave the home, you can allow some of the policies to terminate without renewing as the need for income replacement is diminished.
- If you would like to leave money to your heirs, think to maximize your contribution to Roth products, as these are wonderful assets to leave to heirs (the taxes have already been paid).
- If your desire and plans for estate planning materialize, you can utilize permanent insurance for some of those options. Be careful of costs.

Summary

Getting life insurance is an important step toward becoming financially self-reliant. We would be wise to have an appropriate amount of it.

Life insurance products vary widely, and they can be challenging to understand. It is critical to understand the major principles of life insurance and how life insurance can help you reach your specific personal and family goals.

In this chapter, we answered the five key questions about life insurance: 1. Why should you have life insurance? 2. How does it work? 3. Who needs life insurance? 4. How much should you have? and 5. What kind should you have?

Term insurance provides life insurance protection that is valid over a specific term, or time period. The major advantage of this type of insurance is that, in the short term, it is the least expensive death benefit coverage. However, this insurance is disadvantageous because it is valid only if the insured dies during the term of coverage.

Permanent life insurance is a contract in which premiums go toward both death protection and

savings. Cash-value insurance is often called permanent insurance and is intended to provide benefits over a lifetime. However, the policy will not be permanent if there is not enough cash value, if the insured is not able to continue paying the premiums, or if the investments decline substantially.

Determining which type of life insurance is right for you can be a challenge. For most people, especially students, renewable convertible term life insurance is the cheapest and best alternative. If your goal is income replacement, term insurance is relatively inexpensive and has the most affordable coverage when life insurance is needed the most; it is possible to carry the coverage for only the amount of time insurance is needed.

The five steps to purchasing life insurance are as follows:

1. Understand what you want.
2. Compare costs of competing policies.
3. Select only a high-quality insurance company; base your choice on company ratings.
4. Select an insurance agent with whom you feel comfortable and who does not pressure you.
5. Use wisdom in your decisions.

Assignments

Financial Plan Assignments

Your assignment is to prepare your vision, goals and plans and strategies for life insurance and include these in your PFP Insurance Template (LT01-09). First, determine whether you need life insurance. This drives your vision. Depending on your situation, you may not need it.

Second, determine your goal for having it. Deciding on your goal for insurance is a critical part of evaluating the different types of life insurance products.

Third, determine how much insurance you need based on the framework laid out in this chapter. Remember, as interest rates decline, the size of the assets you will need increases. I encourage you to use Calculating Life Insurance Needs (LT29 – Detailed) or Fin200 Calculating Life Insurance Needs (LT29B – Simpler) to determine how much insurance you need. This will be included in your Plans and Strategies, and will change over time.

Fourth, determine how much insurance you can afford based on your budget. This is a critical step. Take into account the potential for job loss or changes in lifestyle caused by children, teenagers, and so on when you are considering your budget.

Finally, evaluate the different insurance companies and the different products available. Using the criteria discussed, evaluate the different insurance companies for stability; look for signs that they will be around when benefits need to be paid. Determine the type of product you should

have, evaluate the different alternatives, and include your findings in your financial plan.

Learning Tools

Calculating Life Insurance Needs (LT29) - Detailed

This Excel spreadsheet gives a detailed framework for calculating life insurance needs. It gives estimates using multiples of salary, various rules of thumb, and a needs approach.

Fin200 Calculating Life Insurance Needs (LT29B) - Simpler

This is a simpler version of LT29, with fewer methods of calculation. Excel spreadsheet gives a detailed framework for calculating life insurance needs. It gives estimates using multiples of salary, various rules of thumb, and a needs approach.

Review Materials

Terminology Review

Annual Term Insurance. This is a type of term insurance. The face or death benefit amount is constant through the selected term of coverage. Premiums increase each time the contract is renewed, even though the face amount remains the same due to the increasing age of the beneficiary.

Convertible Term Life Insurance. This is a term policy that can be changed to permanent insurance within a specific number of years without evidence of insurability. Typically, it gives a contractual right to convert to some form of permanent insurance, typically whole life, within a certain number of years or before the policy holder reaches a certain age. Conversion allows the policy holder to lock-in the premiums, although at a higher rate, and avoid the ever increasing term premiums.

Equity Indexed Universal Life Insurance. Equity indexed universal life offers some of the upside of the equity market returns with the downside of insurance protection should the market returns be negative. It allocates assets to a stock market index, generally with options (and has a limited upside) but with a minimum guaranteed rate of return. It gives some (limited) upside in equity returns, and gives downside protection in down equity markets. It has huge commissions to salesmen for selling these products (up to 150% of first year commissions), a very high fee structure, large surrender charges, and is not transparent. Market returns are generally lower that historic market returns, are capped with limited upside of 2-4% after fees, and the insurance company can change the caps even after the product is sold if they are not making enough profit.

Renewable Term Insurance. This term policy allows the policy holder to unconditionally renew the policy for successive terms at higher premiums simply by paying the indicated premiums. Premiums increase with each renewal period, and can be renewed for a specific number of years

Universal Life Insurance. Universal life is a type of whole life insurance, but the cash-

value earns interest at current money market rates. Mortality risk is eliminated, and investment risk is low. It is a flexible policy that combines term protection and a tax-deferred savings element invested at current interest rates. Earnings will rise and decline with market interest rates. Its risks are the same with most permanent insurance: it is complex, expensive, with high surrender costs, and commissions to the salesmen are very high.

Variable Life Insurance. Variable life gives life-long insurance coverage with the ability to direct where the cash-value is invested. Mortality risk is eliminated, but investment risk is substantial. Policy holders are responsible for the investment outcome with their chosen investments. It allows for either a fixed (straight variable) or flexible (variable universal) premium, with fluctuating cash-value, reflecting the investment performance. It is complex, expensive, with high surrender costs, and commissions to the salesmen are very high.

Variable Universal Life Insurance. Variable universal life mixes the investment flexibility of variable life with the premium and face amount flexibility of universal life. Policy holders are responsible for the investment outcome with the chosen investment. It offers term protection with full policy flexibility and which can be managed by the account owner (within available options). It is complex, expensive, with high surrender costs, and commissions to the salesmen are very high.

Whole Life Insurance. Whole life insurance gives life-long insurance coverage for a fixed premium. Mortality risk and investment risk is eliminated. It is essentially term protection with a savings element provided by insurance company bonds and mortgages. Premiums are based on when you buy the policy. The earlier you purchase the product, the less your costs will be generally. It is also called “Straight Life” or “Ordinary Life” insurance. Tt is complex, expensive, with high surrender costs, and commissions to the salesmen are very high.

Review Questions

1. What is life insurance? Why should you have it?
2. What are the two different methods for determining how much life insurance an individual will need?
3. What is term insurance? What are the three types of term insurance?
4. What is permanent life insurance? What are the five major types of permanent life insurance?

Case Studies

Case Study 1

Data

Bill and Diana are concerned about their family’s welfare should Bill die. He is currently making $80,000 per year, has two children, and his company gives him $50,000 in life insurance coverage as a benefit. If Bill were to die, Diana could invest the insurance

settlement and make 5% with 2% inflation for 20 years until the kids finish school.

Calculations

What is the process for determining needs using the earnings multiple approach?
(Assume a 22-percent drop in living expenses after death.)
How much insurance should Bill have?

Case Study 1 Answers

a. Adjust salary downward:

Generally, family living expenses fall by 30 percent with the loss of an adult. The larger the size of the surviving family, the less living expenses drop.
Since Bill's family would go from four to three, his target replacement is $80,000 * (1 – .22) or
$62,400

b. Choose the appropriate interest rate:

The return after inflation is 1.05/1.02)-1 = 2.94%.

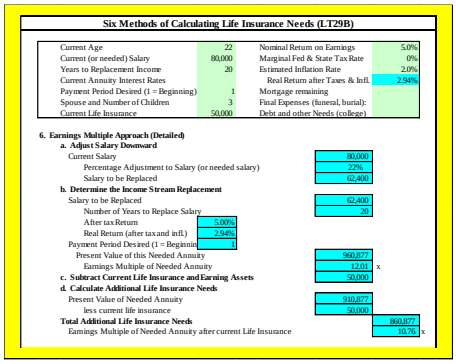
c. Determine the income stream replacement.

Number of years to replace income	N = 20 years
Estimated after-tax and inflation rate	I = 2.94%
Target $80,000 * (1 – .22) or	PMT = $62,400

Solve for the Present Value. Since Bill wants the payments at the beginning of each year, put your calculator in "begin" mode.
Bill needs $960,877

4. Subtract out current insurance available of $50,000:

$960,887 – 50,000 = $910,877
The multiple of salary is:
910,877 / 80,000 = 10.76x
Bill should have 10.8 times his salary, or $910,877.



Six Methods of Calculating Life Insurance Needs (LT29B)

Current Age	22	Nominal Return on Earnings	5.0%
Current (or needed) Salary	80,000	Marginal Fed & State Tax Rate	0%
Years to Replacement Income	20	Estimated Inflation Rate	2.0%
Current Annuity Interest Rates		Real Return after Taxes & Infl.	2.94%
Payment Period Desired (1 = Beginning)	1	Mortgage remaining	
Spouse and Number of Children	3	Final Expenses (funeral, burial):	
Current Life Insurance	50,000	Debt and other Needs (college)	

6. Earnings Multiple Approach (Detailed)			
a. Adjust Salary Downward			
Current Salary		80,000	
Percentage Adjustment to Salary (or needed salary)		22%	
Salary to be Replaced		62,400	
b. Determine the Income Stream Replacement			
Salary to be Replaced		62,400	
Number of Years to Replace Salary		20	
After tax Return	5.00%		
Real Return (after tax and infl.)	2.94%		
Payment Period Desired (1 = Beginnin	1		
Present Value of this Needed Annuity		960,877	
Earnings Multiple of Needed Annuity		12.01	x
c. Subtract Current Life Insurance and Earning Assets		50,000	
d. Calculate Additional Life Insurance Needs			
Present Value of Needed Annuity		910,877	
less current life insurance		50,000	
Total Additional Life Insurance Needs			860,877
Earnings Multiple of Needed Annuity after current Life Insurance			10.76 x

[1] 1 Timothy 5:8
[2] "Handbook for Families: Preparing for Emergencies," *Ensign,* Dec. 1990, 59
[3] Ibid., p. 113

13. Insurance 3: Protecting Health through Health, Long-term Care, and Disability Insurance

Introduction

Having adequate health insurance is crucial; health insurance ensures that you and your loved ones will receive necessary medical treatment throughout the course of your lives. Because of the importance of health insurance, it is extremely important for you to learn how this type of insurance fits into your Personal Financial Plan.

Health insurance is costly, largely because there is a lack of incentive to reduce costs. Rising insurance costs have gotten the attention of corporate managements. Companies are passing on a greater percentage of insurance costs to their employees. This shift is affecting many individuals' financial situations; as medical costs rise, individuals become less able to pay for medical care costs out of their own pockets. Therefore, the number of people who are uninsured and under-insured continues to rise. Health insurance is important and could be a major detraction from attaining your goals if health-related problems arise and you do not have appropriate health insurance to cover your costs.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand how health insurance relates to your Personal Financial Plan and basic health insurance coverage and provisions.
B. Understand the key areas of disability insurance.
C. Understand the key areas of long-term care insurance.
D. Understand how to control your health-care costs.
E. Understand plans and strategies for health insurance.

Understand How Health Insurance Relates to Your Personal Financial Plan and Basic Health Insurance Coverage and Provisions

Health insurance protects you and your dependents from suffering a financial catastrophe caused by high medical expenses. Paying out of pocket for a hospital stay, even if short, can be very expensive. Health insurance offers peace of mind and eliminates the financial risk of having to make large payments to health-care providers for injury or illness.

Concerning the need for adequate insurance, N. Eldon Tanner remarked:

> Nothing seems so certain as the unexpected in our lives. With rising medical costs, health

> insurance is the only way most families can meet serious accident, illness, or maternity costs, particularly those for premature births . . . Every family should make provision for proper health and life insurance.[1]

Understand Obamacare and Basic Health Insurance Coverage

Obamacare (the Affordable Health Care Act) brought many changes to the health care industry. However, in the current Congress, there are likely changes coming. The main changes due to Obamacare were:

- Obamacare doesn't create health insurance; rather, it regulates the industry.
- Many people who have health insurance can keep their coverage, but not all people.
- Young adults can say on their parents' health insurance plan till age 26.
- If you don't have coverage, you can use the Health Insurance Marketplace during the open period.

Other features of Obamacare include:

- You can obtain private health insurance during each year's annual enrollment period.
- If you don't have insurance, you are taxed.
- The cost of your insurance is on a sliding scale.
- You cannot be denied coverage based on health status, and there are no pre-existing coverage limitations and no lifetime coverage limits on your policy.

Getting healthcare through Obamacare, you have many options. You can continue to get health insurance through your work if it is provided. You can obtain healthcare coverage outside or inside of the marketplace during open enrollment. During open enrollment, you can purchase federally regulated and subsidized health insurance through private providers. You can also purchase private health plans through a broker or directly from the provider.

Major Types of Health Insurance Coverage

There are four major types of health insurance coverage:

- Basic health insurance
- Major medical expense insurance
- Dental and eye insurance
- Dread disease and accident insurance

Basic health insurance describes most health insurance policies that cover hospital, surgical, and physician expenses. Hospital insurance covers hospitalization expenses, including room, board, nursing, and prescription fees. Surgical insurance covers only the direct costs of surgery, including the equipment costs and surgeon fees. Finally, physician expense insurance covers physicians' fees, including fees for office visits, lab tests, X-rays, and other necessary tests.

Major medical expense insurance covers medical costs that are in excess of those covered by basic health insurance. This type of insurance normally requires you to pay a co-payment and/or a deductible and has an overall limit.

A co-payment is an amount of money you pay to help cover medical costs. A co-payment may be a flat amount, such as a $15 payment each time you visit a doctor's office, or it may be a percentage of the total cost of a surgical procedure, such as a payment that covers 20 percent of the surgical fee. The insurance company pays the remaining balance of the medical cost—for example, the insurance company pays $50 for the office visit to supplement your $15 co-payment and 80 percent of the surgical fee to supplement your 20 percent co-payment.

A deductible is the amount you pay in full before you receive any benefits from an insurance company. For example, if your medical bill were $1,000, and you had to pay a $200 deductible on your insurance plan, then you would pay the first $200 and your insurance company would pay the remaining $800 of the bill.

Major medical insurance usually includes both a stop-loss provision and a lifetime cap. The stop-loss provision limits your total out-of-pocket expenses to a specific dollar amount. The lifetime cap limits the total amount the insurance company is required to pay over the life of a policy.

Dental and eye insurance pays for the costs of dental work, dentures, eye exams, glasses, and contact lenses. You should know which expenses your plan covers before you go to the dentist or eye doctor. Normally, this type of insurance covers only a portion of the costs and requires you to pay the rest. Dental and eye care insurance plans are often expensive unless they are provided as part of an employee insurance plan.

Dread disease and accident insurance is a unique type of insurance that covers specific diseases and accidents. If your illness is not on the list given by the insurance company, it won't be covered. This type of insurance provides a set dollar amount that is available for reimbursement. If your expenses exceed this amount, you must pay the difference. It is generally best to avoid dread disease and accident insurance unless it is included in your company's total health plan. Instead, you should concentrate on finding health insurance coverage that is as comprehensive as possible so that you will be protected against the widest variety of diseases and accidents that could occur.

Health-Care Plans

The three major types of health-care plans are as follows:

- Group private health-care
- Non-group and individual health-care
- Government-sponsored health-care

Group Private Health-Care Plans

Private health-care plans are sold by private insurance companies to individuals and employers as part of a benefits package. These plans include two types: fee-for-service plans and plans provided by managed health-care providers.

Fee-for-service plans, also called traditional indemnity plans, are private health-care plans in which doctors bill patients directly; the insurance company then reimburses a specific percentage or set amount of the bill to the patient. The advantages of these plans are that they provide patients with the greatest flexibility in choosing doctors and hospitals, and that individuals can go to whatever doctor or hospital they choose and still be reimbursed. Another advantage of these plans is that they define what percentage of each claim the policy will cover and what percentage the patient must cover. Finally, these plans clearly define how much the patient must pay before a claim is eligible for reimbursement. The disadvantages to these plans include that they are usually expensive for those insured and providers, and they require more paperwork than other types of insurance plans.

Plans provided by managed health-care providers offer prepaid health-care plans for employers and individuals. There are four main types of managed health-care providers: health maintenance organizations (HMOs), preferred provider organizations (PPOs), point-of-service plans (POSs), and exclusive provider organizations (EPOs). One of the advantages of managed health-care providers is that these organizations pay for and provide health-care services to policyholders, including preventive health-care. Also, managed health-care providers generally pay bills more efficiently than other providers because they do not require you to pay your doctor's bills and hospital bills first (with the exception of the nominal co-payment for visiting a doctor's office).

However, one disadvantage of working with managed health-care providers is that they limit the number of doctors and hospitals that participate in their program, thereby limiting your choices. Like fee-for-service plans, plans provided by managed health-care providers require you to pay a monthly premium and to share the cost of care; however, these costs are traditionally less than the costs of fee-for-service health care.

Health Maintenance Organizations (HMOs) provide prepaid insurance plans that entitle individuals to the services of specific doctors, hospitals, and clinics. These plans are the most popular form of managed health care because of their low costs, which are roughly 60-percent less than the costs of fee-for-service plans. HMOs provide a system of doctors and hospitals for a flat fee, and they emphasize preventive medicine and efficiency, which are advantages. The disadvantage of HMOs is that they provide limited choices of doctors and hospitals. Because of these limited choices, the quality of service may suffer, and referrals to other specialist doctors are sometimes difficult to get.

Preferred provider organizations (PPOs) provide insurance plans that are essentially a cross between traditional fee-for-service plans and HMO plans. PPOs negotiate with a group of

doctors and hospitals, and these doctors and hospitals provide care to PPO participants at reduced rates. PPOs then give individuals the option of choosing either "plan" or "non-plan" doctors. One advantage of PPOs is that they provide health care for less than the cost of fee-for-service plans while still allowing members to choose their doctor or hospital. Because PPOs provide a group of doctors who work at reduced rates for PPO participants, PPOs assess an additional fee if the participant uses a non-plan doctor or medical center. PPOs are generally more expensive than HMOs.

Point-of-service plans (POSs) have many of the attributes of HMOs, PPOs, and fee-for-service plans. For example, these plans generally have a network of contracted doctors, hospitals, and clinics. If you use these preferred providers, the fees are less. But you also have the option to go outside the network for other medical specialists if you are willing to pay a larger out-of-pocket fee. These plans may have a gatekeeper (a physician or other authority) that must be notified before participants are allowed to receive services.

Exclusive provider organizations (EPOs) are similar to HMOs, but they operate through an insurance company. These organizations are funded through an insurance company, and health care is provided by contracted providers. Only care received from contracted providers is covered, unless there is an emergency situation.

Non-Group and Individual Coverage Plans

Non-group coverage plans (also called individual health-care plans) insure individuals independently. These plans are often used by people who are self-employed or between jobs; they are also used by people whose companies do not offer group insurance. An advantage of these plans is that they provide a custom insurance policy. There are also several disadvantages to non-group coverage plans. These plans are expensive—they are usually 15 to 60 percent more expensive than group plans. Non-group coverage plans may also require subscribers to pass a medical exam prior to enrolling in the program; at a minimum, they require subscribers to submit a personal health history.

Before you sign up for a non-group coverage plan, check the insurance company's ratings and its claim service. It is best to avoid a company that raises premiums when claims are made or reserves the right to cancel policies at any time.

Instead of using a non-group coverage plan when you are between jobs, use COBRA, if possible. COBRA, which stands for the Consolidated Omnibus Reconciliation Act, requires companies with more than 20 employees to continue providing group health care to former employees, retirees, spouses, and dependents for a specific length of time. This length of time is based on the employee's reason for leaving the company and is usually about 18 months. If COBRA is used, the former employer must provide the insurance, but the discharged employee must cover the entire cost of the health insurance.

High deductible health plans (HDHP) are a form of catastrophic coverage with lower premiums and higher deductibles and is intended to cover catastrophic illnesses. Its advantage is that it is very low cost, as it covers only catastrophic illnesses. Its disadvantage is the high costs for medical coverage should it be needed. These should not be used without the following Health Savings Accounts.

Health savings accounts (HSAs) are a newer option to help people pay medical expenses. For 2019, almost anyone with a qualified high-deductible health plan (which is a plan with a minimum deductible of $1,350 for self and $2,700 for a family) can also have an HSA. Contributions can be made by an individual or an employer ($3,500 self, $7,000 family, with catch-up limits for those over 55 of $1,000). Maximum annual out of pocket expenses are $6,750 single and $13,500 family (see Table 2). Individuals contribute each year into an account that grows tax-free to pay for future qualified medical and retiree health expenses.

Advantages include you are paying for "qualified medical expenses" on a tax-free basis. It can be used to pay for medical expenses before you reach your deductible limits. Earnings grow tax-free, and carry over into retirement, and distributions may be used for spouse or kids.

Disadvantages include high deductibles, and if distribution not for qualified medical expenses, then it is included in income and subject to a 10% penalty (no penalty after age 65). These are not for the seriously ill

Table 2. High Deductible Health Plan Contributions, Deductibles and Limits

High Deductible Health Plan Limits			
Maximum Contributions:	Self	Family	Catch-Up *
2015	$3,350	$6,650	$1,000
2016	$3,350	$6,750	$1,000
2017	$3,400	$6,750	$1,000
2018	$3,450	$6,900	$1,000
2019	$3,500	$7,000	$1,000
Minimum Deductibles			
2015	$1,300	$2,600	
2016	$1,300	$2,600	
2017	$1,300	$2,600	
2018	$1,350	$2,650	
2019	$1,350	$2,700	
Maximum Out-of-Pocket Expenses:			
2014	$6,350	$12,700	
2015	$6,450	$12,900	
2016	$6,550	$13,100	
2017	$6,550	$13,100	
2018	$6,650	$13,300	
2019	$6,750	$13,500	

* If you turn 55 before the close of the tax year, you may also contribute an additional Catch Up amount.

Government-Sponsored Health-Care Plans

Government-sponsored health-care plans are sponsored by either the state or the federal government. These plans fall under four headings: (1) workers' compensation, (2) Medicare, (3) Medigap, and (4) Medicaid.

Workers' compensation is a state-sponsored insurance program that insures employees who have suffered work-related accidents or illness. An advantage of workers' compensation is that it provides insurance for workers injured on the job whether they have health insurance or not. A disadvantage is that it covers only work-related accidents and illnesses. Moreover, coverage is determined by state law and varies from state to state.

Medicare provides medical benefits to people who are disabled or are of age 65 and older and covered by Social Security. The costs of this federally sponsored program are covered by Social Security taxes.

The cost of private insurance for people who are disabled or are over age 65 is often unaffordable. Medicare provides a way for these individuals to get affordable health care. A disadvantage of Medicare is that it does not cover all the costs of care and treatment.

Medicare is divided into Part A and Part B. Medicare Part A is compulsory and covers all hospital-related expenses, including costs for hospitalization, skilled nursing-care facilities, home health care, hospice care, and prescription drugs furnished by the hospital.

Medicare Part B is voluntary and carries a monthly fee for services. Part B covers doctors' fees and other medical services, including clinical lab services, health care provided in the home, and outpatient hospital treatment.

Medicare does not cover the total costs of all services. Those insured by Medicare must still pay a portion of their medical costs in order to receive coverage. There are also limitations; for example, out-of-hospital prescription drugs are not covered, and the number of days a person can spend in a skilled nursing-care facility are limited.

Medigap is sold by private companies and covers the gaps between the two parts of Medicare. In all but three states, federal law has limited Medigap insurance provided by private companies to 10 set or standardized contracts, each with different options and costs. Another advantage of Medigap is that a person can't be rejected for health reasons if he or she enrolls in Medigap within six months of enrolling in Medicare Part B. A disadvantage of Medigap is that this type of insurance is expensive; however, consumers should shop around—costs can vary.

Medicaid is a medical assistance program that is jointly operated by states and the federal government through the Social Security program. It provides health-care coverage to persons who have a low income, to those who are blind or aged, and to needy families with dependent children. An advantage of Medicaid is that an individual's payments can be used to offset the

monthly premiums, deductibles, and co-payments incurred with Medicare. A disadvantage is that there is no guarantee Medicaid will still exist in its present form in the future.

Understand the Key Areas of Disability Insurance

Disability insurance provides payments to insured individuals in the event that regular income is interrupted by illness or an accident. Disability is similar to life insurance but is really earning-power insurance. An advantage of disability insurance is that it may provide you with between 50 and 80 percent of your after-tax income if you are disabled by a long-term illness or injury. Anyone who depends on earned income should at least look into disability coverage. The risk of disability is even higher than the risk of premature death.

Table 1. Different Types of Disability Insurance

Individual Disability Income	For personal protection, to provide income to individuals in the event of a disability.
Group Disability Income	For businesses to provide the owners and employees short-term and/or long-term benefits in the event of a disability.
Social Security Disability Income	Provides benefits to individuals covered under the Social Security system.
Workers' Compensation	Provides benefits to employees who incurred a job-related disability.
Disability Overhead Expense	Provides a monthly benefit for covered overhead expenses when a business owner is totally or partially disabled.
Key-Person Disability	Provides a benefit to the business in the event the key person is disabled.

The major sources of disability insurance are employers, the government, and private providers. Workers' compensation coverage is determined by individual states, with wide variability between states. Social Security benefits vary depending on your salary, how many years you have paid into the system, and how long the disability is expected to last.

The key question is how much coverage you should have. Generally, you should have enough coverage to maintain your living standard should you no longer be able to work. Your investment income will not stop with a disability, but your income from working will stop. If you have sufficient savings, you may not need much insurance, perhaps only 30 percent of after-tax income, depending on your investment portfolio. If you have little savings, you may need more,

perhaps 80 percent. Once a person has accumulated sufficient assets, it may be possible to self-insure fully or partially. If a person could stop receiving earned income and live comfortably for the rest of his or her life, then there would be no need for that person to insure his or her income.

Providers of Disability Insurance

Common providers of income in the event of a disability are the government, employers, and private providers.

Government

Disability income benefits may be provided by the government through the Social Security program. Benefits from this program are dependent upon income and time paid into the Social Security system. The Social Security website states:[2]

> The definition of disability under Social Security is different than other programs. Social Security pays only for total disability. **No benefits are payable for partial disability or for short-term disability**.
>
> "Disability" under Social Security is based on your inability to work. We consider you disabled under Social Security rules if:
>
> - You cannot do work that you did before;
> - We decide that you cannot adjust to other work because of your medical condition(s); **and**
> - Your disability has lasted or is expected to last for at least one year or to result in death.

This is a strict definition of disability. Social Security program rules assume that working families have access to other resources to provide support during periods of short-term disabilities, including workers' compensation, insurance, savings and investments.

Employers

Employers may offer two types of protection: workers' compensation and group disability insurance. The former is mandatory, and the latter is optional. Workers' compensation is state-specific and provides benefits only for job-related injuries or illnesses, while group disability insurance provides benefits for injuries or illnesses wherever or whenever they occur.

Group disability insurance is an optional benefit an employer may offer to its employees. The employer may implement or retract this benefit at any time for any reason. Typically a group disability plan will cover 50 to 70 percent of income, and most plans only cover base salary and do not cover bonuses or retirement contributions. The benefits are taxable when the insurance policy is paid for by the employer; sometimes the policy or a portion of the policy may be paid

for by the employee on an after-tax basis, which can result in tax-free benefits. Short-term disability and long-term disability benefits may be offered by group plans. Short-term disability can pay for the first few months of a disability, while long-term disability will start at the expiration of the short-term disability and typically pays out until normal Social Security retirement age. Frequently the definition of disability is constructed to change after 24 months of benefits and goes from an "own occupation" to an "any occupation" definition. An "own occupation" definition states that a person is disabled if he or she cannot perform the material duties of his or her current occupation. An "any occupation" definition requires the worker not be able to perform the material duties of any occupation that he or she may be physically, mentally, or educationally qualified to perform. Most group plans are also offset by any benefits received by Social Security, and group benefits typically do not increase with inflation.

Private Providers

Disability income insurance can be obtained most comprehensively through private providers. Individual disability income insurance policies are typically paid for with after-tax dollars, and the benefits are tax-free. The policies can stand alone or be used to supplement a group disability plan. Unlike group plans, individual plans typically do not change the definition of disability, are not offset by Social Security benefits, and may have benefits that increase with inflation. Individual disability income plans have many choices and factors. It is very important to choose wisely when selecting a company and a policy, as not all disability insurances are equal

Key Areas of Disability Insurance

There are eight key areas of disability insurance:

1. Definition of Disability.

Needs differ, which is why there are many different definitions of disability. It is important to understand the various ways disability is defined. What exactly does the policy consider a disability? Stick with a policy that defines disability as an inability to perform your normal job. A combination definition may include, "if you can't perform your normal job for the first two years, and afterward any occupation for which you are reasonably suited" and may be acceptable. The latter definition will have lower cost.

2. Partial Disability Benefits

Some policies offer partial disability payments that allow workers to return to work part-time. These payments make up the difference in earnings between part-time and full-time work.

3. Benefit Duration

Policies state how long the benefits will continue. Most policies provide benefits for a maximum period or until the disability ends (or the disabled reaches age 65 or 70). Short-term disability

policies, which are more expensive, generally provide benefits from six months to two years.

4. Waiting or Elimination Period

Policies determine the waiting period before the benefits begin. Short-term disability policies, which are more expensive, have a waiting or elimination period of 8 to 20 days. Longer-term policies have waiting periods of between one and six months. Generally the longer the waiting period, the less expensive the policy. Generally, a long-term policy makes more sense as your emergency fund protects you in the short-term.

5. Waiver of Premium

This option waives the premium payments if you become disabled.

6. Non-Cancelable Option

A policy may be purchased as either a non-cancelable and guaranteed renewable policy or as a guaranteed renewable policy. A non-cancelable policy cannot be changed unilaterally by the company. The premiums and provisions are guaranteed once the contract is issued. A guaranteed renewable policy cannot be canceled nor have its terms, other than premiums, changed by the company if timely payments of premiums have been paid. Make sure you have a policy that cannot be canceled. This protects you and guarantees your policy is renewable.

7. Rehabilitation Coverage

Rehabilitation coverage provides for vocational rehabilitation, allowing the policyholder to be retrained for employment through job-training and employment-related educational programs.

8. Cost-of-Living Rider

This provides for inflation adjustments to protect you from the impact of inflation.

Disability insurance is expensive. Generally, the annual premium will be around one to two percent of the income replaced. For example, a policy replacing $50,000 per year of annual salary would cost about $1,000 per year. However, it is something you should evaluate based upon your goals and objectives for you and your family.

Understand the Key Areas of Long-Term Care Insurance

Long-term care (LTC) insurance covers the costs of nursing-home facilities and long-term home health care. This type of insurance provides a daily dollar benefit—for example, $100 per day for the cost of long-term care. It may help families with a history of long-term diseases or disability to plan for the future. Two disadvantages of this type of insurance are that it is expensive and that it has many exceptions and conditions for coverage.

There are four basic ways of paying for long-term care: self-insurance, Medicaid, Medicare, and long-term care insurance. Self-insuring means having enough money set aside through saving and investing to pay for future care. Medicaid will provide coverage for long-term care if your income and assets are low and you have exhausted your own assets. Medicare is the federal medical insurance program for those 65 or older or disabled. It will pay the costs of certain benefits but generally will not cover personal or custodial care. Finally, long-term care insurance covers the costs of nursing-home facilities and the costs of long-term home health care.

Key provisions that control your qualification for benefits include the type of care covered, the benefit period, waiting period, inflation adjustment provision, waiver of premium provision, and non-cancel ability provision.

There are five key areas of long-term care insurance:

- Comprehensive or facilities-only plans
- Daily benefit amount
- Benefit period
- Elimination period
- Inflation adjustments

1. Comprehensive or Facilities-Only Plans

Comprehensive plans help pay for care received at home as well as care received in long term care (LTC) facilities. Facilities-only plans require care at LTC facilities, which include nursing homes, assisted living facilities, and hospice and respite care facilities. These plans are generally cheaper.

2. Daily Benefit Amount

This amount is either the maximum amount or the actual amount the insurance will pay per day for covered services. Some plans offer benefits on a monthly or weekly basis. Understand the rules for any policy you may be considering.

3. Benefit Period

This is the amount of time that you wish to receive the daily benefit amount. The period can range from 2 to 10 years or for an unlimited amount of time. Your total lifetime benefit is your daily benefit multiplied by your benefit period. For example, if your benefit amount is $110 per day * 1,825 days (five years), your lifetime benefit is $200,750.

3. Elimination or Waiting Period

Your elimination period is a period of time during which you are ineligible for benefits (this is the time before the insurance company begins paying claims). Policies with short or no

elimination period are more expensive than those with longer elimination periods.

4. Inflation Protection

There are a number of options to help you protect yourself against the increased costs of care in the future. You can add options for automatic compound inflation, simple inflation, periodic inflation, or future purchases.

Understand How to Control Your Health-Care Costs

Controlling health-care costs is critical for you to achieve your personal and financial goals. Group health-care plans are usually more desirable than individual plans for three reasons. First, participants can generally get group coverage at lower rates. Second, employers often provide group coverage as an employee benefit. And third, people with existing health problems may find it easier to obtain group coverage because this type of coverage is offered based on the group as a whole rather than on the individual.

There are four important things you can do to control your health-care costs:

1.Live a healthy lifestyle.
2. Use a group plan from work or subsidized plan.
3. Use a medical reimbursement or flexible spending account.
4. Use a health savings account.
5. Consider COBRA when changing jobs.
6. Opt out of a company insurance plan if you are already covered through a spouse's plan.

1. Live a Healthy Lifestyle

Living a healthy lifestyle is the most important part of controlling health-care costs. Take care of your body. Scriptures teach us that our bodies are temples (1 Corinthians 3:17). We must therefore learn to treat our bodies as the temples they are.

Learn to live in healthy mode. Get adequate exercise and adequate sleep. Going to bed early and rising early is wise counsel that dates back to Moses' time. Don't put anything into your body that would harm it.

Finally, maintain good relationships with family and friends. In times of trouble, family and friends can help and truly make a difference in our lives.

2. Use a group plan (from work) or subsidized plan

Group plans are generally cheaper, as companies can share the costs over multiple employers. Also, depending on your income, you may be eligible for a subsidized health plan through the health care marketplace. Check your options to find what is best for your current situation.

3. Use a Medical Reimbursement or Flexible Spending Account

A medical reimbursement account (sometimes called a flexible spending account) is an optional employer-established savings plan that allows you to save pre-tax dollars for non-reimbursable medical expenses. Each year, you set aside a specific amount of money in this account on a before-tax basis; as you pay for medical bills out of pocket, you are reimbursed from this account.

An advantage of a medical reimbursement account is that it provides a way for you to pay for non-reimbursable medical expenses with pre-tax dollars. This savings plan is very flexible and covers many items that may not be covered by insurance plans, such as braces, contact lenses, glasses, and other miscellaneous medical expenses. Disadvantages of this type of account include a lot of paperwork and some expenses that are not eligible for coverage. There is a chance that you may lose the money you set aside in this account; if you do not use all the money you set aside by the end of the year, you lose it.

4. Use a HDHP with a Health Savings Account

Depending on your health and needs, you might consider a High deductible health plans (HDHP), which is a form of catastrophic coverage with lower premiums and higher deductibles and is intended to cover catastrophic illnesses. Couple that with a Health savings accounts (HSAs) that will allow you to save for medical expenses with pre-tax money, and allows you to take more control over your health care expenses

5. Consider COBRA When Changing Jobs

If you use COBRA in between jobs, you are still able to have health insurance without getting individual coverage. However, a disadvantage of using COBRA is that you must pay the full cost of the insurance, and the cost may be substantially higher than it was before you left the company. Another disadvantage is that you must notify the company within 60 days of leaving that you are going to use COBRA.

6. Opt Out of a Company Insurance Plan If You Are Already Covered through a Spouse's Plan

Companies will sometimes offer you a cash incentive for refusing insurance coverage for yourself and your family. If you already have insurance through a spouse's (or parent's) company, and you are sure you will not lose coverage, opting out is an option.

If you opt out of insurance just to save money and you do not have other insurance, you may be giving up future financial security for additional cash now. This is a very dangerous situation; it is never recommended that you opt out unless you already have another form of insurance.

Know What to Look for When Shopping for Insurance

Selecting health insurance coverage may be the most important decision you make in regard to your financial plan. Medical problems are a leading cause of personal bankruptcy in the United States.

Health insurance is a technical and challenging issue; however, you can come to understand the different aspects of health insurance and use them to your advantage. Learn about the options for health insurance that are available to you and pick the options that will best help you achieve your personal goals. The following are some general tips to help you select the best option for health insurance.

1. **Always compare ratings.** As you look for health insurance, consider only high-quality insurance companies. Check with A.M. Best at http://www.ambest.com or Standard & Poor's at www.standardandpoors.com to review ratings on insurance companies. Look for strong companies with the least expensive, yet most comprehensive, plans.

2. **Protect yourself from catastrophic illnesses and accidents.** Know what you are buying. Read through the policies and avoid those with major exclusions or exemptions. Make sure you get needed coverage before you get optional coverage.

3. **Buy an individual policy if you are not covered at work.** If you are changing companies, consider using COBRA while you are between jobs. If your COBRA insurance has run out, consider joining a PPO or an HMO to reduce your medical costs. Group plans are generally less expensive than individual plans.

4. **Consider higher deductibles to reduce premiums.** By taking on some of the risk, you can reduce your monthly payments.

5. **Look for policies with a guaranteed renewal.** Avoid polices that are not guaranteed to be renewable. The last thing you want is to do is purchase a policy and then have it canceled after one period or year.

Understand Plans and Strategies for Health Insurance

As part of your Insurance Plan, you will need to include a section on health care strategies. Following are a few ideas for health strategies over different time periods of your life.

Health Insurance Plans and Strategies -
Students and young marrieds

- If planning for children and still on parents insurance, ensure parents insurance covers pregnancy. Deductible may be per person, and the baby is a person.
- If income levels are low, you may be eligible for Medicaid.

- If married without kids, compare your group plans to a Health Savings Account to see which plan has the best coverage for the costs.
- Once children come, switch to a traditional group plan to meet your family needs.
- Build your Emergency Fund to meet your needs.
- Use a flexible spending plan if offered by your employer to reduce your medical expenses.

Married with families

- Make sure you have sufficient health insurance to meet your family needs.
- Review your insurance needs annually during the open period to be most cost effective with your health expenses.
- Use a flexible spending plan if offered by your employer to reduce your medical expenses.

Empty nesters

- Make sure you have sufficient health insurance to meet your family needs.
- Review your insurance needs annually during the open period to be most cost effective with your health expenses.
- As children leave home, make adjustments to your health insurance to be cost effective with your coverage.
- Use a flexible spending plan if offered by your employer to reduce your medical expenses.

Summary

Having adequate health insurance is crucial; health insurance ensures that you and your loved ones will receive the necessary medical treatment throughout the course of your lives. Health insurance offers you peace of mind and eliminates the financial risk of having to make large payments to health-care providers for injury or illness.

There are four major types of health insurance coverage: basic health insurance, major medical expense insurance, dental and eye insurance, and dread disease and accident insurance.

The three major providers of health insurance are private health-care plans, non-group coverage plans, and government-sponsored health-care plans. There are two types of private health-care plans: fee-for-service plans and plans provided by managed health-care providers. There are four main types of managed care providers: health maintenance organizations (HMOs), preferred provider organizations (PPOs), point-of-service plans (POSs), and exclusive provider organizations (EPOs).

Non-group coverage plans (also called individual health-care plans) are health insurance plans that cover individuals on a case-by-case basis. Finally, government-sponsored health-care plans are insurance plans that are sponsored by either the state or the federal government. Government-

sponsored health-care plans fall under four headings: workers' compensation, Medicare, Medigap, and Medicaid.

There are best methods to control your health-care costs include:

1. Live a healthy lifestyle.
2. Use a group plan (work) or subsidized plan if available.
3. Use a medical reimbursement or flexible spending account.
4. Consider using a Health Savings Account (HSA).
5. Consider COBRA when changing jobs.
6. Choose no health care coverage if you already have coverage through a spouse (this is not recommended unless already have coverage).

Finally, we shared some possible health strategies for different periods of your life.

Assignments

Financial Plan Assignments

Health insurance is an important part of every family's financial plan. While it is not necessary (or cost-effective, perhaps) to have every type of health insurance, it is important to have basic coverage should catastrophic accident or illness strike. Determine what you should have and include these in your PFP Insurance Template (LT01-09).

What is your vision and goals for health insurance? What kind of insurance should you have?

Your assignment is first to get a copy of your health insurance plan if you have one. Who is the plan's provider? What kind of coverage do you have? Which of the major types of health insurance coverage do you have?

As part of this, get a copy of your health insurance manual. Go through the manual and review the different types of coverage you have, the co-payments, where you can go for service, the available doctors and clinics, and so on. Plan now so you know where you can go to get coverage. Keep a copy of your insurance company's summary pages in your financial plan. In case of accident or illness, you can go to that summary page to find all the necessary phone numbers and addresses. By having this information readily available, you will also minimize the problems that might arise from misunderstanding your available benefits.

Finally, you should determine what insurance you should have. Develop plans and strategies to obtain the type of insurance you determine to be best for your situation.

Review Materials

Terminology Review

Basic Health Insurance. This is basic health coverage which covers hospital, surgical and physician expense insurance. It covers hospital insurance, which is hospitalization expenses including room, board, nursing, and drug fees; surgical insurance, which is the direct costs of surgery including the surgeon's and equipment fees; and physician expense insurance, which covers physicians' fees including office, lab, X-ray, and fees for other needed tests.

Dental and Eye Insurance. This is insurance which covers only dental work and expenses relating to the eyes and teeth. Generally, it is only partial costs of eye exams, glasses, contact lenses, dental work, and dentures. Know your coverage, as the amount covered varies by plan provider. These plans are generally expensive, unless they are provided as part of an employer plan.

Dread Disease and Accident Insurance. This is a special insurance to cover a specific type of disease or accident. Generally it provides only for 'specific' illnesses or accidents on the "covered" list, and it provides a set maximum dollar amount of reimbursement. This insurance is generally expensive, unless included in your company's total health plan. Generally, concentrate on making your health coverage as comprehensive as possible.

Exclusive Provider Organization (EPO). These are similar to an HMO, but operates through an insurance company. It is funded through an insurance company, with health care provided by contracted providers. Only care received from contracted providers is covered (unless in an emergency situation).

Fee for-service (or traditional indemnity plans). These are health care plans where the doctor bills the patient directly, and the patient is reimbursed, to a specific percentage, by the insurance company. They provide the greatest flexibility for choosing doctors and hospitals, they define the percent of each claim the policy will cover, and they define the amount the insured must pay before a claim is eligible for reimbursement. Generally these plans are more expensive and require more paperwork.

Government-Sponsored Health Care Plans. Government-sponsored health care plans are insurance plans which are sponsored either by the state or the federal government. These plans fall under three headings: Workers' Compensation, Medicare, and Medicaid.

Health Care Coverage. Health Care Coverage is divided into four areas: basic health insurance, major medical expense insurance, dental and eye insurance, and dread disease and accident insurance.

Health Care Providers. These are the major providers of health care. They fall into three types: Private health care plans, which are either fee-for-service (or traditional indemnity plans) or managed health care (HMO, PPO); Non-group (individual) health care plans, or Government-sponsored health care plans.

Health Maintenance Organizations (HMOs). HMOs are prepaid insurance plans which entitle members to the services of specific doctors, hospitals and clinics. They are the most popular form of managed health care, due to their costs, which are roughly 60% of fee-for-service plans. They provide a system of doctors and hospitals for a flat fee, and emphasize preventive medicine and efficiency, and subscribers pay a relatively small co-pay for services rendered. They provide little choice of doctors and hospitals. As such,

service may be less than at other facilities and referrals sometimes difficult to get.

Liability Coverage. Liability is the financial responsibility one person has to another in a specific situation. Liability results from the failure of one person to exercise the necessary care to protect others from harm. Personal liability coverage protects the policyholder from the financial costs of legal liability or negligence. There are two major forms of liability insurance: the liability portions of homeowners and auto insurance and an umbrella liability coverage.

Major Medical Insurance. This is major coverage of medical costs over and above the basic health insurance coverage. It covers medical costs beyond the basic plan. These normally require a co-payment and/or a deductible. There is a stop-loss provision, which limits the total out-of-pocket expenses incurred by the insured to a specific dollar amount and a life-time cap for the insurance company, which limits the total amount the insurance company will pay over the life of a policy.

Managed Healthcare Providers. These are insurance companies which provide pre-paid health care plans to employers and individuals. There are four main types of managed care: Health maintenance organizations (HMOs), Preferred provider organizations (PPOs), POS Plans (POS), and Exclusive Provider organization (EPOs). They pay for and provide health care services to policy holders and are the most efficient payment of bills. However, they limit choices to the doctors and hospitals that participate and they require policy holders to pay a monthly premium and share the cost of care.

Medicaid. Medicaid is a medical assistance program, operated jointly by the states and federal government, to provide health care coverage to low income, blind, or aged persons. Medicaid payments may be used to offset the premiums, deductibles, and co-payments incurred with Medicare. There is no guarantee that this plan will be around in its present form.

Medicare. Medicare insurance provides medical benefits to the disabled and to those 65 and older who are covered by Social Security. Its cost is covered through Social Security taxes. Individuals can get insurance through Medicare that would be prohibitively expensive through other channels, however, it doesn't cover all the costs and expenses so individuals must pay certain amounts. In addition, there are limitations to the coverage, such as out-of-hospital prescription drugs and limitations to the number of days in skilled nursing facilities. Medicare is Divided into three parts: A,B, and C.

- Medicare Part A is compulsory and covers all hospital related expenses, such as bed,board, operating room costs, and lab tests. Patient pays a deductible and coinsurance payment.
- Medicare Part B is voluntary, with a monthly charge. It covers doctors' fees and other outpatient treatment. Patient pays a premium, deductible, and 20% of approved charges.
- Medicare Part C (Medicare Advantage) provides three program alternatives: coordinated care plans, private fee-for-service Medicare, and health savings accounts (HSAs).

Non-group Coverage Plans. These are health insurance plans which cover individuals on a case-by-case basis and are traditionally the most expensive type of coverage. They

provide a custom insurance policy to the purchaser. They are expensive, usually 15% - 60% more expensive than a group policy and may require subscribers to pass a medical exam.

Point of Service Plans (POS). These plans have attributes of HMOs, PPOs, and indemnity plans. The point at which benefits are received determines the amounts of benefits paid. POS may include HMO, PPO, and indemnity type programs, and the POS may also have a gatekeeper.

Preferred Provider Organizations (PPOs). PPOs are insurance plans which are essentially a cross between the traditional fee-for-service and an HMO. PPOs are organizations where in-plan provider's fees are covered, and out-of-plan providers results in higher fees. Insurers negotiate with a group of doctors and hospitals to provide care at reduced rates, while giving insurers the ability to go to non-plan doctors. PPOs provides health care at a discount to fee-for-service plans. They provide a group of doctors which work at reduced costs to the participants, while assessing an additional fee if the participant uses a non-member doctor or center. PPOs are more expensive than HMOs and use of non-PPO providers results in higher out-of-pocket costs.

Private Health Care Plans. These are health care plans sold by private insurance companies to individuals and employers as part of a benefits package.

Workers' Compensation. Workers compensation is state insurance program that insures against work-related accidents and illness. Workers' Compensation provides insurance to workers injured on the job, regardless of whether they have other health insurance or not. It only covers work-related accidents and illnesses, and coverage is determined by state law and varies state by state.

Review Questions

1. What is currently a major concern in the health-care industry? Why is the cost rising?
2. What are the four major types of health insurance coverage?
3. What is a co-payment? Is there a deductible?
4. What are the three major types of health-care plans?
5. What are four important things you can do to control your health-care costs?

Case Studies

Case Study 1

Data

Steven has a major medical policy for $1 million. The policy has a $500 deductible, an 80 percent co-insurance provision, and a $5,000 stop-loss limit. He recently incurred $10,500 worth of covered medical expenses.

Calculations

What amount will the insurer pay in this situation? What amount of these covered medical expenses will Steven pay?

Case Study 1 Answers

The insured pays the deductible first ($500), then the insurance company and the insured split the remainder (80 percent / 20 percent), up to the stop-loss limit of the insured ($5,000). The breakdown of payments for covered medical expenses are as follows:

Total Expenses	$10,500	Insurer Pays	Steven Pays
Deductible	$500	$0	$500
Remaining	$10,000		
80/20 Split		$8,000	$2,000
Total Payments	$10,500	$8,000	$2,500

[1] "Constancy Amid Change," *Ensign*, Nov. 1979, 80

[2] http://www.ssa.gov/dibplan/dqualify4.htm

14. Insurance 4: Protecting Your Assets through Auto, Home/Renters, and Liability Insurance

Introduction

In addition to life insurance and health insurance, you should own and understand three other important types of insurance: auto insurance, homeowner's/renter's insurance, and liability insurance.

These types of insurance are valuable assets for any family working toward financial security. They ensure that when the unexpected happens, you will not lose the things you have worked for all your life because you do not have the necessary funds to pay for damages.

As with all types of insurance, the amount of insurance and the type of coverage you carry should be updated annually. Your insurance policies should also be updated when you acquire additional personal property or when inflation increases the value of your home or other assets.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand the key areas of auto insurance and know how to reduce your costs.
B. Understand the key areas of homeowner's and renter's insurance and know how to reduce your costs.
C. Understand the key areas of personal liability insurance.
D. Understand plans and strategies for asset protection.

Understand Auto Insurance and Know How to Reduce Costs

"There are 30 million accidents in the United States annually, which equals about 1 accident for every five licensed drivers. These accidents result in over $100 billion in economic losses, 2 million injuries, and 40,000 deaths."[1]

There are many steps you can take to reduce the probability of an accident. You can drive defensively, obey all traffic rules, avoid high-traffic areas, and use good judgment when driving. However, although you can control how you drive, you cannot control how others drive; therefore, your risk of being in an automobile accident remains high. Auto insurance is a necessity for all drivers.

Auto insurance is a contract between you and the insurance company in which you agree to pay a

monthly premium, and the insurance company agrees to pay a specified amount for any losses defined in your policy. Losses that exceed your policy's limit are your liabilities, so it is important that you have adequate coverage.

Basic Parts of Auto Insurance

To legally drive your car, you are required by law to carry a minimum level of auto insurance. However, most experts agree that the minimum coverage required by law is insufficient. There are four basic parts of automobile coverage:

- Part A: Liability coverage
- Part B: Medical payment
- Part C: Uninsured/underinsured motorist coverage
- Part D: Comprehensive physical damage coverage

Part A: Liability coverage pays for losses related to bodily injury, property damage, lawsuits, and defense costs. Bodily injury refers to expenses related to deaths or injuries resulting from an accident. Property damage refers to costs for damage to the car or cars involved in an accident, as well as damages to other property (such as lampposts or fire hydrants). Lawsuit coverage refers to losses related to any lawsuit resulting from an accident; in addition to the maximum amount of expenses your policy covers for a lawsuit, your policy may also cover your defense costs if the case goes to trial.

Liability coverage may be listed on your policy as a combined limit or as a split limit, depending on the type of insurance you have. Combined-limit insurance lists one maximum amount the insurance company will pay to cover all types of liabilities. Split-limit insurance lists the maximum amount the insurance company will pay for each of the specific types of liability. For example, if you have a 100/300/50 split-limit insurance policy, it means your limits are $100,000 per person for bodily injury liability coverage, $300,000 per accident for bodily injury liability coverage, and $50,000 per accident for property damage coverage. These dollar amounts are the maximum amounts your insurance company will pay per person or per accident. Should the costs of the accident exceed these limits, you will be responsible for paying the difference. My recommended split-limit minimum liability coverage limits are $100,000 per person and $300,000 per accident with $50,000 for property damage. My combined-limit recommended liability coverage limits are a minimum of $300,000 per accident with $50,000 property damage.

Part B: Medical payment coverage pays for accident-related medical costs and funeral expenses incurred by you or your family members within three years of an accident. It also covers the insured while walking, even though he is not in a vehicle. My recommended minimum medical payment coverage is $50,000.

Medical payment coverage does not cover all medical expenses, however. For example, it does not cover your medical expenses if you are injured by a vehicle that is not designed for public streets, such as an unlicensed three- or four-wheel all-terrain vehicle. Be sure you know what

types of injuries are excluded from your policy.

Part C: Uninsured or underinsured motorist coverage covers your costs if you are injured by an uninsured motorist or if you are injured in a hit-and-run accident. It also covers your costs if the other driver's insurance is insufficient to pay for your expenses (in other words, if the other driver is underinsured). The other driver must be at fault for you to collect on this coverage. I recommend that you keep your uninsured/underinsured insurance coverage the same as your liability coverage.

Part D: Comprehensive physical damage coverage (also called collision coverage) pays for damage resulting from any collision, regardless of who is at fault. If the other driver is at fault and has liability insurance, your insurance company should be able to recover losses from the other driver's insurance company. If the accident does not involve a collision with another car, comprehensive physical damage coverage pays for damage to your vehicle.

Standard Exclusions

Exclusions are clauses in your contract that limit the insurance company's liability to pay for specific claims. For example, your insurance company may not pay on a claim if the following situations apply:

- You intentionally cause damage or injury.
- You drive the vehicle without permission.
- Your vehicle has fewer than four wheel.
- You drive someone else's vehicle on a regular basis.
- Your automobile is not listed on your policy.
- You are carrying passengers for a fee.
- You are driving in a race or speed contest.

You should be aware of and avoid any circumstances where exclusions to your insurance would apply.

No-Fault Insurance

No-fault insurance is coverage that pays for the driver's injuries, regardless of who causes the accident. Such policies are designed to promote faster reimbursement and reduce the amount of litigation necessary. No-fault policies vary from state to state and are available only in "no-fault" states. There are many advantages to having no-fault insurance. It is easier to deal with because your insurance pays for your injuries, and the other driver's insurance pays for his or her injuries—there are no legal battles. Claims are processed faster because you are guaranteed immediate compensation for your losses.

However, there are disadvantages to having no-fault insurance as well. Damages from pain, suffering, and emotional distress are not usually covered by no-fault insurance; other

disadvantages include lower dollar limits on medical expenses and lost income, and losses above your established limits are not covered. Vehicle damage is not covered: to repair your vehicle, you must rely on your collision coverage or the other driver's. No-fault insurance also has liability thresholds that may restrict your ability to pursue a liability lawsuit.

Keeping Costs for Automobile Insurance Down

The cost of your auto insurance is determined by the type of car you drive, how much and how far you drive the car each day, and your driving characteristics. These driving characteristics include your driving record, where you live, and any discounts for which you qualify. Insurance companies also use your credit score to determine the cost of your insurance. The following are some tips for keeping your automobile insurance costs down:

1. **Shop comparatively.** Know what different insurance companies in your area are charging for similar coverage. Determine the amount and type of insurance you need and then shop comparatively.

2. **Consider only high-quality insurance companies.** Review insurance ratings from different companies such as A.M. Best (look for a rating of A and higher) at www.ambest.com, Standard & Poor's (AA and higher) at www.standardandpoors.com, Fitch (AA and higher), and Moody's (Aa2 and higher). Make sure the company you have chosen is sound. Find examples of others who have made claims with the company and determine how well the company handled those claims. Having cheap insurance is worthless if the company fails to pay on claims.

3. **Make use of all available discounts.** Apply for all discounts you think you or your family members would qualify for, such as non-smoking, non-drinking, good grades, and multiple vehicles. In addition, consider buying auto insurance from the same company with which you have your homeowners' insurance or life insurance because you should get a multiple-policy discount. Always ask your insurance agent, "Are you sure you can't do better than that?" and "Are you sure there are no other discounts?"

4. **Buy vehicles that are inexpensive to insure.** Ask your insurance company about the costs of insuring specific vehicles before you purchase a new car. Buying a car that is a favorite of thieves is likely to raise your insurance costs. However, buying a car with extra safety features and antitheft devices may reduce your insurance costs.

5. **Drive defensively.** Driving defensively is critical to reducing your insurance costs. Keep your driving record clear of tickets and accidents. If you or someone in your family gets a ticket, go to traffic school to keep the ticket off your record whenever possible.

6. **Raise your deductibles.** If you want to cut monthly insurance costs, raise your deductibles. Moreover, consider dropping collision coverage completely once the value of your car drops below $2,000; it may be more cost effective for you to pay repair costs out of your own

pocket if the car is in a collision.

7. **Keep adequate liability insurance.** Never reduce your liability limits to reduce your insurance costs! Liability insurance is fairly inexpensive, but it is very important: keep your limits high.

8. **Be cautious of allowing others to drive your car.** Remember that if a friend causes an accident in your car, and you gave your friend permission to drive the car, you (and your insurance company) will likely have to pay the bill, and your insurance costs may go up.

9. **Improve your credit score.** Take the steps necessary to improve your credit score; insurance companies believe that those with high credit scores are less of an insurance risk than those with lower credit scores. Review your credit score and credit reports every few years and make sure they are correct.

10. **Review your insurance coverage on a regular basis.** Review your insurance costs, coverage, liability limits, and discounts on a regular basis—at least annually. Make sure all your vehicles are included in your policy. Review your CLUE (Comprehensive Liability Underwrites Exchange) report at www.choicetrust.com and make sure it is correct.

Filing a Claim on Your Auto Insurance

If you are in an accident, the following tips may be helpful.

First, use wisdom in your actions: If there is an accident, call the police immediately and cooperate with them when they arrive. Move the vehicles out of traffic or put up flares. (I recommend that you keep flares in your vehicle's emergency kit.) Get help for anyone who has been injured. Write down the names and contact information of any witnesses to the accident. Insist that all drivers be tested for alcohol consumption if you are concerned that alcohol may have been a factor in the accident. Before leaving the scene of the accident, get the police case number for your records.

Second, keep calm and stay in control. Write down your memories of the events leading up to and following the accident. Don't sign anything or admit guilt. Remember to be firm on your views about what happened when you speak with the police officers. Don't be afraid to speak up and give pertinent information about the accident—even if that information contradicts the other driver's story.

Third, follow up on the accident properly and promptly. Get the name of the other driver's insurance company and call your insurance company as soon as possible. Cooperate with your agent and your claims adjuster, the person assigned by your insurance agent to determine the amount of the loss. Obtain a copy of the police report and keep records of all accident-related expenses. Review the settlement steps in your policy and follow these steps exactly.

Finally, if you are dissatisfied with the settlement the insurance company offers, request a meeting with your agent and your claims adjuster. If you are still not satisfied after this meeting, contact your insurance company's consumer affairs office or the state insurance commissioner and explain your concerns.

Understand Homeowner's and Renter's Insurance and Know How to Reduce Costs

Your home is likely one of the largest purchases you will ever make. Because your home is such an important purchase, it needs to be protected. The purpose of homeowner's insurance is to cover the costs of repairing or replacing your home in the event it is damaged by specific disasters, such as fire, theft, or storms. Know which risks you want homeowner's insurance to cover, and make sure you get the type of that covers those risks.

Basic Types of Homeowner's Insurance

There are six basic types of homeowner's insurance:

1. **HO-2** is a general form of homeowner's insurance and the least expensive type; it covers only named perils. These perils may be fire, lightning, hail, explosions, and so on. If a peril is not listed, it is not covered by the insurance.

2. **HO-3** includes open perils protection. Open perils protection covers all direct physical losses to your home and lists specific exclusions. All forms of homeowner's insurance exclude certain types of damage, including damage caused by law (problems caused by a lack of proper permits), earth movement (earthquakes), water damage (floods), power failure, neglect, war, nuclear accidents, and intentional loss. Although HO-3 excludes these perils as a general rule, coverage for some of these specific perils may be added separately to the policy. HO-3 coverage is generally recommended as a minimum level of homeowner's insurance.

3. **HO-4** is renters' and tenants' insurance. Because this coverage is available only to renters and tenants, it covers damage or loss of personal property rather than loss or damage to the structure itself. HO-4 provides liability coverage in case of an accident, but it does not cover structural damage. The personal property coverage provided by HO-4 is similar to the coverage provided by HO-2. All-risk coverage is available for HO-4 insurance and is recommended. All-risk coverage includes coverage for all risks except those excluded from homeowners coverage.

4. **HO-5** is a new, unique form of homeowner's insurance that covers open perils and includes a rider (HO-15) that allows open perils coverage on personal property in addition to other coverage. HO-5 covers all direct physical losses to your home, or open perils protection. HO-5 has the same exceptions as HO-3.

5. **HO-6** is condominium owners' insurance. HO-6 is similar to HO-4 coverage, but it is

available only to co-op or condominium owners. Besides covering personal property, this insurance also covers improvements you have made to the dwelling. All-risk coverage is available as an option and is recommended.

6. **HO-8** is modified coverage for older homes. HO-8 is similar to HO-1 coverage, or insurance against named perils. It insures the dwelling for the repair cost or market value instead of the replacement value. All-risk coverage is available as an option and is recommended.

Basic Parts of Homeowner's Insurance

Homeowner's insurance covers four key components: the main dwelling, other structures, personal property, and loss of use.

Coverage A: Main dwelling coverage protects the home and any attachments to the home. It does not cover any damage to the land.

Coverage B: Other structures coverage protects buildings on the property that are not attached to the main dwelling, as well as landscaping; however, it does not protect land or structures used for business purposes. Coverage of other structures is limited to 10 percent of the value of the home's coverage.

Coverage C: Personal property coverage pays for all personal property that is owned or used by the policyholder. It covers personal property regardless of the property's location. For example, loss to contents in your personal vehicle at work would be covered by the personal property component of your homeowner's insurance. Personal property coverage also covers property of guests in your home. It is limited to 50 percent of the home's coverage. For example, if your home is covered for $250,000, you can have up to $125,000 coverage for personal property. In addition, there is a $200 limit on cash, gold, and silver; a $1,000 limit on securities, tickets, and stamps; and a $2,500 limit on silverware. Note that birds, fish, and other animals are not considered personal property.

Coverage D: Loss of use coverage pays for losses that are incurred if your home becomes uninhabitable. It is limited to 20 percent of the home's coverage. Benefits of this type of coverage cover living expenses that are incurred if you need to relocate temporarily until your home is repaired. This type of coverage also covers fair rental value of any structure in which a renter was leasing part of the home. Finally, this type of coverage covers losses in the case that a civil authority prohibits you from using the structure.

If you need additional coverage, a homeowner's policy can be supplemented in a number of ways through endorsements or additions to your policy. Examples of endorsements include inflation, floaters, and specific risk coverage. An inflation endorsement allows insurance protection to increase parallel to the increase of repair and rebuilding costs. A floater policy

endorsement insures valuable personal property for an amount that is higher than your existing homeowner's policy limits. Flood insurance, earthquake insurance, and terrorism insurance provide protection in case of specific types of loss as well.

Keeping Costs for Homeowner's Insurance Down

Three basic factors determine how much a policy costs: location of structure, type of structure, and level of coverage. There are eight major areas you should consider when looking to reduce your homeowner's insurance costs:

Table 1. Homeowner's Insurance Coverage

Homeowners Insurance Summary 2019
Fin200/Fin418/MBA620 (02/18/19)

		Section 1: Property				Section 2: Liability	
Policy Type	**Description**	**Coverage A: Dwelling**	**Coverage B: Other Structures**	**Coverage C: Personal Property**	**Coverage D: Loss of Use**	**Coverage E: Comprehensive Liability**	**Coverage F: Medical Payments and Other**
HO 02: Basic Insurance Coverage							
	"Basic form" that provides insurance on a "named-peril basis for dwelling and personal property, " i.e., only covers losses listed on the policy	Broad form, $15,000 minimum	Broad form, 10% of A	Broad form, 50% of A	Broad form, 20% of A	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 03: Broader form, includes open perils (this has been the standard form for decades)							
	"Broad form" that provides "open-peril" insurance on dwelling and structures but "broad form" on personal property	Open Peril, $20,000 minimum	Open Peril, 10% of A	Broad form, 50% of A	Open Peril, 20% of A	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 04: Renters, or Tenant's Insurance							
	Renters insurance with liability and personal property covered up to the policy limits	Not covered	Not covered	Broad form, $6,000 minimum	Broad form, 20% of C	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 05: Broader form, incl. open perils coverage on Personal Property (only for newer homes, higher values and well maintained)							
	"Comprehensive form" that covers both the home and personal property on an "open-perils" basis--broadest form of insurance available	Open Peril, $20,000 minimum	Open Peril, 10% of A	Open Peril, 70% of A	Open Peril, 30% of A	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 06: Condominium Insurance							
	Condo policy that generally cover personal property and condo structure from the wall studs in	$1,000	Included in A	Broad form, $6,000 minimum	Broad form, 40% of C	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits
HO 08: Modified coverage for Older Homes							
	Policy used to insure older homes that would be difficult to replace if destroyed, hence the home is insured at market value	Basic, $15,000	Basic, 10% of A	Basic, 50% of A	Basic, 10% of A	All amounts due to bodily injury or property damage to policy limits	All amounts for medical and property payments to others to policy limits

HO-3 Standard Named Perils: These include theft, fire, explosion, smoke, freezing, vehicles, falling objects, volcanic eruption, windstorm or hail, riot or civil commotion, aircraft damage, vandalism, snow damage, water damage. **Excluded generally from HO-3 and HO-5**: These include power failure, pollution, earth movement, flood damage, intentional loss, war, nuclear accident, pets, settling, wear and tear, negligence, actions by government, legal action, theft or damage from vandalism, and deterioration due to weather

1. Know your needs. Know what you want out of your homeowner's insurance. Remember to insure against the high-risk, high-severity items and self-insure against the

low-severity, low-risk events.

It may be wise to buy guaranteed full-replacement cost coverage for your home in case the home is damaged beyond repair. If you have this type of coverage, your home will be replaced without cost to you, regardless of what you paid for the home. Also, determine whether other structures or landscaping on your property have adequate coverage. Purchase additional insurance if part of your home is used as an office. You can also purchase extra coverage for unique situations if you have specific concerns that are not included in a policy; for example, if you live on a flood plain, you may want to add flood insurance to your policy. Finally, consider extra coverage, or floater policies, for valuables such as paintings, jewelry, or collections.

2. Don't underinsure. The 80-percent rule states that a dwelling should be insured within 80 percent of its replacement cost. If you do not carry adequate insurance on your home, co-insurance requires you to pay for a portion of your home's loss. If your home is not insured for at least 80 percent of its replacement cost, your settlement will be the greater of two amounts: either the settlement will be the cash value of the damaged or lost portion of the home or the settlement will be the amount of your insurance coverage divided by 80 percent of the replacement cost multiplied by the value of the loss. For example, if your home was insured for $300,000 but its replacement cost was $400,000, you are underinsured. You should have had a minimum insurance amount of $320,000, or 80 percent of $400,000. If you had a loss of $250,000, the company would pay $300,000 (your insured amount) divided by $320,000 (80 percent of the replacement value), times $250,000—or $234,375 (not including deductibles). You would be personally responsible for $15,625.

3. Select a financially sound insurance company with comparatively low costs, and stick with them. Shop around for homeowner's insurance—knowledge is your most important asset. Remember, the more types of insurance you have with a single insurance company, the lower your costs on specific types of insurance will be (multiple-policy discounts can be substantial). Once you have decided on an insurer, check with www.ambest.com to review your insurer's ratings and financial health. Pick a good insurer that is not likely to go out of business. Different companies have different discounts for different areas; talk with your agent and get as many discounts as you possibly can.

4. Get a CLUE (Comprehensive Loss Underwriting Exchange) report for both your home and your automobiles. A CLUE report is similar to a credit report. It gives a list of all payments made by the insurance company on your behalf. Review this report—this is what potential insurance companies will see when they are considering you as a client. You can get one copy a year from www.choicetrust.com. Be careful that inquiries are not listed as actual payments.

5. Reduce the insurance company's risk. There are a number of ways to do this. First,

you may want to consider paying your premiums annually instead of monthly; paying your premiums annually lowers administrative costs for your insurer and usually lowers your costs as well. In addition, some companies will give you a 5 to 10 percent reduction in costs if you allow them to deduct your insurance costs monthly through electronic funds transfers (EFTs). Second, increase your deductible. The higher your deductible, the lower your premium costs; by raising your deductible you are self-insuring a greater part of your risk.

Third, make your home more disaster-resistant and safer. Companies may give discounts if you make your home more disaster-resistant, for example, by adding storm shutters or buying strong roofing materials. Contact your insurance company to find out about possible discounts. Insurance companies may also give a 5 to10 percent discount if you add fire extinguishers and burglar alarms that are connected to police monitoring. Because of the high cost of home security systems, contact your insurance agent to see what the agent recommends and how much savings would be before you purchase these systems.

6. Know your coverage. You should read and understand your policy completely. Remember, the amount paid by the insurance company will never exceed the limit listed on your policy. An important restriction you should be aware of stipulates that in order to receive full insurance benefits, you must rebuild in the same location. If you don't rebuild in the same location, your insurance company will give you only the cash value of the home and not the replacement value.

7. Make your coverage work. Create an inventory of everything you insure, preferably on videotape, to establish proof of ownership. Keep the inventory in a safe place away from the house and update it yearly. Videotape the exterior of your home to document the value of landscaping and the condition of the house and update this record yearly as well. Make a list of the value of your assets. These records will be invaluable if your home or assets are damaged.

8. Keep your credit score high. Having a solid credit history can reduce your insurance costs. Monitor your credit report annually, check your credit score every two years, and keep your credit score high.

Filing a Claim on Your Homeowner's Insurance

If you have to make a claim on your homeowner's insurance, there are a number of steps you should take to protect yourself and speed the insurance process.

First, notify the police immediately of any theft or loss. Get copies of all police reports. Call your insurance company and notify the company of the loss as well. In some circumstances, you will need to follow up your call with a written claim.

Second, make a list of damaged, stolen, and destroyed items. If the loss required you to live outside the home, submit receipts for any additional living expenses to your insurance company as needed. Provide information requested by your claims adjuster, and accommodate the insurance company as much as possible.

Finally, review the steps of settlement explained in your policy and follow these steps exactly. If you are dissatisfied with the settlement offer, request a meeting with your insurance agent and claims adjuster. If you are not satisfied after this meeting, contact your insurance company's consumer affairs office or the state insurance commissioner and explain your concerns.

Understand the Basics of Personal Liability Insurance

A liability is the financial responsibility one person has to another person in certain situations. Liability results from negligence or the failure of one person to exercise the necessary care to protect other people from harm.

The cost of liabilities can be substantial. Every year, thousands of people are sued for more than one million accidents caused by or related to cars or homes. The purpose of personal liability insurance is to protect you from the financial costs of legal liability and negligence.

There are the two major forms of liability insurance: (1) the liability portions of homeowner's and automobile insurance and (2) an umbrella liability policy.

An umbrella liability policy is an insurance policy that adds additional protection to the protection provided by your homeowner's and automotive policies. An umbrella policy becomes effective only after the limits of your homeowner's or automotive policy have been reached. Therefore, many companies require specific coverage limits on homeowner's and automotive policies. For example, an insurance company may require you to have 250/500/100 insurance on all vehicles and $300,000 on all homes before they will write an umbrella policy.

Understand Plans and Strategies for Asset Protection

As part of your Insurance Plan, you will need to think through what asset protection strategies you will use during your live. Following are a few ideas for asset protection strategies over different time periods.

Asset Protection Plans and Strategies

Students and young marrieds

- Keep your credit score high to keep your insurance costs low.
- Have adequate auto insurance, with a minimum 100/300/100 split coverage initially.
- Have adequate renters insurance. If you get renters insurance from your auto insurer, there is likely a reduction in auto insurance costs. Some actually save money by purchasing renter's insurance.

- Keep an adequate emergency fund. With a higher emergency fund, you can raise your auto and home deductibles to reduce costs and co-insure a greater proportion of your assets.
- Raise your auto and home deductibles to reduce costs and co-insure a greater proportion of your assets.

Married with families

- Raise your split coverage to 250/500/100 to offer more protection when you have teenage drivers.
- Make sure teenage drivers keep grades, us, take "safe-drivers courses" to reduce their insurance costs, and take all "good student discounts" for auto insurance.
- Stay ticket free. If you get a ticket, go to traffic school. Get the ticket removed from your record.
- Raise your auto and home deductibles to reduce costs and con-insure a greater proportion of assets
- Consider an umbrella policy to reduce the risk of future litigation expense as your assets rise.
- Buy Guaranteed Full Replacement cost coverage.

Empty nesters

- Make sure you have sufficient auto and home insurance to meet your family needs.
- Review your insurance needs annually to ensure you have adequate coverage.
- As children leave home, make adjustments to your asset insurance to be cost effective with your coverage.
- Consider an umbrella policy to reduce the risk of future litigation expense as your assets increase.
- Take into account toys that are used for kids and grandkids and keep coverage up.
- Consider an umbrella policy to reduce the risk of future litigation expense as your assets rise.

Summary

Auto insurance is a contract between you and the insurance company in which you agree to pay a monthly premium, and the insurance company agrees to pay a specified amount for any losses defined in your policy. Losses that exceed your policy's limit are your liabilities, so it is important that you have adequate coverage.

Your home is likely one of the largest single purchases you will ever make; it is important for you to protect this important purchase. The purpose of homeowner's insurance is to repair or replace your home in the event it is damaged by specific disasters. Know which risks you want homeowner's insurance to cover, and make sure the policy you choose covers those risks.

An umbrella liability policy is an insurance policy that adds additional protection to the protection provided by your homeowner's and automotive policies. This policy becomes effective only after the limits of your homeowner's policy or automotive policy have been reached.

As part of your Insurance Plan, you should come up with strategies how you will utilized insurance in asset protection.

Assignments

Financial Plan Assignments

There are several different assignments for this chapter. Having auto insurance is a critical part of owning and driving a car; in fact, it is illegal to drive a car unless you have insurance. Your assignment is to get a copy of your auto insurance and include it in your financial plan and include these in your PFP Insurance Template (LT01-09).

Auto insurance. Look at your credit score if it is reported on your policy. The credit score shown on your policy should be consistent with the credit score you received from the credit-scoring agencies for an earlier assignment. Improving your credit score can lower the cost of your auto and other insurance.

Look at the discounts on your policy, such as discounts for good students, good drivers, multiple cars, and so on. Call your insurance provider and find out if there are any other discounts you qualify for. Discounts can reduce the cost of your insurance policy.

Review each of the four basic parts of your insurance: liability coverage, medical coverage, uninsured/underinsured coverage, and comprehensive physical damage coverage. What are your liability limits? If you have split coverage, how is the coverage split? Remember that most state requirements for liability insurance were set more than 30 years ago; these requirements are generally insufficient, given the rising costs of medical and automobile repair. If you must reduce your insurance costs, increase your deductible rather than reducing your liability limits.

Homeowners/renters insurance. If you own a home or a condo, get a copy of your homeowner's policy and review it carefully. Which type of homeowner's insurance do you have? Is your homeowner's insurance sufficient for your needs? Does it cover the current value of your home? What could you do to improve your coverage?

Liability insurance. Do you have a need for umbrella coverage? As the size of your assets increases, umbrella insurance may be something to look into.

Find out what insurance companies see when they look at your insurance reports. Under the FACT Act of 2003 (Fair and Accurate Credit Transactions Act) you can obtain a free copy of the following reports each year from the Comprehensive Liability Underwriting Exchange, or CLUE:

- CLUE Auto: A five-year loss-history report is generated if a loss is filed against your automobile insurance policy and the insurance company reports the information to CLUE.

- CLUE Personal Property: A five-year loss-history report is generated if a loss is filed against your homeowner's insurance policy and the insurance company provides this information to CLUE.

To get both CLUE reports, go to www.choicetrust.com, click on *CLUE Reports*, click on *CLUE reports* again, then *order options*, then *both reports*, then *new member*. Fill out the information for new members, including Social Security number, driver's license number, and address. Then verify the information and obtain the reports. If claims that the insurance company has paid are shown on these reports, copy the reports and include them in your Personal Financial Plan. You can also dispute the information if it is not correct or if you are planning on switching insurance companies.

Review Materials

Terminology Review

Auto Insurance. Insurance against financial loss due to an auto accident. It is a contract where you agree to pay the premium and the insurance company agrees to pay up to a specified amount for any policy defined losses. Losses in excess of policy limits are your responsibility.

Auto split-coverage insurance limits. These limits have reference to your coverage amounts which includes bodily injury liability per person, bodily injury liability per accident, and property damage liability per accident. These are the maximum amounts your insurance company will pay per person or per accident. Should the cost of the accident exceed the stated limits, you are personally responsible for any amounts exceeding these limits.

Exclusions. Exclusions are contract clauses which limit the insurance company's liability in specific situations or events. Your insurance may not pay up if: there is intentional injury or damage, there was use of the vehicle without permission, the vehicle has less than four wheels, someone else's vehicle was provided on a regular basis, its your automobile, but not listed on your policy, you were carrying passengers for a fee, or you were driving in a race or speed contest.

Homeowners Insurance. Homeowners insurance repairs or replaces your home from specific perils or accidents including: Fire, theft, storms; faulty household systems or appliances; and riot, volcanoes, vehicles, aircraft. Three key areas of homeowners insurance are: Dwelling: direct and consequential loss resulting from damage to the dwelling itself; Personal Property: loss or damage to personal property, and Liability: liability for unintentional actions arising out of the non-business, non-automobile activities of the insured and the insured's family. It is sold in six basic versions.

Homeowners Insurance Coverage. Homeowners insurance is divided into six areas:

- **Coverage A: Dwelling**. This protects the dwelling and any attachments. It does not cover any damage to the land.
- **Coverage B: Other Structures**. This protects other, unattached, dwellings on property. It also covers landscaping as well as buildings, but not the land. It also

does not cover other structures used for business purposes. It is limited to 10% of the home's coverage.

- **Coverage C: Personal Property**. This covers all personal property owned or used by the policyholder up to policy limits, and covers it regardless of location. It also covers property of guests in your home as well. It is limited to 50% of the home's coverage, with a $200 limit on cash, gold, and silver; $1,000 limit on securities, tickets, and stamps; and $2,500 limit on silverware. Animals, birds, and fish are excluded.
- **Coverage D: Loss of Use**. This covers losses incurred as a result of your home being uninhabitable or un-useable. It is limited to 20% of the amount of coverage on the home. There are three benefits of coverage: additional living expenses should to need to relocate temporarily; fair rental value, and prohibited use.
- **Coverage E: Personal Liability**. The insurer will pay, to the limit of liability in the contract, all amounts due to bodily injury or property damage.
- **Coverage F: Medical Payments**. The insurer will pay all reasonable medical payments to others, claims, expenses, and damage to the property of others to the limits of the policy. Other coverage includes claims expenses, first aid expenses, damage to the property of others, and loss assessment coverage

Homeowners Insurance Types. Homeowners insurance comes in various forms.

- **HO-2**. It is a broad form homeowner's insurance, and covers only named specific named perils. These perils may be fire, lightning, hail, explosions, etc. If the peril is not named, it is not covered by the policy. In general, all forms of coverage exclude law, earth movement, water damage, power failure, neglect, war, nuclear accidents, and intentional loss.
- **HO-3**. It is a special form of homeowner's insurance that includes open perils. This is generally recommended at a minimum. It covers all direct physical losses to your home, i.e. open perils protection. It lists specific exclusions to the policy for perils not covered.
- **HO-4**. It is Renter's or tenant's insurance. It is equivalent to HO-2 perils for personal property, but only for renters and tenants. It covers personal property rather than the dwelling, and provides liability coverage in case an accident, but does not cover causing damage to the structure. All-risk coverage available as an option (this is recommended).
- **HO-5**.It is a newer special form homeowner's insurance that includes open perils and includes a rider (HO-15) that allows open perils coverage on personal property in addition to other coverage. It covers all direct physical losses to your home, i.e. open perils protection. The listed exceptions are the same as HO-3.
- **HO-6**. It is condominium owner's insurance. It is similar to HO-4 coverage, has the same named perils for personal property as HO-2, but is available to co-op or condominium owners. It also covers improvements you've made. All-risk coverage is available as an option (recommended).
- **HO-8**. It is modified coverage for older homes. It insures the dwelling for the

repair cost or market value, instead of the replacement value and is designed specifically for older homes. All-risk coverage available as an option (recommended).

Homeowners Policy Riders. Should you need to add additional coverage, a homeowners policy can be supplemented in a number of ways through specific endorsements or riders including: Inflation: This allows protection to increase with the increase in repair and rebuilding costs; Floater Policies: These are policies that provide protection for valuable personal property over and above existing policy limits; and Flood, Earthquake and Terrorism Insurance: This provides protection in the event of a flood, earthquake, or terrorist activity.

No Fault Insurance. No-Fault Insurance is insurance coverage that pays for each driver's own injuries, regardless of who caused the accident. No-fault varies from state to state. Such policies are designed to promote faster reimbursement and to reduce litigation, and is only available in "no-fault" states (including Utah). The advantages of no-fault insurance are its easier and faster as your insurance pays for your losses and their insurance pays for their losses. However, generally damages from pain, suffering, emotional distress are not covered and there are dollar limits on medical expenses and lost income and vehicle damage is not covered.

Other than collision, it covers comprehensive physical damages.

Personal Automobile Policy. This includes the four key areas of automobile coverage: A. Liability, Part B: Medical Payment, Part C: Uninsured/Underinsured Motorist's Protection, and Part D: Damage to Your Car.

- **Liability Coverage** (Part A). Liability coverage is payment for losses due to: Bodily injury: Death or injury for all those involved in the accident; Property damage: All damage to the car or cars and any property damage; and Losses due to lawsuits: Losses from lawsuits resulting from the accident. Liability coverage may be a combined single limit or a split-limit coverage.
- **Medical Payment Coverage** (Part B). Medical payments covers all reasonable medical costs and funeral expenses incurred, by the insured or the insured's family members within 3 years of an accident. It also includes coverage for the insured when walking. It does not cover medical expenses if the insured is injured by a vehicle not designed for public streets, such as an unlicensed 3 or 4 wheeler (quad, four wheeler or go cart).
- **Uninsured/Underinsured Motorist's Coverage** (Part C). Uninsured/underinsured insurance covers costs if injured by an uninsured motorist or a hit-and-run driver. The other driver must be at fault to collect on this coverage. It also covers costs in excess of the other driver's liability coverage (i.e., under-insurance), if it is inadequate to pay for your losses.
- Comprehensive Physical (Part D). Comprehensive covers collision loss regardless of who is at fault. If the other driver was at fault and has liability insurance, your insurance company should be able to recover losses without collision coverage from the other driver's insurance company

Renters Insurance. Renters insurance repairs or replaces your rental property's contents

from specific perils or accidents including fire, theft, storms, water damage, etc. It also provides liability insurance against accidents caused by you or a member of your family. Your landlord has insurance only for the rented property and building. You are responsible for your contents and the liability risks you and your family bring. Renters insurance is relatively cheap and protects your property regardless of location.

Umbrella Liability Coverage. It is an insurance policy that adds protection over and above the insured's homeowners and auto policies, i.e., the policy becomes effective only after the limits of the homeowner's and automotive policies have been reached. As such, many companies require specific coverage limits, i.e., 250/500/100 insurance on all vehicles and $300,000 on the home before they will write an umbrella coverage.

Review Questions

1. What is auto insurance? Homeowner's insurance? Liability insurance? Why have them?
2. What are the four basic parts of an auto insurance policy?
3. What are "exclusions"? What is an example?
4. What are the four basic components of a homeowner's insurance policy?
5. What is an umbrella policy? When does it become effective?

Case Studies

Case Study 1

Data

Larry has a split-limit 100/300/50 automobile liability insurance policy. Several months ago Larry was in an accident in which he was found to be at fault. Four passengers were injured in the accident and were awarded $100,000 each because of Larry's negligence.

Application

How much of this will Larry's insurance policy cover? What amount will Larry have to pay out of pocket? Note: Larry's coverage is (A/B/D) 100/300/50: A = Liability: bodily injury liability per person, B = Medical: coverage per accident, D = Damage: collision or comprehensive coverage.

Case Study 1 Answers

Larry's maximum liability limit is $300,000 per accident. This amount must cover payments to all persons involved in the accident.

Unfortunately, it is not enough, because the four liability claims total $400,000. The remaining $100,000 awarded in the settlement will not be covered by Larry's insurance, and Larry must pay this expense out of his own pocket.

Case Study 2

Data

Janet currently insures her home for 100 percent of its replacement value with an HO-2

policy. For Janet, dwelling coverage (A) comes to $280,000.

Calculations

What are the maximum-dollar coverage amounts for parts B, C, and D of her homeowners policy?

Case Study 2 Answers

To determine the base amount of coverage on B, C, and D, use the $280,000 of the dwelling coverage (A) as a starting point. Coverage B (other structures) is limited to 10 percent of the dwelling coverage and is calculated as ($280,000 * 10%) = $28,000. Coverage C (personal property) is limited to 50 percent of the home's coverage and is calculated as ($280,000 * 50%) = $140,000. And coverage D (loss of use) is limited to 20 percent of the home's coverage and is calculated as ($280,000 * 20%) = $56,000.

Case Study 3

Data

Kelly has personal property coverage with a $250 limit on currency; a $1,000 limit on jewelry; and a $2,500 limit on gold, silver, and pewter. She does not have a personal property floater. Her deductible is $250.

Calculations

A. If $500 in cash, $2,500 of jewelry, and $1,500 of pewter ware were stolen from Kelly's home, how much of the loss would be covered by her homeowner's policy?

B. How much will she pay (or lose) on the claim?

Case Study 3 Answers

Kelly's policy would pay as follows:

Item	Amount Insurance Pays	Amount Kelly Pays	Total
Cash	$250	$250	$500
Jewelry	1,000	1,500	2,500
Pewter	1,500	0	1,500
Totals	2,750	1,750	4,500
Deductible	-250	250	
Total Amount Paid	$2,500	$2,000	$4,500

The insurance company would pay $2,500, and Kelly would pay $2,000.

Case Study 4

Data

Catherine called her insurance agent to learn how she could reduce her $1,000 annual homeowners insurance premium. The agent suggested increasing the $250 deductible on her policy to $500, which would result in a 10 percent premium savings. Her agent also indicated that if Catherine were to increase her deductible to $1,000, she would save 18 percent, and if she were to increase her deductible to $2,500, she would save 25 percent.

Calculations

A. How much will Catherine save per year in premiums if she increases her deductible to

$500, $1,000, or $2,500?

B. What are the advantages and disadvantages of increasing Catherine's policy deductible? What should be the key factor in her decision?

Case Study 4 Answers

A. Her current policy is $1,000 per year. Annual savings would be as follows:

$500 deductible = 10 percent savings, or $100
$1,000 deductible = 18 percent savings, or $180
$2,500 deductible = 25 percent savings, or $250

B. The advisability of increasing homeowner's insurance deductibles depends on the adequacy of her emergency fund or her capacity to cover a loss from current earnings. Catherine would save $250 on her annual premium by increasing her deductible from $250 to $2,500. On the other hand, she would be responsible for the first $2,500 of losses. Catherine would need about 10 claim-free years ($2,500/$250) to break even. Her decision should be based primarily on her emergency fund.

<u>Case Study 5</u>

Data

Paul is confused about his umbrella policy. His insurance agent requires him to have 250/500/100 split insurance on each of his automobiles before they can be put under his umbrella policy. He also has to have similar liability coverage for his home.

Application

What is the purpose of an umbrella policy? Does it pay before or after Paul's home or auto coverage?

Case Study 5 Answers

Paul's umbrella policy provides protection against lawsuits and judgments. It doesn't go into effect until after he has exhausted his homeowner's and automobile liability coverage. For that reason, the insurance company requires high liability coverage on his home and automobiles.

[1] Louis Boone, David Kurtz, and Douglas Hearth, *Planning Your Financial Future*, 3rd ed., 2003, 275

15. The Housing Decision I: The Process

Introduction

Once you understand the principles for using wealth, have your priorities in order, decide what you want to accomplish in life, and learn to live on a budget, one of your next goals may be to own a house. I like how some have defined the word *house*, "A house is a hole in the middle of land that you pour money into."

How true that statement is. There are very different connotations of the word "home" and the word "house," as illustrated by the following story:

> A while back a house caught fire and burned down. A local journalist went to cover the story. Upon arriving at the site, the reporter found a little boy. The child was standing in the midst of ashes and ruins. The reporter asked the boy what his family would do without a home. "Oh, we still have a home, we just don't have a house to put it in" the child replied.[1]

It is important to remember the difference between a home and a house as you look for and eventually purchase a house. A house is what you live in while a home is what you bring to the house. The purpose of this chapter is to help you avoid some of the pitfalls of buying a house for the first time. For the remainder of this chapter, I will use the words "home" and "house" interchangeably.

Objectives

When you have completed this chapter, you should be able to do the following:

> A. Understand our leaders guidance and the principles of home buying and ownership.
> B. Understand the process of buying a home.

Understand our Leader's Guidance and the Principles of Home Buying and Ownership

Buying a home is not easy. The purchase of a home will likely be one of the largest financial commitments you will ever make. As such, you should not rush into this commitment. If you use wisdom and judgment in trying to decide what you want, what you can afford, and where you want to live, and if you will listen to and obey the promptings of the Holy Ghost, you will make correct decisions regarding your housing needs.

There are risks in home ownership—not just the risks of owning the home but the risks of owning the wrong home. What happens if you buy a house you can't afford? Your most

important financial goals will likely be downgraded to goals of minor importance because you will not have sufficient funds to meet them. Individuals who own a house they can't afford are referred to as being "house poor."

What if you buy a "fixer-upper," but you don't have the necessary skills or time to do the fixing up? Your new home will likely remain a fixer-upper.

What if you buy the wrong type of house for your lifestyle? For example, if you are a condo person in a family neighborhood, you will likely want to pay others to keep up the landscaping and other exterior elements.

Or what if you buy a house without obtaining the necessary inspections? You could pay dearly for the problems the previous owners left behind and should have fixed before your purchase.

Finally, what if you get too far in debt, and you lose your job? Quite simply, you could damage your credit score, lose your house, and lose your self-respect as well.

Principles of Home Ownership

Gordon B. Hinckley shared principles of home ownership when he shared what his father told him regarding a home:

> When I was a young man, my father counseled me to build a modest home, sufficient for the needs of my family, and make it beautiful and attractive and pleasant and secure. He counseled me to pay off the mortgage as quickly as I could so that, come what may, there would be a roof over the heads of my wife and children. I was reared on that kind of doctrine.[2]

The decision to buy a house, since it is one of the most expensive purchase you will make in your lifetime, should be done in wisdom and order. You should do significant research as to yourself, your budget, your needs, the market, the mortgage process, and how to get the best mortgage you can. It is important that you understand the key principles of home ownership. Following are five key principles that are important to the housing decision.

> **1. Understand yourself, your vision, goals and plans, and your current and future housing needs.** Understand yourself. What needs does your home fulfill? What are your family needs now and in the future? What is your vision and your goals? What are the things you want to accomplish in life? A good start is to determine your needs. What are your housing needs that you have? What different options do you have for those needs? Whatever you choose, make sure it is the right type of house and right time for your lifestyle and budget.
>
> **2. Seek, receive and act on the Spirit's guidance**. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it

once it is received.

3. Understand the key areas and process of finding, buying, and funding a home. Know the process of how mortgages are marketed and sold, so you know how to get the best deal on your mortgage. You have received the best deal on your mortgage when you have the lowest Effective Interest Rate (EIR) calculation that includes all your points and fees (to be discussed later).

4. Be wise in your finances. Spend your money wisely and carefully. Be wise in your budget and in your spending. Make your house fit your budget, not your budget fit your house. Use the recommended 25-40% of take-home for housing expenses (which will be discussed later). Going beyond these limits will put significant financial burdens on you and your family. Get the necessary inspections (even if its new). Finance it wisely and try to pay it off before retirement or sooner.

5. Be a good steward over all your blessings. Don't just live in it—keep it up. Plan 1-2% of the cost per year for upkeep and maintenance on your home.

Based on this counsel, we can see that our challenge is to determine what a modest home is. The *Handbook for Families* recommends, "Avoid spending more than 25 to 40 percent of your take-home pay for the total house payment, including insurance, taxes, and maintenance costs."[3] That advice gives us a good start as we begin our study of home-buying.

Doctrines

As you work on the housing decision, finding balance among doctrines, principles and application is important in helping you make better decisions. We have shared some ideas for principles, although I am sure you can find others. Below are a few ideas for doctrines on which the principles are based. As you strive to increase your ability and effectiveness in the housing decision, I recommend you study and ponder the doctrines and principles supporting the housing decision.

Principles	Doctrines
Understand yourself, your vision, goals and plans	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Be wise in your finances, make sure it is in your budget	Stewardship
Understand the key areas of making the home decision	Agency
Be a good steward over your blessings	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with our housing decision, which is an application. Rather, from a higher perspective, or increased vision,

We are children of Heavenly Parents (identity), striving to live worthy of the Spirit (obedience), learning about available housing options (accountability), so we can find the best housing option for our family (stewardship). This will allow us to enjoy a safe and secure home (accountability) at an acceptable cost (stewardship), so we can accomplish our personal missions and achieve our individual and family vision and goals.

Understand the Process of Buying a Home

There is a process to buying a home, which, if followed, will help you make wise decisions and may help you reduce some of the problems people face when they do not understand this process. It is a four-step process:

- Understand your limits
- Find your home
- Find, fund, and service your loan, and
- Enjoy home ownership.

Step 1. Understand Your Limits

Understand yourself and your limits in the following areas:

1.a. Know your budget. The first part of understanding your limits is to check whether or not you have developed and are living on a budget. We have already talked about many important topics related to budgeting in **Chapter 3: Budgeting and Measuring Your Financial Health.** If you have questions about budgeting, please review that chapter.

1.b. Know your credit history and credit score and keep it high. If you don't have good credit or a satisfactory credit score, you may find that no one is willing to lend you money. Keep your credit score high.

We have already talked about many important topics concerning credit in **Chapter 6: Understanding Credit.** If you have questions concerning credit, please review Chapter 6. As we have discussed previously, your credit history can play an important role in your opportunity to buy a home. When you request credit, financial institutions will pull your credit history to determine how likely it is that you will pay back the loan. If you have made timely payments in the past, creditors assume it is likely you will continue to make payments in the future. Because your credit history can have a big impact on how much you pay for your loans and whether or not you get a loan in the first place, you need to periodically examine your credit reports from all three major reporting agencies. Make sure the reports are correct.

1.c. Know your affordability ratios. The third topic you should understand is mortgage lending. We have already talked about the different types of mortgage loans in **Chapter 7: Consumer and Mortgage Loans.** Review this chapter if you need to.

It is critical that you know your affordability ratios, or how much debt the bank thinks you can take on. There are two main ratios: the housing-expense ratio (or front-end ratio) and the debt-obligations ratio (or back-end ratio).

You should know how to calculate your housing-expense ratio, or front-end ratio. It is your monthly payment of principal, interest, property taxes, and insurance (PITI) divided by your monthly gross income. Banks have determined that if this ratio is 28 percent or less, there is much greater chance you will be able to pay back your loan.

The back-end ratio is your monthly payment of principal, interest, property taxes, and insurance (PITI) plus any other long-term debt (including any debt older than 12 months, i.e., car payments, student loans, alimony payments) divided by your monthly gross income. Banks have determined that if this ratio is 36 percent or less, it is an indicator that you have much more flexibility in your finances and are more likely to pay back your loan.

Know your affordability ratios before you get your loan. Don't use all the money the bank will lend, and don't buy the most expensive house on the block. Know how much you can afford.

1.d. Calculate your affordability ratios taking into account payment of tithes and offerings. Before you calculate affordability, take into account the amount you should be saving. Look at your budget realistically. I recommend you set aside 10 percent for tithing, plus an additional amount for other offerings. Set aside 10 to 20 percent more for paying yourself, for money you are saving for retirement and other goals. Since you pay the Lord first with tithes (10 percent of your increase) and offerings and since you pay yourself each month as well, you should really adjust these affordability ratios downward to take your donations and savings into account. I would encourage you not to borrow too much money for your home. To help you review your situation, please see Maximum Monthly Payment for Christian Savers (LT11). This spreadsheet takes the front- and back-end ratios, as well as the fact that you pay tithing and savings, into consideration when it calculates the amount a bank will likely lend you.

1.e. Choose your preferred loan type and term. The best type of loan takes into account your goals, budget, income stream, down payment, and view on risk. There are a number of different types of mortgage loans available. These include:

> *Fixed rate (FRMs):* I generally recommend this type of loan. The lender takes the interest rate risk, and you make constant payments throughout the life of the loan. This makes planning and budgeting easier.
>
> *Variable or adjustable rate* (ARMs): You take the interest-rate risk, so the lender may accept a lower rate of interest. However, there is the risk that interest rates will rise in the future.
>
> *Interest-only options, variable or fixed interest:* This is an option on a fixed or ARM loan. However, once the interest-only period is over, for example, 3 to 10 years, the loan

resets so the principal and interest is paid over the life of the loan, generally 30 years. There can be substantial payment shock when the loan resets. This is not like a minimum payment on a credit card.

There are also special loans, if you can qualify for them. They include Federal Housing Assistance loans for lower-income borrowers or Veterans Assistance loans, which are guaranteed by the U.S. Department of Veterans Affairs for those in the military.

Choose your loan term. Generally, I recommend a 30-year fixed-rate loan, which may give you flexibility in case financial concerns arise in the future. However, I recommend you make additional payments on principal to pay off the loan sooner if possible.

1.f. Determine down payment and up-front costs. Before you buy, remember that the down payment on a loan may be from 3 to 20 percent of the cost of the home, and the closing costs may be an additional 2 to 5 percent. Be aware that these costs are significant; given that these costs are paid up front, they must be planned for before you purchase the house.

Points are one percent of the loan value, or 100 basis points of the loan. Lenders charge points to recover costs associated with lending, to increase the effective interest rate they are receiving, to provide for negotiating flexibility in a market where interest rates fluctuate, and to adjust for differences in risk between loans. Points are deducted directly from the loan amount at closing. In other words, if you have a $200,000 loan with two points (2 * $2,000), you will only receive $196,000 at closing—the mortgage broker will keep $4,000. However, you will have to pay back the full $200,000.

Other up-front costs include title insurance, attorney fees, property survey fees, recording fees, lender's origination fees, appraisals, credit reports, termite/mold inspections, escrow payments, and the home inspection report.

Your impound account (or escrow, or reserve account) is the portion of your monthly loan payments that is held by the lender or servicer to pay for specific costs. These costs include property taxes, hazard insurance, mortgage insurance, and other items as they become due. These payments are made in addition to your monthly mortgage payments of principal and interest. An impound account may or may not be required for a loan, depending on your lender.

1.g. Have copies of two years of tax returns. Lenders want confirmation that you can pay back the loan. As such, they generally want to see two years of tax records for documentation. If you are a recent college graduate, you might share a confirmed job letter with salary.

1.h. Get pre-approved—not pre-qualified. Know that you should get pre-approved for a mortgage, not just pre-qualified. In addition, know your affordability ratios that the bank uses to determine credit worthiness. Pre-approved means the financial institution has done all the necessary analyses to qualify you for a loan, including checking your credit report and approving you for a specific amount. Pre-qualified, on the other hand, means that the financial institution

has essentially said that you will roughly qualify for some undetermined amount on a mortgage loan. Many times people have thought that they were pre-approved for a loan when they were only pre-qualified. When it comes time for these people to close on a house, they may discover they can't get all the money they need. Not only do they lose the house but they may lose their earnest money as well. (Earnest money is given by a buyer to a seller to show their good faith.) Should the deal fall through, the earnest money may be forfeited.

Step 2: Establish a Sound Plan and Find Your Home

Plan what you want, and then work your plan. There is a five-step process for finding your home.

2.a. Determine what is important to you. Determine what is important to you: how much of a commute are you willing to endure? How important is it that your house is close to schools? Do you need a yard for your kids? Do you want a flat lot or a lot on a hill? Write down which qualities you will and will not do without; articulate what you want regarding your desired location, type of home, future plans, and so on. Realize you will probably move within five to seven years if you are like the average US family.

2.b. Develop a plan and build your team. Once you know your limits, what you can afford, where you want to be, and what you want, you can then start developing your plan. How will you find your home? What resources will you use, including realtors, online resources, etc. In what areas will you look, in in what types of homes?

Be wise in your decisions, as you may be in the house you buy for a long time. Therefore, be patient and take your time in deciding which house to purchase.

Estimate the amount of time you will be in the house. If it is less than three to five years, consider renting. Remember, you will have to make at least seven percent on the selling price when you sell your house to break even from realtor's fees alone; you must also consider how much you paid for other up-front fees. Buying a house will likely be the largest financial commitment you will make for a long time, so be wise.

I often recommend that recent college graduates should generally plan to rent a nice apartment for at least 6 to 12 months before they buy a house. This gives them the time they need to search thoroughly, figure out what they want, decide on the area where they want to live, and determine which amenities they want in a house and location.

Do your homework—and footwork. Buying a house is not easy. It takes time, thought, and effort. Find a good realtor to help you. Realize that realtors work for the seller instead of for you, the buyer: as the seller pays the realtor's fees. It may be wise to hire a buyer's broker (or realtor), who works for you and gets paid by you as well. This buyer's realtor should be someone who knows the ins and outs of the neighborhoods you are interested in.

Use a team approach. Get others to help you in the process of buying a home. Remember, you can't, and shouldn't, do everything by yourself. Get a good appraiser who can help you make

sure you don't pay too much for a house. Get a good lawyer who can help you make sure you fill out the correct forms. Most importantly, get a good home inspector. The last thing you want to do is buy someone else's problems. Use multiple home inspections if necessary. Don't become emotionally attached to a potential house. The best thing you can do in many cases is to just walk away.

2.c. Have a home inspection. Once you have found the home you like, can afford, and is where you want to live, have a home inspection. While this is at your expense, it may alert you to potential problems with the home before you decide on the purchase. Many of these problems should be fixed by the seller prior to purchase at the seller's expense. Don't buy someone's problems.

2.d. Determine any CCRs, fees, and costs. With your home you like, look to potential costs. Look first through all Covenants, Conditions and Restrictions (CCRs) for your potential home. What additional costs are required. These can be quite restrictive as to what you can and cannot do with your home. If you cannot live with the CCRs, don't buy there.

There also may be lane or other monthly fees. Moreover, for condos or town homes, determine the amount of the transfer/setup fees. Understand any other homeowners/association fees for potential homes and what they include.

Finally, ask to see records of monthly utility costs and other monthly expenses. Compare these to your current costs for additional expenses. Remember that these costs will vary depending on the season so try to find the last few years of utility costs. Make sure these costs are consistent with your budget.

2.e. Negotiate the price of the home. Use the best available resources to negotiate a price for the home. Use wisdom and judgment in determining what you can and should pay for the home. Compare the cost of your potential home to those which may have sold recently. If you are working with a realtor, have them do a "comps" study of homes that have sold recently in the area.

This is a negotiation process—do not be afraid to haggle, and your best negotiating technique is walking away. Also realize that closing costs, things that need to be fixed from your home inspection report, and other things can all be part of the negotiated price. Most things are negotiable.

Step 3: Find, Fund and Service the Loan

Finding, funding, and servicing the loan is a five-step process.

3.a. Understand the lending process. This process utilizes the services of a number of different professionals, including realtors, lenders, title insurance professionals, and escrow professionals (see Chart 1).

The key players in this process are the realtors and mortgage brokers. Realtors, or real estate brokers, are individuals or companies who act as intermediaries between sellers and buyers of real estate. Unless stated otherwise, they represent the seller and the seller's interests and are paid by the seller. Generally, sellers pay a commission to the realtor for selling the property, which is split between the listing realtor (the realtor who listed the property), and the selling realtor (the realtor who brought the buyer of the property to the seller). The commission is generally a percentage of the value of the property and may range from five to seven percent or more.

Mortgage brokers are individuals or companies that arrange loans between the lenders (those who have money to lend for mortgage loans) and borrowers. Traditionally, banks and other lending institutions sold their own products. However, as the markets for mortgages became more competitive, the mortgage brokerage industry evolved and broadened beyond banks.

Mortgage brokers make money two ways: origination fees and discount points. Origination fees are the costs and profits on making the loan, while discount points are payments by the borrower to lower the loan interest rate.

3.b. Choose Multiple lenders and get Loan Estimates (LEs). To get the best deal in the lending process, the key is competition. You will get a lower interest rate on your loan when lenders compete for your business. Work with multiple lenders. Talk with friends and others who have gone through the process and ask for the names of their favorite brokers. Hold brokers accountable for what they say.

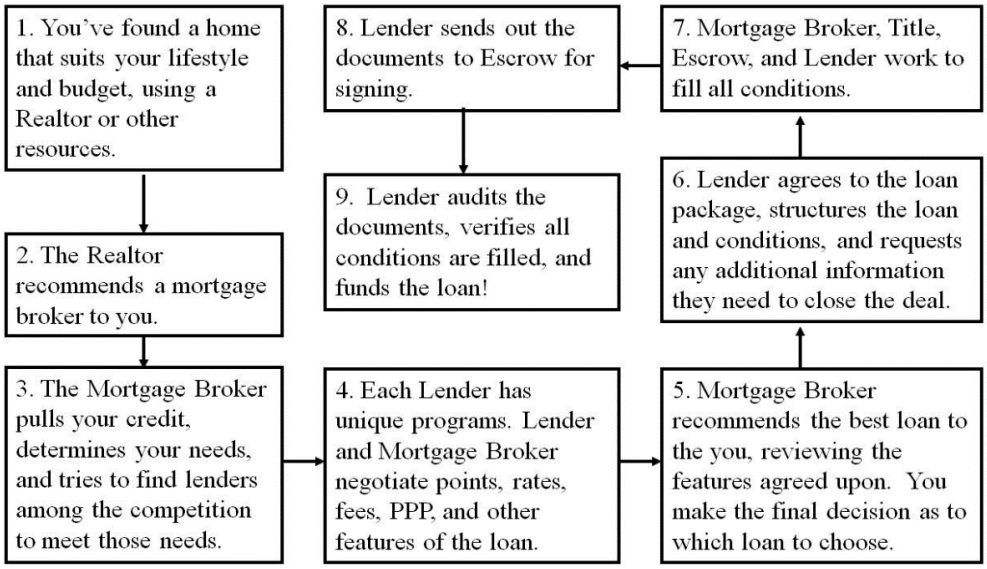
Get Loan Estimates (LEs) from each lender (and not just a Summary). A LE is an outline of the cost to be charged upon the closing of the loan. The LE also acts as protection for borrowers to keep lenders honest on what they charge. These are the estimated costs you will likely pay when the loan closes. Then compare LEs from each lender.

3.c. Calculate your Effective Interest Rate. Calculate your effective interest rate from each of your lenders. As inputs to this, estimate how long you will be in the home. This is important as it helps determine over what period you can allocate points and other costs. From your GFE, calculate your effective interest rate for each loan. Your effective interest rate is the interest rate you will pay after all your points, costs, and fees are taken into account and will be discussed in the next section.

The key is to get your best rate. Your lowest effective interest rate is the best indicator that you got a good rate on your loan.

3.d. Negotiate with your favorite lender. Once you have multiple offers from multiple lenders, you have bargaining power. Determine your lowest effective interest rate, which includes points, fees, and the loan APR after evaluating each of the offers from the various lenders. That is your beginning point. You can take that offer if you want.

Chart 1. The Lending Process



However, generally I recommend you take that offer to your favorite lender, and ask them to beat it by 1/8 to 1/4 percent and you will go with them. Remember, if they don't get your business they don't make any money.

In summary, mortgage brokers make money in two ways: origination fees and discount points. Origination fees are the costs and profits on making the loan. Discount points are payments by the borrower to lower the loan interest rate.

The objective in borrowing for a home is to minimize the interest rate you pay and the points and fees you pay (origination and discount points). How do you minimize these two areas? Following are a few ideas:

1. Talk with multiple mortgage brokers. Make this a competitive process. Remember that multiple institutions requesting your credit report and score within a specific period of time are only counted as a single request on your credit score. Get multiple bids.

2. Compare rates and points across different brokers from different companies. This will give you a general idea of rates and points, which can be very helpful.

3. Look at the minimum interest rate they will let you buy down to. Perhaps it is close to the lender's required rate. Once you have a feel for that rate, it may give you an indication of what the mortgage broker's back-end bonus would be.

4. Once you find the best rate and points from the multiple mortgage brokers you checked on, go to your favorite broker and agree to go with him or her if he or she can beat the best offer by 1/8 to ¼ percent.

Pay off the loan early and save. The key now is to service the loan consistently. Make sure payments are on time. Set up procedures to ensure you do not miss payments.

Strive to pay off the loan early. We recommend you set a goal to pay it off after a certain number of years. This increases the money you can save for your personal and family goals once the loan is paid off. This also brings freedom from worry when you own the home instead of still needing to make payments.

Step 4: Enjoy Home Ownership

If you have completed the home-buying process well, you will enjoy the fruits of your labors for many years. Maintain your home well. If you take care of your purchase, it will take care of you. For example, having your home professionally cleaned a few times a year can help retain your home's value. For budgeting purposes, realize that maintaining your home will generally require roughly one percent of the home's value each year, so add that amount to your budget. This amount should be an included expense you will likely pay each year.

Summary

Buying a home is not easy. The purchase of a home will likely be the largest financial commitment you ever make. As such, you should not rush into this commitment. If you use wisdom and judgment in trying to decide what you want, what you can afford, and where you want to live, and if you will listen to and obey the promptings of the Holy Ghost, you will make correct decisions regarding your housing needs.

Understanding the key principles of home ownership are critical. These include:

- Understand yourself and your current and future housing needs.
- Seek, receive, and act on the Spirit's guidance.
- Understand the process of finding, buying, and funding a home.
- Be wise in your finances.
- Be a good steward over all your blessings.

There is a process to buying a home, which, if followed, will help you make wise decisions in buying a home. The process is the following.

- Understand your limits.
- Establish a plan and find your home.
- Negotiate your loan.
- Enjoy home ownership.

There is much to learn and remember when buying a home. Keep your goal of buying a home in the perspective of your overall goals and objectives. Develop a home buying strategy, and follow it when you are buying a home. Buying a home is an important goal—but it is not the only one.

In spite of the challenges associated with buying a home, having a home may bring many blessings and opportunities.

Assignments

Financial Plan Assignment

As you think about where you want to live, it is important to develop your own housing strategy. Include this as part of your PFP Education, Mission, Home and Auto Template (LT01-15).

Start first from where you are. What is your current housing strategy? Where do you currently live? What expenses and fees are you paying, including rent, mortgage, maintenance, utilities, gas, repair and insurance? How can you reduce your housing expenses?

Then work on your Housing Plan. This will be covered in the following chapter.

Learning Tools

The following Learning Tools may be helpful as you prepare your Personal Financial Plan:

Maximum Monthly Payment for Christian Savers (LT11)

This Excel spreadsheet will help you determine the maximum amounts that financial institutions will generally lend; the spreadsheet uses traditional front-end and back-end ratios. However, traditional banking ratios do not take into account the fact that Latter-day Saints pay tithes and other offerings and save a certain percentage of their earnings. This spreadsheet allows you to take these other factors into account and illustrates that you should be borrowing less for a home than those who do not pay tithes and offerings.

Home Loan Comparison with Prepayment and Financing (LT19)

This Excel spreadsheet helps you determine the effective interest rate for multiple home loans; it takes into account the loan amount, interest rate, compounding periods, points, and other fees. In addition, it also calculates the rate, assuming prepayment, after a certain number of years. The spreadsheet also helps you determine how much time and money you will save if you prepay a specific amount of principal each period over the life of your loan.

Debt Elimination Schedule with Accelerator (LT20)

This spreadsheet allows you to input your different debts and interest rates. It then prioritizes that debt based on interest rates and creates a repayment plan based on the minimum payments due each month. This repayment plan is consistent with Marvin J. Ashton's plan in the article "One for the Money." This spreadsheet also allows you to include an accelerator amount and an amount in addition to your normal monthly payments; you will be able to see how long it will take you to pay

off your debt.

Review Materials

Terminology Review

Annual Percentage Rate (APR). The APR is a rate that is generated from a precise calculation specified in Regulation Z. It only takes into account the fees going into the loan and does not take into account the time value of money.

Balloon Mortgages. These are mortgage loans whose interest and principal payment won't result in the loan being paid in full at the end of the term. The final payment, or balloon, can be significantly large. These loans are often used when the debtor expects to refinance the loan closer to maturity.

Buyer's Broker. This is a realtor that works specifically for the buyer and is paid by the buyer. The have a fiduciary responsibility to the buyer and not the seller which is different from the traditional buyer seller broker relationship.

Conventional Loans. These are loans that are neither insured nor guaranteed. They are below the maximum amount set by Fannie Mae and Freddy Mac of $417,000 in 2014 (single family). They require Private Mortgage Insurance (PMI) if the down payment is less than 20%.

Covenants, Conditions and Restrictions (CCRs). These are legal documents that can affect what you can do with any potential homes. These can be quite restrictive as to what you can and cannot do with your home including exterior, landscaping, and other requirements. If you cannot live with the CCRs, don't buy there.

Debt Obligations or Back-end Ratio. This housing affordability ratio calculates what percent of your income is used for housing expenses plus debt obligations. It should not exceed 36% of your monthly gross income. The formula is: Monthly PITI and other debt obligations/ monthly gross income < 36%. Debt obligations include mortgage payments, credit card, student loan, car, and other loan payments. PITI = Principal, interest, property taxes, and property insurance

Discount Points: These are payments made by the lender to reduce the interest rate on the loan. They are somewhat similar to prepaid interest. You pay more upfront in points but you will pay less on interest costs in the future. Your challenge is to minimize your overall interest costs, i.e., your effective interest rate.

Down Payment. This is the amount that you pay on the house to reduce the cost of the loan. Generally, lenders like a significant down payment as that indicates that the borrower is not likely to walk away from the loan. Different loans require different down payment amounts, i.e Conventional loans – 20 % recommended (but you can get in with 5%), FHA loans – 3.5%, and VA loans – 0% down payment required.

Good Faith Estimates (GFE). This is an estimate from each lender (not just a Summary) of the likely costs you will likely pay as you complete the loan process. I recommend you get GFEs from each potential lender and compare them.

Home Inspection. This is a service, usually paid for by the buyer, to alert them to potential problems with the home. Many of these problems should be fixed by the seller

prior to purchase and so these problems need to be discovered and disclosed. Don't buy someone's problems.

Housing Expenses or Front-end Ratio. This is a housing affordability ratio that calculates what percent of an your income is used to make mortgage payments. Housing expenses should be less than 28% of your monthly gross income. The formula is: monthly PITI*/monthly gross income <28%. PITI = mortgage principle, mortgage interest, property taxes, and property insurance.

Impound/escrow/reserve accounts. These accounts are that portion of a the monthly payments held by the lender or servicer to pay for: Taxes, Hazard insurance, Mortgage insurance, Lease payments, and Other items as they become due. These are for payments for items above which are over and above your monthly mortgage payments of principle and interest. These may or may not be required by your lender.

Housing Ratios for Christian Savers. As Christians, we have other important obligations that we also pay, i.e., tithing and paying ourselves, i.e., savings. As such, should have smaller houses (at least less expensive), because we pay the Lord first and ourselves second. For a spreadsheet that takes into account the fact that we pay the Lord first and ourselves second within this front-end and back-end ratio framework, see: Maximum Monthly Mortgage Payments for Christian Savers Spreadsheet (from the website).

Loan term. This is the duration of the loan. It can be 10, 15, 20 or 30 years depending on your goals and your cash flow situation.

Origination fees: These are the costs and profits made by the mortgage broker for originating the loan.

PITI (Principle, interest, property taxes and insurance). This is the acronym for the separate parts of a typical mortgage.

Piggyback loans. These are two separate loans, one for 80% of the value of the home and one for 20%. The second loan has a higher interest rate due to its higher risk. The second loan is used to eliminate the need for PM Insurance. With a piggyback loan, PMI is not needed, but these are much harder to get now.

Points. Points are fees for a loan. 1 Point is one percent or one hundred basis points of the loan. This money is pre-paid interest, money paid to the mortgage broker (not the lender). It is deducted from the loan proceeds (you still must pay it back), and is essentially another fee for helping you arrange the loan (minimize points). Lenders charge points to recover costs associated with lending, to increase their profit, and provide for negotiating flexibility. You will like have to pay origination points, but buy-down points (to reduce the interest rate on the loan) are purely optional.

Pre-approval. Pre-approval is the process whereby lenders have pull your credit score, looked at your tax records and approve you for a specific amount of a loan. Get pre-approved for your loan by a number of lenders (with mortgage loans, you can have multiple loans requested within a 90 period and its counted as one loan request). You can borrow up to this pre-approved amount without a problem. Remember however that you do not need to borrow that amount. I recommend you borrow less than that amount.

Pre-paids. These are the expenses put into escrow at closing, usually including real

estate taxes, insurance, and interest.
Prepayment. Prepayment is the process where you repay the loan early, either through paying off the loan or selling the house and then paying off the old loan.
Prepayment Penalties. These are penalties enforced by the lender for prepaying a loan too soon. Prepayment penalties have a stated period of time, i.e., 1, 2, or 3 years the prepayment penalty is in effect, a maximum pay down percentage (MPP), i.e., 6% of the principal per year, and a prepayment penalty if you sell it before, i.e., 6 months interest. With a soft prepayment you cannot within the stated period of time without penalty, refinance at all, sell the loan to family members, or pay down more than your MPP each year. The only way to get out of a soft prepayment penalty is to sell the property to an unrelated party. With a hard prepayment, you cannot within the stated period of time without penalty refinance at all, sell the loan to anyone, or pay down more than your MPP each year. There is no way to get out of a hard prepayment penalty before the defined period without paying the penalty.
Pre-qualified. Pre-qualified is a process where lenders estimate your credit based on information you tell them. I recommend you get pre-approved, not pre-qualified.
Private Mortgage Insurance (PMI). This is an insurance policy the borrower buys to protect the lender from non-payment of the loan. PMI policies are usually required if your down payment is less than 20% of the appraised value.
Realtor or Real Estate Broker. This is a person supposedly trained in the process of selling and buying real estate. You want a realtor that know the market in the area you are looking at. Remember that realtors are paid by the seller, so remember that in your associations. Sellers divide the sales commission (usually 6-8%) between the listing realtor and the buying realtor.
Title Insurance. This is an insurance policy that insures you against errors in the title search, guaranteeing your and your lenders financial interest in the property.
Total Costs Analysis. This is a form of loan analysis that does not take into account the time value of money, but is simple to calculate. To do this, calculate your total new costs and fees from the loan until it is paid off, your total current monthly principal and interest costs remaining without refinancing, your total refinance monthly principal and interest costs. If you will be paying equal or less overall, it likely does not make finance sense.
Underwriting. Underwriting is the process whereby the borrower fulfills the requirement of the lender and the lender funds the loan. It also includes the lender selling the loan and the loan being syndicated and sold to investors.
Upfront costs. These are cost due at the signing of the loan which include closing costs and points, down payment (3-20 percent of the loan amount), and other closing costs including points (3-7 percent).

Review Questions

1. We have been counseled to stay out of debt with the exception of what two things?
2. What are the four options in regards to the home decision?
3. According to the *Handbook for Families*, how much of our take-home pay should we

spend on our total house payment, including taxes, insurance, and maintenance costs?

4. In regard to a home mortgage, what are "points"? Why do lenders charge points?

Case Studies

Case Study 1

Data

Bill and Brenda make $60,000 per year. They found the house they want for $225,000. They are looking at a 30-year fixed rate loan at 6.5%, and estimate property taxes and insurance costs at $200, a car loan of $270 and student loans of $50 per month. They pay tithes/offerings of 11%, save 15% in their company 401k (tax deferred and with a 5% match), and they estimate their marginal tax rate at 17%.

Calculations

Calculate Bill and Brenda's front-end ratio and back-end debt to income ratios for banks (28 percent and 36 percent, respectively) and for savers. What is the amount most banks will lend them (remember that most banks will lend to the lower of the two ratios)?

Case Study 1 Answers

1. Bank Front-End Ratio Calculations at 4.5%

PITI / Gross Income

Monthly Income ($60,000 / 12) $5,000

$5,000 * 0.28% 1,400

Real Estate Tax (T) and Insurance Payments (I) –200

Maximum Monthly Mortgage Payment of Principal (P) and Interest (I) 1,200

Set 4.5% = I, PMT = 1200, N = 30 * 12, PV

Maximum Amount Bank Will Lend = $236,833

1. Saver Front-End Ratio Calculations at 4.5%

Income ($60,000 / 12) $5,000

Adjustments

- 11.0% *(1-.17% tax shield) = 9.1%
- 15.0%*100%*(1-.17% tax shield) = 12.5%
- Total adjustments = 21.6%

Subtract adjustments, percentages and insurance

- 5,000 * (1-.216) = $3,920 *.28 – 200 = $898

Calculate amount based on adjustments

- Set 4.5% = I, Pmt = 1200, N=30, PV = ?
- $177,207 Maximum Monthly Mortgage Payment

2. Bank Back-End Ratio Calculations at 4.5%

(PITI + Debt Expenses) / Gross Income

Monthly Income	$5,000
$5,000 * 0.36%	1,800
Real Estate Tax and Insurance Payments (I)	200
Monthly Debt Payments: Car Payment	270
Student Loan	50
Maximum Monthly Principal and Interest	1,280
Set 4.5% = I, PMT = 1280, N = 30 * 12, PV	
Maximum Amount Bank Will Lend	$252,622

2. Saver Back-end DTI Ratio Calculations at 4.5%

   Monthly Income = $5,000

   Adjustments

   - 11.0% *(1-.17% tax shield) = 9.1%
   - 15.0%*100%*(1-.17% tax shield) = 12.5%
   - Total adjustments = 21.6%

   Subtract taxes & insurance, and loans

   - 5,000*(1-.216) = $3,920*.36 – 200 - 320 = $892

   Calculate amount based on projections

   Set 4.5% = I, Pmt = 892, N=30, PV = ?

   $175,959

Maximum Monthly Mortgage Payments for LDS Borrowers (LT11)
Includes Charitable Contributions and Savings

Directions: Fill in the green cells with your data. Be careful not to modify the blue cells

Loan Data and Closing Costs:	
Estimated Mortgage maturity (in years)	30
Estimated FIXED interest rate	4.50%
Estimated monthly real estate tax and insurance payments	200
Marginal Tax Rate	17.0%
Method 1: Housing or Front-end Debt to Income Ratio (LT11)	
Maximum Mortgage Payment Using the Ability to Pay and PITI Ratio	
a. Annual income	60,000
Calculated monthly income	5,000
b. Percentage of PITI (principal, interest, taxes and insurance) to monthly gross income that lenders will lend in the form of a mortgage loan	28%
Estimated Maximum monthly mortgage payment	1,400
c. Estimated monthly real estate tax and insurance payments	200
Maximum monthly mortgage payment using the 28% Rule	1,200
d. Maximum mortgage amount using the Front End Ratio	$236,833
With Adjustments for Christians Paying Tithes/Offerings and Paying Yourself:	
Tithes and Other Offerings (in percent)	11.0%
Effective cost of donations (after your tax shield)	9.1%
Payments to yourself, i.e. retirement savings, 401k, Roth IRA, IRAs,	15.0%
Percent of personal savings that is tax-deferred (IRA, 401k, SEP IR	100.0%
Effective cost of savings (after your tax shield)	12.5%
Total Additional Payments not usually included in this calculatio	21.6%
Maximum adjusted monthly mortgage payment using the 28% Rule	897.88
e. LDS adjusted maximum mortgage using Front-end DTI ratio	$177,207

Maximum Monthly Mortgage Payments for LDS Borrowers (LT11)
Includes Charitable Contributions and Savings

Directions: Fill in the green cells with your data. Be careful not to modify the blue cells

Loan Data and Closing Costs:	
Estimated Mortgage maturity (in years)	30
Estimated FIXED interest rate	4.50%
Estimated monthly real estate tax and insurance payments	200
Marginal Tax Rate	17.0%
Method 2: Debt or Back-end Debt to Income Ratio (LT11)	
Maximum Payment Using the Ability to Pay, PITI Plus Other Fixed Debt Expenses	
a. Monthly income	5,000
b. Percentage of PITI+current monthly fixed payments to your current gross income that lenders will lend in the form of a mortgage loan	36%
Total amount at 36% ratio	1,800
c. Estimated monthly real estate tax and insurance payments	200
d. Current nonmortgage debt payments on debt that will take over 12 months to pay off and other monthly legal obligations	
Auto loans, credit card debt you cannot pay off in 12 months	270
Student Loans, child support, alimony, or other long-term debt	50
Total long-term non-mortgage debt payments	320
e. Maximum payment using the Debt or Back-end DTI Ratio	1,280
f. Maximum payment using PITI plus Other Fixed Debt Payments R	$252,622
With Adjustments for Paying Tithes/Offerings and Paying Yourself:	
Tithes and Other Offerings (in percent)	11.0%
Effective cost of donations (after your tax shield)	9.1%
Payments to yourself, i.e. personal/retirement savings, 401k, IRAs, (	15.0%
Percent of personal savings that is tax-deferred (IRA, 401k, SEPs,	100.0%
Effective cost of savings (after your tax shield)	12.5%
Total Additional Payments not usually included in this calculatio	21.6%
Maximum adjusted monthly mortgage payment using the 36% Rule	891.56
e. LDS adjusted maximum payment using Back-end DTI ratio	$175,959

Application

Since the bank will generally lend the lesser of the two ratios, they would likely be allowed $236,855.

The saver would adjust his prices downward toward $180,000.

Conclusions (LT11):

Maximum Mortgage Amount using Method 1:	$236,833
Maximum Mortgage Amount using Method 2:	$252,622
Lower of the Two Methods, and Most likely to be used by the Bank	$236,833

Maximum Adjusted Mortgage Amount using Method 1:	$177,207
Maximum Adjusted Mortgage Amount using Method 2:	$175,959
Average of the Two Methods (for food for thought) for LDS	$176,583

[1] All Things Cherished Blog, http://allthingscherished.blogspot.com/2008_05_04_archive.html
[2] "The Times in Which We Live," *Ensign*, Nov. 2001, 72
[3] "Preparing for Emergencies," *Ensign*, Dec. 1990, 59

16. The Housing Decision II: Comparing Loans and Creating Your Housing Plan

Introduction

Once you understand the home buying process, it is important that you understand your options in the home decision, the process of comparing different mortgage loans, and how to crate your housing plan.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand your options in the housing decision.
B. Understand how to compare different types of loans with different fees and points.
C. Understand and create your Housing Plan.

Understand Your Options in the Housing Decision

Some individuals will be making decisions about buying a house soon because of graduation, marriage, or prospective job offers. Should you buy a house immediately, or should you rent for a while? Are you interested in building or renovating? Decisions about housing are challenging but inevitable. As you understand yourself, your goals, and your job, you will be equipped with valuable information that will help you as you make the home decision. There are four major options for the home decision: renting, buying, building, renovating and other.

Renting

Renting has many advantages, including mobility. When you rent, it is relatively easy and relatively inexpensive to move from one place to another if your job or life situation changes. There are no costs for repairs or maintenance: for example, you don't have to worry about the cost of replacing the water heater or other household appliances if they break down. Another advantage is that financial commitments are lower with renting than with buying: rent costs are relatively low, there are fewer initial costs associated with moving in, and there are none of the legal headaches that often accompany buying a home. Finally, rent is easy to budget. You generally have only one bill—rent—to worry about.

Nevertheless, renting also has its disadvantages, such as a lack of stability and lack of the pride that comes from ownership. You can't modify your rental house as you would be able to modify a home. Although you can put up pictures, you can't paint walls, put up wallpaper, or renovate

the kitchen. Another disadvantage is that rent may increase unexpectedly. Someone else makes major financial decisions that affect you; these decisions can have a huge impact on your budget and pocketbook. There may also be restrictions on where you can rent: zoning laws make some locations unavailable. Tax benefits are also missing when you rent. Since you pay no interest as part of your rent, you cannot deduct interest costs from your taxable income. Finally, there is no potential for property appreciation with renting.

Buying

Many of the disadvantages of renting are advantages to buying a home. With buying, there is permanence and a pride of ownership. You can change the paint color, the kitchen, the landscaping, the garage, and so on. Generally, the monthly payment is fixed. The decision on how you pay for the house is between you and the bank, and once you decide, you won't have to worry about payment fluctuations. Buying allows you to use leverage, which means you can own the house using borrowed money, up to 95 percent in some cases. Another advantage to buying is that you get Uncle Sam's help. The interest payments you make to the bank or mortgage company on your house can be deducted on your itemized tax forms from your adjusted gross income, or AGI. Finally, you can borrow against the equity in your home. Equity is the difference between what your house is worth and how much you have borrowed to buy it. In emergencies, you can borrow money from the bank against your home's equity to meet your specific goals and needs.

However, buying also comes with disadvantages. Mobility is low, since houses are not liquid assets. It would likely be a challenge to sell the house quickly, and it is generally expensive to sell illiquid assets. Other disadvantages to buying include significant up-front costs, such as the down payment, points, title, and title insurance. Also, it generally costs more to own and operate a home than to rent. Costs for utilities, repairs, water, landscaping, painting, and so on are avoided when you rent but must be paid when you own. Finally, buying a home is a large financial commitment. Owning a home is a costly investment—in terms of dollars, time, and energy. And because a home is a large financial commitment, you need to remember that the home's value could decrease, that its mortgage could default, or that it could need repairs.

Building

There are many advantages to building. You can build exactly what you want because you design the house. Sometimes it is even cheaper to build than to buy, depending on market conditions. With building, you get new appliances and housing systems, so repairs in the first few years are generally less. And you can pick the location of where you want to build, assuming lots are available.

However, building also has disadvantages. It may be difficult to interpret building plans, such as the size of rooms, if you are unfamiliar with these plans. Building, like renovating, often exceeds the budget and has delays if not done correctly by competent labor. Building also necessitates additional expenses for a yard and fencing. There are also expenses for construction-loan interest

and rental costs that are incurred while you are waiting for the home to be built. Most importantly, there are high monitoring costs, in terms of time and money; high stress tolls, as you make the myriad decisions about the house; and high risk that the project may become more expensive than planned.

Renovating

The advantages of renovating include that you can often accomplish your housing goals faster than with building because the outside structure of the house is already in place. Another advantage is that you can generally see the house you are getting. It may be cheaper to buy and renovate than to build, particularly if you can do much of the work yourself (i.e., sweat equity). Renovating may be preferable if there are no available lots in a desired area, but there are existing homes for sale.

The disadvantages of renovating include that it may be more expensive to renovate than to build. Renovations often go over budget and have delays because of the uncertainty about what will actually need to be renovated. The rule of thumb for renovating, and sometimes building, is that you should double your budget and then double the resulting amount again. Moreover, you should be aware that you may have unanticipated additional expenses for a yard and fencing, depending on what was renovated. Also, the same construction-loan interest costs and rental expenses may be applicable, depending on how extensive the renovation is. During the renovation process, you may encounter other costly problems that were not noted before. Most importantly, just like in building, there are high monitoring costs, high stress tolls, and high risk that the project may become more expensive than planned.

Other Options

Other options include mobile homes, tiny houses, and recreational vehicles. The advantages of these are their lower costs. The main disadvantages are their much lower resale value, lack of permanence, challenge in getting financing, and the difficulty in building equity.

Understand How to Compare Different Types of Loans with Different Fees

Once you determine what you want and find a house you like, the next step is to determine how much you can afford. Don’t buy the most expensive house in the neighborhood—use wisdom in your purchases. Remember, statistics indicate that most people are likely to move within seven years.

Many factors go into your decision of which loan to choose, and you have lots of options for your mortgage, fixed rate, adjustable rate, fixed with an interest only option and variable with an interest only option. The key factors that go into your choice of mortgage include time horizon, how long will you be in the home; risk tolerance, who will take the interest rate risk; cash flow preferences, how stable is your cash flow; and goals, what are your goals for this home. For help with these questions, see Choosing a Mortgage Loan (LT35).

It is critical that you understand all fees and expenses before you close on a house—there are many expenses. One of the largest expenses is your mortgage. With so many different options available for a mortgage, it is critical that you understand how to calculate a comparable rate on loans with different points and fee structures. Understanding the different expenses involved in buying a house and how to compare different loans with different points and fees will save you a lot of money overall. Critical to this ability to compare is an understanding of points, effective interest rates, how to calculate effective interest rates, and prepayment.

Points

Points are one percent of the loan, or 100 basis points of the loan. Some lenders offer mortgage loans with high contract interest rates and low points, while others offer the opposite. The borrower's challenge is to choose the mortgage contract that minimizes the effective cost of borrowing. How do you differentiate between loans with different interest rates, different points, and different costs? One way is to calculate the effective interest rate (EIR) for each of your loan options; you will then be able to choose the loan that minimizes the effective interest rate.

Effective Interest Rates

The effective interest rate (EIR) is the precise interest rate the borrower pays after all fees and costs have been taken into account. The EIR is different from the annual percentage rate, or APR. The APR is generated from a precise calculation specified in Regulation Z of the Truth in Lending Act. The difference between the APR and the EIR is that the EIR takes into account the costs of points and fees. If the loan has no prepayment, points, or other fees, then the EIR is the same as the APR.

The EIR is important because it allows you to quickly compare rates from various lenders with various schedules and costs; the EIR allows you to choose the rate that gives you the lowest cost. To calculate the EIR, you must make a major simplifying assumption. Many of the fees associated with home-buying are paid out of pocket, meaning that they do not come out of the loan. Other fees (like points) do come out of the loan. The assumption necessary for this calculation is that all fees come out of the loan. This is not an unreasonable assumption, especially if you assume you will pay back all out-of-pocket expenses with proceeds from the loan. Remember, the lender will retain the amount of the loan attributable to points when distributing loan proceeds, but the monthly payment will be based on the entire loan amount.

Calculating Effective Interest Rates

The three-step process for calculating the EIR is:

1. Calculate the payments on the total amount you will be repaying (the amount borrowed). Using your financial calculator, set N = your number of years, I = your interest rate, PV = minus the loan amount, and solve for your payment, or PMT.

2. Calculate the amount of money you actually received (the total loan minus all costs). Again, assume that all costs for the home come out of the loan. This amount becomes your present value (with a minus sign).

3. Set your payment (PMT) to your annual/monthly payment. PV = minus what you actually received, N = your years, and solve for your interest rate. This is the rate you are actually getting based on the costs you are paying.

If you are borrowing $200,000 at 3.75% for 30 years, and you agree to pay one point and $1,500 in fees, the following is your process:

1. Your monthly mortgage payment will be $926.23 (PV = –200,000, I = 3.75, N = 30 P/Yr = 12, and solve for your PMT).

2. One point and $1,500 in fees will be $3,500, resulting in a net to your amount of $196,500 ($200,000 – 3,500).

3. Inputting these figures into the equation, your PMT = $926.23, PV = –196,500, N = 30, P/Yr=12. Solve for your effective interest rate, and you get a rate of EIR of 3.89 percent (see Home Loan Comparison (LT19)).

Home Loan Comparison (LT19.a)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					2
Loan Information:			**Amount Needed (after points & fees):**		$ 200,000
Loan Amount		$ 200,000.00	Total Periods	360	**Rates:**
Interest Rate (APR)		3.75%	Loan Payments:	360	**APR**
Years (1-30)		30	***Prepayment of Principal***		3.75%
Payments per year (12)		12	Number of Prepayments:	0	**Effective**
Monthly Payments		$ 926.23	Total of Prepayments:	$ -	**Interest Rate**
Prepayment after # years?			Savings from Prepayments:	$ (0)	3.89%
		(blank = no early payoff)			
Received Before Fees		$ 200,000	Amount Received After Fees		$ 196,500
Points	1.00	2,000	Other Fees	1,500	Total Costs 3,500

Regular Pmts.	Extra Payments	Pts & Fees	Balloon Pmt	Total Paid	less Received	Interest Paid
333,443	-	3,500	-	336,943	200,000	136,943
Cost of loan without prepayment				Total Paid	less Received	Interest
333,443				336,943	200,000	136,943
					Interest Saved by Prepayment:	**(0)**

Prepayment

Prepayment is the process of paying down the loan early by increasing principal payments or by selling the home. On average, most homeowners in the United States move every five to seven years. You should know how to calculate your effective interest rate when you plan to prepay the

loan (or sell the house) before maturity.

The EIR with prepayment is calculated in a similar manner to the EIR, except you must make an additional calculation for the balloon payment you will make when you pay off the loan:

1. Calculate the payments on the total amount you will be repaying (the amount borrowed). Using your financial calculator, set N = your number of years, I = your interest rate, PV = the loan amount, and solve for your payment, or PMT.

2. Calculate the amount of money you actually received for your loan (the total loan minus all costs). Again, assume that all costs for the home come out of the loan. This amount becomes your present value (with a minus sign).

3. Calculate the balance that will remain after you prepay; in other words, calculate your balloon payment. This is the amount you will need to pay off the remainder of the loan. To calculate the balloon payment, set N to the number of years or periods you will pay off the loan early. If you have a 30-year loan, and you pay the loan off after 12 years, you want to know the present value of 18 years of payments. Set I to your interest rate and PMT to your monthly or annual payments, then solve for the present value. This balloon payment is the amount of principal you will still owe after you prepay your loan. This amount becomes your future value.

4. Finally, set the number of years before prepayment as N (12 years in the above example), the balloon payment or balance remaining as FV, the PMT as monthly or annual payments, and the PV as negative the amount you received after paying points and fees, then solve for I to find your effective interest rate.

For example, assume from the previous problem that you want to know the effective interest rate should you pay off the loan after seven years. The first two steps are the same.

1. Your monthly mortgage payment will be $926.23. (PV = –200,000, I = 3.75%, N = 30, P/Yr = 12, and solve for your PMT).

2. One point and $1,500 in fees will be $3,500, resulting in a net to your amount of $196,500 ($200,000 – 3,500).

3. Your final payment at the end of year seven will be $. This is calculated at PMT = $926.23, N = (30 – 7), P/Yr = 12, I = 3.75%, and solve for your present value.

4. Finally, put these figures into the equation— your PMT = $926.23, PV = –196,500, N = 7, P/Yr = 12 months, FV = 171,116.08—and solve for your effective interest rate. You will get a rate of 4.06 percent (see Home Loan Comparison (LT19)).

Home Loan Comparison (LT19.a)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					2
Loan Information:		**Amount Needed (after points & fees):**			$ 200,000
Loan Amount	$ 200,000.00	Total Periods		360	**Rates:**
Interest Rate (APR)	3.75%	Loan Payments:		84	**APR**
Years (1-30)	30	***Prepayment of Principal***			3.75%
Payments per year (12)	12	Number of Prepayments:		0	**Effective**
Monthly Payments	$ 926.23	Total of Prepayments:		$ -	**Interest Rate**
Prepayment after # years?	7	Savings from Prepayments:		$ 84,524	4.06%
	(blank = no early payoff)				
Received Before Fees	$ 200,000	Amount Received After Fees			$ 196,500
Points 1.00	2,000	Other Fees	1,500	Total Costs	3,500

Regular Pmts.	Extra Payments	Pts & Fees	Balloon Pmt	Total Paid	less Received	Interest Paid
77,803	-	3,500	171,116	252,420	200,000	52,420
Cost of loan without prepayment				Total Paid	less Received	Interest
333,443				336,943	200,000	136,943
				Interest Saved by Prepayment:		**84,524**

Understand and Create Your Housing Plan

As you prepare your Housing Plan, it will be helpful to develop a housing strategy for different periods of your life. This Plan will guide you as you make the housing decision which will impact your financial situation for a long time. Just a few suggestions before you develop this Plan.

- Before you begin looking for a home, spend a significant amount of time trying to understand your needs and requirements. What is important to you, spouse, and children? How important are schools, shopping, work? How long are you willing to commute each day?

- Generally, this will require you to rent for a period of time. Use this time wisely. Try to rent in your preferred area first. Check into rental houses. These can be a good intermediary between renting and buying.

- When you are planning to buy, calculate how much you can afford to spend. Don't spend so much on this goal that you are crimped in your other personal goals. Calculate into your spending the fact that you will be paying tithes and offerings and saving 10-20% each month for savings. Don't buy a "fixer-upper" unless you have the time and the inclination to do it. Remember your first priority is to do well at work. Having a beautiful house may not advance your career (although your spouse may love it).

- Once you have decided on a home don't scrimp on home inspections—they are good investments. Don't let the current owners discourage you from doing home inspections. Beware of the hidden costs of home ownership. Keep room in your budget for these.

- Get pre-approved for your loan, not pre-qualified. Don't spend the maximum amount banks will lend you. Keep good records of improvements for tax purposes. These can increase the cost basis of your home and reduce taxes when you sell.

- If you decide to build the key decision is your contractor. He will either make it extremely easy or difficult for you. Choose wisely. Interview his past clients, and check their financial condition and licenses. Ensure permit repairs have final inspections. Know what you want and put it on the plans in the beginning. Changes are four times as expensive after plans are completed. Work with the contractor (but a penalty clause for completion may be useful). Keep back 5% of the cost of the home until all problems are fixed.

- If you decide to renovate, make sure you have your vision of the house, and make sure that vision is on paper (plans). For every change, ensure a change order is drawn. Keep a running tally of all past, current, and estimated costs to complete the project. Review this weekly with the contractor. You might even put in a clause that if the contractor goes over the planned amount, he makes no new money on the excess over the planned amount. And be aware of the large time commitment necessary to renovate.

Housing Plan Example

As you think through the housing decision, it is necessary for you to create a Housing Plan. Following is an example of a possible Housing Plan that may give you some ideas. We have divided the plans and strategies into each of the specific areas discussed.

Vision

- This will be likely from your Plan for Life. It may also include:
    - We will have a home where the Spirit of the Lord is present.
    - We will dedicate our home and strive to make it a place where the Spirit is felt.
    - It will be both a modest and a model home, modest in terms of the neighborhood and model in that we will keep its value up and live within front- and back-end ratios.
    - It will be a home that is open to our children's friends, as well as open to foreign exchange students and others needing temporary lodging.
    - It is a place where we can be safe and comfortable and we can raise a righteous family.
    - It is where we will teach our children to work.

Goals

- A modest and model home, that we can share with family, neighbors and friends.
- A play area for the kids, and garages for dad, which we will use to bring the family together.
- We will pay our home off by age 45.
- A home that we keep up it value and live within front- and back-end ratios.

- We would eventually like to retire to a smaller home, one that is close to the grandkids and is in the mountains that opens up to the open area by lakes and streams.
- A home that is open to our children's friends, foreign exchange students, and others.

Plans and Strategies

Understand your limits

- We will buy a home consistent with the front- and back-end ratios and keep housing expenses (PITI and utilities costs) at less than __% (40% maximum) of my monthly budget. We will not buy too big a house.
- We will make sure our home fits our budget, not our budget fits our home.
- We will save 5-20% for our first home down payment and pay 20% down on each future home.
- We won't buy a home on two incomes when we know you will go to one income in the future.

Finding your home

- We will do our homework before buying/renting to ensure that we are in the best place for ourselves and our family.
- We will do our homework to ensure that the schools are the best for our children and the neighborhood safe for my spouse.
- We will understand our "must haves" for our home and the "would like to haves" as well.
- We will not buy the largest home in a neighborhood as we know that the highest priced home generally does not sell for more than 10% above the median for a neighborhood.

Finding, funding and servicing the loan

- We will get a minimum of three realtors to bid for my business to ensure that I get the best loan for myself and family.
- We will get the lowest EIR for the loans provided given my expectations of how long we will be in the home.
- We will make additional payments each month to pay off the loan in __ Years (i.e., 15 years).

Enjoying home ownership

- We will dedicate our home to the raising of a righteous posterity. A home need not be paid for to be dedicated to the Lord.
- We will ensure that we keep up the value of the home by budgeting ___% for home maintenance and repair (recommended 1-2% of the value of the home).
- We will keep up the appearance of the home by taking care of yard, interior and structure as a good steward.
- We will have my house paid off by age ___. I recommend that you have your home paid off by retirement and that you do not have mortgage debt in retirement.

- We will strive to have 20% saved for a down payment or to get rid of PMI as quickly as we can.
- We will maintain the value of the home by spending 2% of the home's value each year on maintenance.
- We will replace the roof every 20 years, 10% of the landscaping each year, and internal machinery as needed.
- We will pay off the home as soon as we can, and will not go into additional mortgage debt after age 60.
- We will up each mortgage payment to the closest $100, and will strive to be wise stewards over all areas of home ownership.

Constraints

- Key to paying off the home is living on a budget and saving 20%.
- One half of all unexpected money (bonuses, tax refunds, etc.) will be put toward paying down principal (after our emergency fund).
- We will do all required maintenance and plan on replacing key housing machinery as needed. We will also not skimp on required maintenance.
- While we will try to do most of the work ourselves as a family, and will learn as we go, we will bring in experts in areas outside of our proficiency.
- We will stay strong in the gospel to keep our perspective, keeping our family focused, attending the temple and our meetings, and serving each other.

Accountability

- Children will have daily and weekly indoor jobs, as well as weekly yardwork.
- Home is where we teach our children to work. They will learn to use all landscaping and woodworking tools as we work together on our modest and model home.
- We will rotate the jobs weekly so all children will have the opportunities to work throughout the home and will become proficient on all tools.

For answers to additional questions regarding your housing decision, see The Housing Decision III: Questions and Answers.

Summary

Buying a home is not easy. The purchase of a home will likely be the largest financial commitment you ever make. As such, you should not rush into this commitment. If you use wisdom and judgment in trying to decide what you want, what you can afford, and where you want to live, and if you will listen to and obey the promptings of the Holy Ghost, you will make correct decisions regarding your housing needs.

There are four major options for the home decision: renting, buying, building, and renovating. Each of these options has specific advantages and disadvantages.

One of the largest expenses is your mortgage. With so many different options available for a mortgage, it is critical that you understand how to calculate a comparable rate on loans with different points and fee structures. Understanding the different expenses involved in buying a house and how to compare different loans with different points and fees will save you a lot of money overall. Critical to this ability to compare is an understanding of points, effective interest rates, how to calculate effective interest rates, and prepayments.

There is much to learn and remember when buying a home. Keep your goal of buying a home in the perspective of your overall goals and objectives. Develop a home buying strategy, and follow it when you are buying a home. Buying a home is an important goal—but it is not the only one. In spite of the challenges associated with buying a home, having a home may bring many blessings and opportunities. Develop a Housing Plan when you are young, and follow it. It can be a great tool to helping you accomplishing your individual and family vision and goals.

Assignments

Financial Plan Assignment

As you think about where you want to live, it is important to develop your own housing strategy. Include this as part of your PFP Education, Mission, Home and Auto Template (LT01-15).

Start first from where you are. What is your current housing strategy? Where do you currently live? What expenses and fees are you paying, including rent, mortgage, maintenance, utilities, gas, repair and insurance? How can you reduce your housing expenses?

Then work on your plans and strategies. What is your housing strategy? I would break this down into your four areas: understanding your limits; finding your home; finding, negotiating, and funding your loan, and enjoying home ownership.

Strategies may include how often you will move, down payment strategy, negotiation strategies, strategies for warranties, how long you will stay in the house, etc. Again, the purpose of this strategy is to help you make wise decisions as to your housing needs and wants.

Learning Tools

The following Learning Tools may be helpful as you prepare your Personal Financial Plan:

Maximum Monthly Payment for Christian Savers (LT11)

This Excel spreadsheet will help you determine the maximum amounts that financial institutions will generally lend; the spreadsheet uses traditional front-end and back-end ratios. However, traditional banking ratios do not take into account the fact that Latter-day Saints pay tithes and other offerings and save a certain percentage of their earnings. This spreadsheet allows you to take these other factors into account and illustrates that you should be borrowing less for a home

than those who do not pay tithes and offerings.

Home Loan Comparison with Prepayment and Financing (LT19)

This Excel spreadsheet helps you determine the effective interest rate for multiple home loans; it takes into account the loan amount, interest rate, compounding periods, points, and other fees. In addition, it also calculates the rate, assuming prepayment, after a certain number of years. The spreadsheet also helps you determine how much time and money you will save if you prepay a specific amount of principal each period over the life of your loan.

Debt Elimination Schedule with Accelerator (LT20)

This spreadsheet allows you to input your different debts and interest rates. It then prioritizes that debt based on interest rates and creates a repayment plan based on the minimum payments due each month. This repayment plan is consistent with Marvin J. Ashton's plan in the article "One for the Money." This spreadsheet also allows you to include an accelerator amount and an amount in addition to your normal monthly payments; you will be able to see how long it will take you to pay off your debt.

Review Materials

Terminology Review

Breakeven Analysis. This is a form of loan analysis that does not take into account the time value of money, but is simple to calculate. You calculate all new costs and fees for the new loan, and savings in principle and interest over the old loan. You then divide all new costs by monthly savings which will give you your breakeven point in months. If your breakeven point is less than 4 years, it may be a good idea, 5-7 years, it might be considered, or greater than 7 years, be careful. You may likely move before 7 years.

Internal Rate of Return (IRR). This is a form of loan analysis to determine whether you should refinance or not. The process is to calculate all costs and fees for the loan, calculate the monthly savings, determine the number of months of savings, and set the number of months on the new loan equal to the number of months remaining on the old loan so you are not extending the loan! If your IRR is greater than your risk-free rate, then refinance.

Housing Ratios for Christians. As Christians, we have other important obligations that we also pay, i.e., tithing and paying ourselves, i.e., savings. As such, should have smaller houses (at least less expensive), because we pay the Lord first and ourselves second. For a spreadsheet that takes into account the fact that we pay the Lord first and ourselves second within this front-end and back-end ratio framework, see: Maximum Monthly Mortgage Payments for Christian Savers Spreadsheet (from the website).

Refinance. The process of getting another mortgage loan on your home and repaying the old loan with a goal to reducing your interest and other costs overall.

Short-sell. A short-sell is where a lender allows a property to be sold for less than the

amount owed on a mortgage and takes a loss. A short sell allows the borrower to avoid foreclosure, which involves hefty fees for the bank and poorer credit outcome for the borrower, and the lender to make "less" of a loss on the property and to not enter foreclosure. A short sell does not necessarily release the borrower from the obligation to pay the remaining balance of the loan.

Review Questions

1. What are the four options in regards to the home decision?
2. According to the *Handbook for Families*, how much of our take-home pay should we spend on our total house payment, including taxes, insurance, and maintenance costs?
3. What is the best measure of the total cost of a loan?
4. What is the best way to determine if you received a good loan or not?

Case Studies

Case Study 1

Data

You have decided on your dream house (well, at least your first house). In discussions with your mortgage broker, you have the choice between two loans, both of which are amortized over 30 years. Loan A is for $200,000 at 6.0 percent with no points or loan-origination fees, and Loan B is for $203,535 at 5.75 percent with a $1,500 loan fee and one point (both loans will receive $200,000 after the stated fees). In the problem we assumed you use the money from the loan to pay for the points and fees.

Calculations

Assuming you plan to stay in the house for 30 years, which loan is more advantageous based on the effective interest rate (EIR) and assuming annual payments?

Loan A: $200,000 at 6.0 percent, no points, no fees, 30 years

Loan B: $203,535 at 5.75 percent, 1 point, $1,500 fees, 30 years

Case Study 1 Answers

Notes:

a. Loan A has an EIR of six percent, as there are no fees and points. In that case, your EIR = your APR.
b. To get the amount borrowed after fees to equal the same amount for Loans A and B, I used Teaching Tool 19 and Excel Goal Seek and set Amount Received After Fees to the total loan amount for Loan A.

1. Calculate payment for Loan B.

   N = 30, I = 5.75%, PV = –$203,535, PMT = ?

   PMT = $14,393.25

2. Calculate the amount you received after all fees.

   $203,535 – 1 point ($2,000 * 1) – 1,500 = ?

   $200,000

3. Calculate your effective interest rate.

   Set your PMT = $14,393.25, N = 30, PV = –$200,000, Solve for I.

   I = 5.91%

   Loan B is cheaper.

Home Loan Comparison (LT19.a)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					2
Loan Information:		**Amount Needed** (after points & fees):			$ 300,000
Loan Amount	$ 300,000.00	Total Periods		30	**Rates:**
Interest Rate (APR)	6.00%	Loan Payments:		30	**APR**
Years (1-30)	30	***Prepayment of Principal***			6.00%
Payments per year (12)	1	Number of Prepayments:		0	**Effective**
Annual Payments	$ 21,794.67	Total of Prepayments:	$	-	**Interest Rate**
Prepayment after # years?		Savings from Prepayments:	$	(0)	6.00%
(blank = no early payoff)					
Received Before Fees	$ 300,000	Amount Received After Fees			$ 300,000
Points	-	Other Fees		Total Costs	-

Regular Pmts.	Extra Payments	Pts & Fees	BalloonPmt	Total Paid	less Received	Interest Paid
653,840	-	-	-	653,840	300,000	353,840
Cost of loan without prepayment				Total Paid	less Received	Interest
653,840				653,840	300,000	353,840
					Interest Saved by Prepayment:	(0)

Home Loan Comparison (LT19.b)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					1
Loan Information:		**Amount Needed** (after points & fees):			$ 200,000
Loan Amount	$ 203,535.35	Total Periods		30	**Rates:**
Interest Rate (APR)	5.75%	Loan Payments:		30	**APR**
Years (1-30)	30	***Prepayment of Principal***			5.75%
Payments per year (12)	1	Number of Prepayments:		0	**Effective**
Annual Payments	$ 14,393.25	Total of Prepayments:	$	-	**Interest Rate**
Prepayment after # years?		Savings from Prepayments:	$	(0)	5.91%
(blank = no early payoff)					
Received Before Fees	$ 203,535	Amount Received After Fees			$ 200,000
Points	1.00 2,035	Other Fees		1,500 Total Costs	3,535

Paying Off Your Loan Early:

Regular Pmts.	Extra Payments	Pts & Fees	BalloonPmt	Total Paid	less Received	Interest Paid
431,798	-	3,535	-	435,333	203,535	231,798
Cost of loan without prepayment				Total Paid	less Received	Interest
431,798				435,333	203,535	231,798
					Interest Saved by Prepayment:	(0)

Case Study 2

Data

Your spouse suggests that you will likely only be in the home for six years, although you estimate a longer time frame because current job looks very positive. You compromise and estimate that you will be in the home for 12 years. Review your choice between the two loans, both of which are amortized over 30 years but which will be paid back in 12 years with a balloon payment at year 12. Loan A is for the same $200,000 at 6.0 percent with no points or fees, and Loan B is for $203,535 at 5.75 percent with a $1,500 loan fee and one point.

Calculations

Calculate the EIR for both loans, assuming a balloon prepayment after 12 years and annual payments.

Application

Which loan is more advantageous with prepayment using the EIR?

Case Study 2 Answers

1. Calculate payment for Loan B.

   N = 30, I = 5.75%, PV = –$203,535, PMT = $14,393.25

2. Set PV = to the amount you receive after all costs.

   $203,535 – 1 point ($2,000 * 1) – 1,500 = $200,000

3. Solve for your balloon payment at year 12.

   N = 18, PMT = $ 14,393.25, I = 5.75, PV = $158,812.56

4. Solve for your effective rate.

   PMT = $14,393.25, PV is –$200,000, N = 12, FV = $158,812.56, solve for I.

   I = 5.97%

   Loan B is still cheaper (barely).

Home Loan Comparison (LT19.b)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					1
Loan Information:		**Amount Needed (after points & fees):**			$ 200,000
Loan Amount	$ 203,535.35	Total Periods		30	**Rates:**
Interest Rate (APR)	5.75%	Loan Payments:		12	**APR**
Years (1-30)	30	***Prepayment of Principal***			5.75%
Payments per year (12)	1	Number of Prepayments:		0	**Effective**
Annual Payments	$ 14,393.25	Total of Prepayments:		$ -	**Interest Rate**
Prepayment after # years?	12	Savings from Prepayments:		$ 100,266	5.97%
	(blank = no early payoff)				
Received Before Fees	$ 203,535	Amount Received After Fees			$ 200,000
Points 1.00	2,035	Other Fees	1,500	Total Costs	3,535

Paying Off Your Loan Early:

Regular Pmts.	Extra Payments	Pts & Fees	BalloonPmt	Total Paid	less Received	Interest Paid
172,719	-	3,535	158,813	335,067	203,535	131,532
Cost of loan without prepayment				Total Paid	less Received	Interest
431,798				435,333	203,535	231,798
				Interest Saved by Prepayment:		**100,266**

Case Study 3

Data

Your broker has said that for one more "buy down" point (a total of two points with the same $1,500 fees), he can give you Loan C with an interest rate of 5.50 percent. Because of the additional point, the new loan amount is $205,612.

Calculations

Calculate the EIR for Loan C of $205,612 at 5.5%. How much did that extra point save you in terms of your effective interest rate over Loan A and Loan B?

Application

Assuming the same 12-year prepayment plan, which loan should you take?

Case Study 3 Answers

1. Calculate payment for Loan C.

   N = 30, I = 5.5%, PV = –$205,612, PMT = $14,147.21

2. Calculate amount received after all fees (two points).

   $205,612 – 2 points ($2,000 * 2) – 1,500 = $200,000

3. Calculate the balance owed after 12 years (18 years remaining). The PV of 18 years of the PMT is:

   N = 18, I = 5.5%, PMT = –$14,147.21, PV = $159,100.62

4. Calculate effective interest rate to lender.

   Set your FV at year 12 to = $159,100.62, PMT = $14,147.21, N = 12, PV = –$200,000, solve for I = ?

   I = 5.85%

   Loan C saves 0.15% and 0.13% over Loans A and B, but because of the increase in points, the amounts of the loans increases to give the same $200,000 needed.

Home Loan Comparison (LT19.c)

Amount Needed: After points and fees = 1, Before Points and Fees=2:					1
Loan Information:		**Amount Needed (after points & fees):**			$ 200,000
Loan Amount	$ 205,612.24	Total Periods		30	**Rates:**
Interest Rate (APR)	5.50%	Loan Payments:		12	**APR**
Years (1-30)	30	***Prepayment of Principal***			5.50%
Payments per year (12)	1	Number of Prepayments:		0	**Effective**
Annual Payments	$ 14,147.23	Total of Prepayments:		$ -	**Interest Rate**
Prepayment after # years?	12	Savings from Prepayments:		$ 95,549	5.85%
	(blank = no early payoff)				
Received Before Fees	$ 205,612	Amount Received After Fees			$ 200,000
Points 2.00	4,112	Other Fees	1,500	Total Costs	5,612

Paying Off Your Loan Early:

Regular Pmts.	Extra Payments	Pts & Fees	BalloonPmt	Total Paid	less Received	Interest Paid
169,767	-	5,612	159,101	334,480	205,612	128,868
Cost of loan without prepayment				Total Paid	less Received	Interest Paid
424,417				430,029	205,612	224,417
				Interest Saved by Prepayment:		**95,549**

17. The Transportation Decision: Making it Wisely

Introduction

One of the challenges consumers face is making wise large-ticket purchases. Besides the decision to purchase a home, one of the next largest financial decisions for many is buying a car. Therefore, you should ask yourself how you can become a wiser steward and make the best automotive decision for yourself and your family. This chapter covers a few ideas you may find helpful regarding the automobile decision.

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand key areas and principles of car ownership.
B. Understand how to buy or lease a new car.
C. Understand the lease versus buy decision.
D. Understand and create your auto and adult toy plan.

Determine the Key Issues and Principles of Auto Ownership

There are a number of important topics you must understand before you buy or lease a new or used vehicle, including the following: choosing a vehicle, steps to take before you go looking, and steps to take after you have found the vehicle.

Buying means you are purchasing the vehicle outright. The advantages of buying include that you are protected against losing your vehicle in case of job loss or change of employment if you have paid cash for the vehicle. If you buy, you can drive unlimited miles each year, and if you pay cash for the vehicle, you have no monthly payments. The vehicle can be used for any purpose, and you can modify the vehicle as you like (e.g., changing the color, rims, or tires). The main disadvantage of buying is that there are higher up-front costs. Buying is also expensive if you want to have a new car every few years.

The advantages of leasing include that the payments are usually lower because you pay for only a portion of the car you are using. When you lease, you pay a depreciation fee and sales tax on a monthly basis instead of making a payment on the total cost of the vehicle. As a result, leasing can be economical if you want to have a new car every two or three years.

However, there are many disadvantages of leasing including higher costs, loss of flexibility, increased costs due to buying new cars every few years, and risks of ownership, which will be included in the next section on the challenges of leasing.

1. Choosing a Vehicle

There are four steps to choosing a vehicle. This includes knowing your vision, goals and budget; evaluating safety; estimating total vehicle costs; and estimating insurance costs.

Know your vision, values, goals and budget. What is important to you? What is your vision for this vehicle and have you written down your goals? Are you living on a budget? It makes no sense to purchase a vehicle on which you cannot afford to make the payments. It is important that the money you spend on a vehicle does not take away your ability to achieve your other important goals. Make sure you can afford the vehicle by knowing your goals and budget.

If you are planning to finance the vehicle (which I do not recommend), are there sufficient funds to cover the costs of the vehicle and still attain your other personal goals? In addition, are you putting aside money each month to fund the purchase of another vehicle once it is no longer cost effective to run your current vehicle?

Evaluate vehicle ratings and safety. As you are making decisions about an automobile, remember to pick a vehicle that is safe for your family. There are a number of good websites that evaluate vehicle safety records. A good place to start is the National Highway Traffic Safety Administration site at www.nhtsa.gov. Other sites include Safer Car at www.safercar.gov and the Insurance Institute for Highway Safety at www.iihs.org. Each of these sites offers information on safety ratings, crash tests, and other important information about specific vehicles.

Examine total automobile costs. In addition to looking for a strong safety record, look at overall costs of the vehicle, including maintenance and repair. Repair records can be found on in reviews of the various automobiles. How many miles per gallon does the vehicle get on the highway and around town? With gas prices constantly on the rise, having a fuel-efficient vehicle makes a lot of sense.

Mileage and repair information can be found at a number of different websites, including Consumer Reports at www.consumerreports.org. Consumer Reports gives relatively unbiased information on mileage and repair histories, so you can determine which vehicles have the best track records on repairs and which vehicles will be less costly to operate.

Evaluate insurance costs. Pick a vehicle that is inexpensive to insure and drive. The Insurance Services Office (ISO) rates each vehicle on its loss history, a study on how much it costs to repair the vehicle, using a number between 3 and 27. Generally, the higher the number, the more expensive the vehicle is to repair and the more expensive the coverage. Sports cars, high-performance cars, and SUVs are more expensive to insure. Work with your insurance agent when you are considering purchasing a new or used automobile.

2. Steps to Take Before You Go Looking

Once you have determined which vehicle you want, there are a few more key issues you should

be aware of. These issues include finding new and used vehicle prices, understanding holdbacks, warranties, service contracts, and lemon laws.

Finding new and used vehicle prices: There are a number of automobile websites that provide reliable estimates of what a dealership paid the manufacturer for a particular car. There are a number of different prices you should be aware of. The MSRP (manufacturer's suggested retail price) is the amount the dealership hopes to get for the vehicle. This amount is a recommended price only. The dealer invoice is the reported amount the dealership actually paid to the manufacturer for the vehicle. This price is often called the invoice price. Some of the websites that can help you determine the dealer invoice price include www.edmunds.com, www.autosite.com**,** and www.kellybluebook.com**.** It is important to know the dealer invoice price because you should use the invoice price rather than the MSRP as the beginning point when you are negotiating for a vehicle.

You can find pricing information for used cars in the same manner you find pricing for new cars, although the final price of a used car depends on how well the car has been taken care of. Key sources those previously mentioned as well as www.nada.com and www.vehix.com.

Understanding holdback: A holdback is a rebate the manufacturer gives the dealership as compensation for holding the vehicle on the dealer's lot. It is important for you to realize that even when the dealership sells a vehicle at a low cost, or even below invoice, the dealership still makes money because the dealer's profit includes the holdback. The holdback money is not usually negotiable, but it is important to understand. Different manufacturers have different holdback amounts for dealers.

Warranties: Companies offer warranties to guarantee a product has the features and capabilities promised at the time of purchase. Warranties guarantee that any problems that arise after the purchase is completed will be resolved within a reasonable period of time.

Full warranties are contracts that promise the following: (1) the product will be fixed at no cost to the buyer within a reasonable time frame after the buyer makes a formal complaint, (2) the buyer will not have to perform an unreasonable task to bring the product back for repair, and (3) if the product cannot be repaired, the defective product will be replaced with a new product, or the buyer's money will be returned.

Service contracts: Service contracts are agreements between the contract seller (the dealership, the manufacturer, or an independent company) and the buyer in which the contract seller agrees to provide specific services on the vehicle. These contracts may specify that the contract seller must provide free or discounted repair services or that the contract seller must cover components of the car for a specified length of time or mileage (for example, five years or 70,000 miles) after the original warranties expire. When purchasing a service contract, you should be concerned about what components are covered, the length of the coverage, and the number of miles covered. Generally, service contracts that come from the manufacturer are better because you can get service nationwide, rather than from a single dealer.

Lemon laws: Lemon laws are laws to protect the consumer if the vehicle he or she purchased is a "lemon." According to these laws, your car is defined as a lemon if you make at least four attempts to fix a problem and if the car is out of service for at least 30 days during the first 12 months or 12,000 miles following your purchase. These laws give a consumer the right to return a car and request a replacement or a full refund if the circumstances meet the criteria of the lemon law.

3. Steps to Take after You Have Found the Vehicle

After you have found a vehicle you are interested in buying, look at a printout of the vehicle's history, have the vehicle checked by a good mechanic, and look at the vehicle's service records.

Vehicle history: Before you purchase a vehicle, get its vehicle identification number (VIN) so you can get a printout of its history. The vehicle history is a record of every time a different owner has registered the vehicle with the state; it lists all past owners and their locations. You can get a copy of a vehicle's history for a fee by going to www.carfax.com and typing in the VIN. This record is important because you can see where and when a vehicle was registered, the type of title the vehicle has (i.e., was it salvaged or not), and the mileage listed on previous registrations. Generally, the more times a vehicle has been sold, the more likely it is that one or more of its owners has not done the maintenance required to keep the vehicle in good operating condition.

Inspection by a good mechanic: After you have found the vehicle you think you may want, get the vehicle checked by a qualified mechanic, preferably one from a dealer; the mechanic will do a major checkup to make sure there are no hidden problems. While it may cost between $80 and $250, the expense will be worth it if the mechanic finds problems you may not have discovered otherwise.

Service records: After you have found a vehicle you are interested in, ask the seller for a copy of the vehicle's service records. Sellers should have kept a record of all services performed, including repairs, oil changes, tire rotation, etc. It is likely that vehicles with good service records were better taken care of than vehicles without such records.

The most important reason for having a car is convenient transportation. Less important reasons for having a car include that cars are fun, they can make a statement about your lifestyle, and they just look cool. If a car fits into your budget and you are achieving your other financial goals, then it may be appropriate for you to have a car for any one of these reasons.

Principles of Effective Auto Ownership

Keep in mind that buying a car can hurt your financial goals if you must borrow money to pay for it. When you borrow money for a car, you must use your money to pay interest, which means it can't be used to earn interest or build wealth. If you have not considered car expenses in your budget and you purchase a car, it can take the place of more important goals. In addition, if you

spend more than you had planned for the car, making payments can become a financial burden and can limit your ability to achieve other goals. Before ever purchasing a vehicle, determine if the purchase fits into your financial plan and if the costs fit into your budget.

There are five key principles of effective car ownership:

1. Understand yourself, your vision, goals, values and budget. What are you trying to accomplish and how will transportation help you accomplish those goals.

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received.

3. Understand the key areas of vehicle ownership. Ideally, the purpose of car ownership should be to provide safe, dependable transportation in a cost effective manner. Realize that a car is a tool to achieve your other goals, not necessarily a goal in itself.

4. Make your car fit your budget, not your budget fit your vehicle. Understand the total cost of the vehicle ("the out the door price"), and negotiate this amount.

5. Understand and minimize your costs. These costs include the basic purchase price, gas, oil, and insurance. However, it also includes other costs such as scheduled maintenance, repair, taxes (which includes sales tax, registration, licensing, documentation, and in many places, property tax), depreciation, and resale value. Be wise in your choice of vehicle to minimize these costs.

6. Be a wise steward over your vehicles. In terms of your car, this means to minimize all costs over the car's effective life. This means that you do the necessary repairs, maintenance, and other activities to ensure the car will last for many years. While skipping a scheduled maintenance may save you money short-term, in the long run it may result in higher maintenance and repair costs.

Finding Balance

As you work on developing a transportation plan, finding balance among doctrines, principles and application is important. We have shared some ideas for principles, although I am sure you can find others that are important to you. Below are a few ideas for doctrines on which the principles are based.

Principles	Doctrines
Understand yourself, vision and goals	Identity
Seek, receive, and act on the Spirit's guidance	Obedience
Understand the key areas of vehicle ownership	Stewardship
Make vehicle fit budget	Agency

Minimize all costs over the car's useful life	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on obtaining a vehicle for transportation, which is an application. From a higher perspective, or with increased vision,

> We are children of a loving Father in Heaven (identity), striving to live worthy of the Spirit (obedience), learning to be a wise stewards over the things God has blessed us with (stewardship). We understand the benefits and costs of vehicle ownership and we use that agency wisely as we choose good vehicles, minimize costs, maintain them well, and keep them our predetermined amount of time (stewardship) so we can accomplish our personal missions and our individual and family vision and goals.

If you think about a car with correct perspective, as a tool to help you achieve other more important goals, you will make better decisions when purchasing your car.

Understand How to Buy or Lease a New Car

Buying or leasing a new car can be both exciting and frightening—you are looking forward to driving a new car, but you want to make sure you get the best deal possible. The information in this chapter can help guide you through the process of buying or leasing a new car.

Buying a vehicle is a fairly straightforward process. If you pay cash, the vehicle is yours. If you finance, you borrow money from a lending institution and as you make payments, you build equity in the vehicle until it is eventually yours. You can keep the vehicle as long as you like and you can do whatever you want with the vehicle.

Because you are typically paying back the entire cost of the vehicle, your loan's payments are higher than when leasing. And when you are ready to get a new car, you either need to trade in or sell your old vehicle.

Leasing may seem to be more appealing that buying. Your monthly payments compared to financing a purchase will be much lower. You enjoy a trouble-free 2-3 years of the vehicle's life and either lease another vehicle or simply walk away. There is often no down payment, many can get a higher-priced, better equipped vehicle than they might otherwise be able to afford, and they always have a late-model vehicle that's usually covered by the manufactures warranty. However, should you decide to lease a new or used vehicle, the section after this describes the challenges with leasing, which are many and which are not well understood and thought through by most consumers.

Before you buy or lease, there are five general guidelines you should know about the buying and leasing process. The decision to lease or buy comes in guideline four.

1. Know the Terminology

Knowing the terminology associated with buying and leasing a car is very important. The following terms are critical to both leasing and buying:

MSRP is the price a manufacturer hopes to get for a vehicle. Remember that it is acceptable and expected that you will negotiate for most vehicles. Research has found that those who negotiate generally pay less for their vehicles than those who do not.

Interest rate is the rate of interest you will be paying each year on the loan should you choose to finance the loan.

Loan period is the period over which you will finance the loan should you choose to finance.

Capitalized cost is the agreed-upon or negotiated cost. This amount is often significantly different from the MSRP. Realize that the MSRP is a hoped for amount, and not the negotiated amount.

Capitalized cost reduction is the capitalized cost that has been reduced by any rebates, incentives, and/or a trade-in vehicle.

Net capitalized cost is the agreed-upon or negotiated cost minus the capitalized cost reduction.

Residual value is the bank-determined expected value of the vehicle at lease term end. The actual value at term end may be either higher or lower than the residual value. This value is expressed as a percent of MSRP, such as 55 percent, meaning that the residual value at the end of the term would be 55 percent of the MSRP.

Lease term is the number of months the vehicle is leased.

2. Narrow Your Choices and Select Your Vehicle

When choosing an automobile, it is critical that you comparison shop. You should compare prices, features, and quality to find out exactly what you want. Be informed. Check the library and the Internet, and look at the alternatives. As you look at different cars, determine what is available in your price range and budget.

After you have looked at what is available, the next step is to choose your vehicle. As you narrow the choices, test-drive the exact vehicles you are considering. Do not buy any car without test-driving it first.

As you make your final decision, it is critical that you remember to make your car fit your budget. Don’t make your budget fit your car. If you must finance your car, determine exactly how much you can afford to spend each month and select a vehicle with a payment plan that fits within that limit. Do not spend more on a car than you can afford.

3. Determine Your Total Price and Negotiate for This Price

Once you know which car you want to buy and how much you can spend from your budget, you are ready to begin negotiations. Do your homework to find out how much the dealer paid for the car (the dealer invoice), the rebates that are available, how much the holdback from the manufacturer is, the amounts of the total markup, and the MSRP.

Start your negotiations at the dealer invoice. The dealer invoice is the price that appears on the invoice that the manufactures ends to the dealer when the dealer received the car from the factory. Please note that this price is almost always higher than the amount the dealer actually ends of paying to the manufacture, but it is a good starting point. If the company you are working with won't share the dealer invoice, go someplace that will. Most car dealerships will share this information with you. Often you can buy a car for invoice plus $100–$500, and sometimes you can negotiate for even less depending on dealer sales quotas and how long they have had the vehicle on the lot.

The dealer's inventory often impacts how much of a difference there is between the invoice price and the price for which the dealer will sell the vehicle. The fewer the number of available cars and the more people who want those cars, the more the dealership will charge—this follows the basic principle of supply and demand. The calendar date may also affect how willing the dealer is to work with you on price. The end of a month or year is a particularly good time to buy because salespeople are trying to reach their quotas and are therefore more willing to negotiate.

Remember that no matter what price you negotiate, there are many other fees you will be expected to pay on top of the sale price. For example, if you and the dealer agree on a price of $30,000 and a trade-in credit of $5,000, the difference is $25,000. But in addition to that $25,000, you will need to pay for state tax and documentation, registration, and licensing fees. You will either pay for these costs in cash or finance them along with the price of your vehicle. In addition, if you lease a vehicle, you may also have to pay an acquisition and termination fee. Know that most of these fees—except for title, documentation, and licensing fees—are negotiable before you purchase or lease the vehicle.

Be careful in your negotiations, as dealers will try to sell you additional services such as extended warranties, leather or seat protection, tire warranties, additional service contracts for oil changes, theft protection services, vehicle care programs, and gap protection services, which can increase the cost of the vehicle substantially and may not add value. You are not required to purchase any of these programs.

4. Make Your Purchase

This is where the leasing versus buying decision comes into play.

Buying. If you must finance your automobile purchase (which is not recommended), remember that banks and credit unions will charge different interest rates than the dealer will charge.

Usually, financing provided through the dealership is the most expensive type of financing, so compare interest rates on auto loans from multiple institutions before you purchase a car. If you choose financing from the dealership, make sure your credit financing is approved before you drive the vehicle off the lot.

When comparing different loans, look at the term of the loan, the interest rate, and the fees. Financial institutions will typically finance newer vehicles for longer periods of time than they will finance older vehicles. Your credit score will have a major impact on the interest rate you will pay on your auto loan, so keep your credit score high. For more information on this topic, refer to the chapters on Understanding and Managing Credit and Consumer and Mortgage Loans.

Calculate the overall costs of the purchase, including down payment, fees, taxes, license, documentation, and any dealer options. Know your total cost for the vehicle before you sign any sales documents so you will know how much you are paying. Realize that many of the dealer-installed options, such as rust coating, leather treatment, special rims and tires, and so on, are not required for the sale, even though the dealer may have done the work beforehand. Also, realize that nearly all costs are negotiable.

Leasing. If you decide to lease, realize that each leasing organization has different rates and programs, depending on your credit worthiness. Keep your credit score high and find the cheapest source of financing for your vehicle. Information on how to calculate your lease cost is given in the next section. Make sure you understand the challenges and costs of leasing before you sign the lease document.

5. Enjoy Your Purchase and Keep It Well Maintained

Once you have made your purchase, read the owner's manual carefully and follow the suggested maintenance schedule. One of the best things you can do for your car is to change the oil every 3-5,000 miles. Don't ignore warning signals when your car doesn't work as it should. When problems arise, get them fixed. Find a good garage with well-trained and experienced mechanics, and let the mechanics take good care of your new vehicle.

Understand the Challenges of Leasing and Calculating Lease Costs

Leasing may at first seem to be more appealing that buying. The payments are usually lower because you pay for only that portion of the car you are using. When you lease, you pay a depreciation fee and sales tax on a monthly basis only on the part of the vehicle used instead of making a payment on the total cost of the vehicle. As a result, leasing can be economical in the short term and allows you to have a new car every two or three years.

In getting a new car every two to three years, think about your perspective, what you are doing longer-term. You are purchasing the vehicle new, which is a major cost. You are developing the habit of buying a new car every 2-3 years, which is perpetual renting. You are paying the most for depreciation and insurance, as these costs are higher with new vehicles. And you are paying

higher costs due to higher finance charges and fees that are coming due every few years. Moreover, you are constraining future decisions because of your lease term and mileage allotments. Is this what you want? In short, most consumers only look at the monthly costs and fail to take into account the real costs of leasing which are significant.

Challenges of Leasing

While there may be a place for leasing, particularly if your business can expense your lease costs. Monthly costs are cheaper. However, for most people, there are challenges of leasing which should be understood before you make the decision to lease.

1. Leasing typically costs more than an equivalent loan. This is in part because of the higher finance charges, which are often difficult to understand unless you know how they are calculated. We will detail those costs below. In addition, assuming similar rates and fees, the total cost of leasing will still be higher due to the way interest and fees are calculated.

2. Once you get into the leasing habit, monthly payments go on forever. You are perpetually paying interest, instead of earning it. In contrast, the longer you keep a vehicle after the loan is paid off the more value you get out of it.

3. There is a fixed-mileage allotment for your lease, generally 10-15,000 miles a year, with a high cost if you go over. If you go beyond your allotment, you are required to pay a penalty charge for every mile you drive over your predetermined mileage allotment. These costs are substantial (.10-.25 per mile). This may limit flexibility in moving to another location or going on internships because of the possibility of exceeding mileage limits.

4. You must maintain the vehicle in good condition, or there may be wear-and-tear charges. If you choose to lease, be sure to find a *closed-end* lease, not an *open-end* one. With a closed-end lease, you simply pay the monthly payments and various fees and then return the car when the lease is over. If you have an open-end lease and the dealer is not able to sell the car for what he or she originally estimated, then you must pay the difference. Open-end leases are generally not a good idea due to the risks involved. An open end lease with your child's messy behavior can have financial consequences later on.

5**. At the end of your contract, you do not own the car.** Your is not an asset; rather, it is a monthly expense. While this may be good if a business is expensing the car payments monthly for tax purpose, for an individual or family this is not the case.

6. There are many extra fees for leasing and profits are hidden. These include acquisition and termination fees, and other hidden recurring fees with each new lease. Because leases are generally short-term, dealerships make a lot of money by leasing new

cars to buyers every few years. However beneficial to the dealer, it is likely more cost effective to keep your vehicles for more years.

7. Leasing has early termination penalties and fees. If you need to get out of the lease before the lease term expires, you may need to pay thousands in early termination fees and penalties which could equal the amount you would have paid had you stuck with the lease in its entire term. Moreover, should you opt for a longer lease than the car warranty or should the vehicle have problems, you will be required to fix these problems at your expense before you can return the vehicle. If you choose to do a longer lease, it is advisable to get an extended warranty to ensure you do not have to pay these additional costs.

Calculating Lease Costs

Once you have negotiated the cost of the vehicle with your chosen options, determined your capitalized cost reductions (rebates, and trade in allowances), and added your required additional fees, such as license, registration, and documentation, now is when you begin the determination of whether you will lease or buy.

The first decision is how much you will pay outside the loan versus in the loan. If you can pay cash for the vehicle, this is best. However, if that is not possible, payments outside the loan would include a down payment, and any other fees you decide to cover. The more you pay upfront, the less you will have to finance.

Once you have the total cost you need to finance, the next decision is whether to lease or buy. The key areas are the interest rate and loan term. With that information, you are able to determine the monthly payments.

However, with a lease there are other things you need to determine, including additional costs, lease term, money factor, and residual value.

Additional Costs. There are specific costs with a lease that you do not have when you buy and finance through a bank. For example, you may have an acquisition and/or termination costs which are not part of the buy decision. These fees need to be understood and applied up front.

Lease term. Generally, most vehicles depreciate more in the early years of a lease than in the later years. As such, you will pay more for newer vehicles than you will pay for older vehicles. Lease terms can be as short as 24 months and as long as 72 months. Remember that if you choose a lease term that is longer than your new vehicle's warranty (generally three years or 36,000 miles) you will be responsible for any repairs beyond the new vehicle's warranty period. If you are looking at a longer lease, it may be wise to get an extended warranty or a service contract to minimize the risk of additional costly repairs (See Table 1).

Residual value. Your residual value is the bank-determined expected value of the vehicle at

lease term end. The actual value at term end may be either higher or lower than the residual value. This value is expressed as a percent of MSRP, such as 55 percent, meaning that the residual value at the end of the term would be 55 percent of the MSRP. If your MSRP is $25,000 and your residual value was 38 percent, the residual value of the vehicle would be $9,500.

Money Factor. Your money factor is simply the APR in percentage terms divided by 24. It is an archaic way of showing interest rates, which has led to some confusion by consumers.

Lease Costs. Once you have your total amount to finance, there are three parts to the cost of a lease.

Part 1. Usage or depreciation charge. Usage is the amount of the value of the vehicle that is used over the lease life. This charge is the difference between your net capitalized cost (which is your negotiated price less any down payment, rebates, or trade in) and your residual value (which is the value the bank estimates the vehicle to be worth at term end). This is the amount you will be charged for the depreciation on the vehicle over the life of the lease.

Part 2. Interest (or finance costs): This is your monthly interest cost for leasing the vehicle. It is calculated by determine your average amount borrowed times your average monthly interest rate, which would give you your monthly interest or finance charge.

In a lease, you agree to a specific price for the vehicle now (your negotiated cost less any rebates, down payment and trade in) and a specific price that the vehicle will be worth at the end of the lease (which is your residual value). To determine the average amount borrowed over the lease term, use the following calculation:

If you leased a $20,000 vehicle which has a $10,000 residual value (i.e., the bank-determined value of the vehicle at term end), the average amount borrowed would be $20,000 cost + $10,000 residual divided by two, or $15,000. This is your average amount borrowed. Remember that leases are not like buying where your equity increases the more you pay down the loan. With a lease, you never have equity in the vehicle because you are in essence renting the vehicle in perpetuity. You simply add what you paid, plus the value at term end and divide by two to get the average amount borrowed.

(net capitalized cost + residual value) / 2

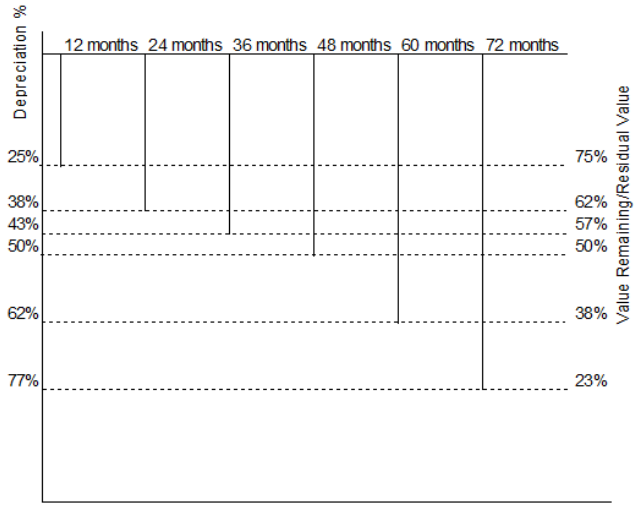
The average monthly interest rate is easier to determine. The calculation is simply your annual percentage rate (APR) in decimal form divided by 12, or APR / 12.

Your monthly interest expense is found by multiplying your average amount borrowed by your average interest rate; the result is your monthly interest expense, or your monthly finance charge, on the lease.

In leasing terms, your monthly interest cost is calculated as your net capitalized cost plus the

residual value multiplied by the money factor ((NCC + Residual) * MF). This is in essence just the average amount borrowed times your average interest rate.

Table 1: **Depreciation Schedule of a Typical Vehicle**



Part 3. Taxes (or government costs): In addition to paying taxes on the down payment of a lease, you must also pay taxes on your usage or depreciation charge and your interest or finance charge. Taxes are calculated as your usage and interest costs multiplied by your tax rate.

> Calculate the amount of your residual value, usage or depreciation charges, interest or finance charges, taxes, and all the fees you will be paying. It is a good idea to compare the cost of leasing versus the cost of buying over the life of the lease. For an example of how to compare the costs of leasing versus buying, see Lease versus Buy Analysis (LT22).

Understand and Create your Auto and Adult Toy Plan

Autos and adult toys are expensive and can have a significant impact on the family budget. As such, it is important to develop and auto and toy strategy to ensure these costs are planned for an in the budget.

Having an auto strategy for what you will and will not do for transportation is critical. Without a defined auto strategy, it is easy to succumb to the following challenges.

- You borrow the money for the autos and toys, so instead of earning interest, you pay it.
- You get in the habit of buying or leasing a car on credit, so you pay interest for the rest of your life and find it difficult to fund your other important goals because of the cost of transportation.
- It's not in your budget or is more than you planned, so it relegates more important goals to a lesser position.
- You buy a new car too often, and so you pay too much for expensive depreciation,

insurance and other costs.

What should your Transportation Plan include? It can include a number of different areas, depending on your vision for these vehicles, your goals, and your tactical plans to achieve your vision and goals. Examples include:

- Budget: Ensure the auto fits the budget, not the budget fits the auto; Budget for all costs, including purchase, fuel, maintenance, and insurance before you buy.
- Vehicle age: Keep your cars for 10 years or 200,000 miles whichever comes first; buy new vehicles 1-2 years old with less than 24,000 miles, then buy 100,000 extended warranty at $150 over invoice; spouse gets newer vehicle.
- Maintenance: Be diligent in oil changes every 3-5,000 miles and do the recommended maintenance.
- Financing: Pay cash for all vehicles; save a specific amount each month for purchase of your next vehicle.

Transportation Plan Example

Using the creative process, we can put together a Transportation Plan that will guide is in our financial lives. Following is an example of an auto strategy for someone close to me.

Vision

- This will likely come from your Plan for Life. It may also include:
    - I will have reliable transportation to meet the needs of my spouse and family and not for pride purposes.
    - Autos will be used for transportation; we will pay cash and take good care of them. We will keep them an extended period of time, thereby reducing overall costs.

Goals

- Budget: We ensure the auto fit the budget, not the budget fits the auto.
- Vehicle age: We will keep vehicles for 10 years or 200,000 miles, whichever comes first.
- New car purchases: We will buy used vehicles until our net worth is > $750,000.
- Financing: We pay cash for all vehicles.
- Maintenance: We will be diligent in oil changes every 3-5,000 miles, and do the recommended maintenance.

Plans and Strategies

- Before you buy a vehicle, check out the vehicle thoroughly.
- Budget for all costs, including purchase, fuel, maintenance, and insurance.
- Purchase new vehicles 1-2 years old with less than 24,000 miles, then buy the 100,000 extended warranty at $150 over invoice.
- Spouse gets the newer vehicle.

- Once you have a vehicle, save a specific amount each month for purchase of your next vehicle when this vehicle dies.

Constraints

- We will buy a new vehicle only after we have a $750,000 in net worth; and spouse gets the newer and safer car.
- The value of vehicles and toys will not exceed 50% of annual income (Dave Ramsey)

Accountability

- From your Plan for Life, but may also include:
    - Spouse and family will help with the process of selecting, maintaining, and cleaning the vehicles.

Adult Toy Strategy

Adult toys are adult motorized vehicles that are not necessary for transportation yet still may be important for some individual and families for recreation. These include boats, motorcycles, all terrain vehicles (ATVs), side by sides (SxSs), jet skis, bikes, trailers, RVs, etc. It is generally anything motorized and not used in the landscaping or yard.

The challenge becomes what happens when you don't have an effective toy strategy. Individuals and families can spend significant amounts of resources on things that are not consistent with their personal and family goals and do it at the wrong time, thereby displacing other important goals.

What can your toy strategy include? These could include different things, such as:

- Age: Purchase good toys which have parts available (and close by) and keep those toys for 20 years. Be careful of no-name vehicles as parts and repair may be difficult to find.
- Maintenance: Do all required maintenance so toys will last--expect toys to last a minimum of 20 years; include toy gas, oil, maintenance and insurance in the family budget.
- Goal Priority: Pay cash for all toys, and only after saving 20% for our other goals. Toys should only be purchased if you are on track for your other goals.
- Usage: Don't allow others to use toys unless they take good care of them so they will last your required age.

Toy Strategy Example

Following is an example of a Toy strategy which is part of your Transportation Plan. Again, you can be very creative when you put these strategies together.

Vision

- Likely from your Plan for Life. May also include:
    - Toys will be used for new experiences and to bring our family closer together. We

will pay cash for good toys that are budgeted for and will take good care of them. We will keep them an extended period of time.

Goals

- Our first toys will be bikes, then tents and camping equipment, then later perhaps a small ATV for the kids. As our net worth increases, we may purchase a trailer, and move to larger ATVs consistent with our budget and savings.

Plans and Strategies

- Our first toys will be bikes, then tents, camping equipment, then perhaps a small ATV for the kids.
- As net worth increases, we may purchase a trailer and larger ATVs consistent with our budget and savings.
- We will purchase good toys with available parts.
- We will pay cash for all toys, and only after saving 20% for our other goals.
- We will not allow others to use toys unless they take good care of them so they will last our required time.

Constraints

- We will keep close to the Spirit so we are not enticed by the traps of the world to spend more.
- We will buy toys only if we are reaching our budget and savings goals.

Accountability

- Froom your Plan for Life. It may also include:
    - Spouse and family will help with the process of selecting, maintaining, and cleaning the toys.

While it is not easy to discipline our desire for automobiles and adult toys for recreation and other usage, it is important that we keep our goals in perspective and that we use wisdom in our purchases, particularly those that are not critical to our family responsibilities.

Summary

Besides the decision to purchase a home, the largest financial decision for many individuals is the decision to buy a vehicle. While it is important to have a car for convenient transportation, having a car can become a significant financial burden if you must borrow money to pay for the purchase, if a car is not in your budget, or if the car costs more than you planned.

There are a number of important topics you must understand before you buy or lease a new or used vehicle. Know your budget and understand safety reports, automobile reports, and insurance. Before you look for a vehicle, understand the pricing on new and used vehicles, holdbacks, warranties, service contracts, and lemon laws. After you have found the vehicle you

want to buy, be sure you look at vehicle reports, have the vehicle checked by a mechanic, and review the vehicle's service or maintenance records.

Before you begin the process of buying a vehicle, you should understand five general guidelines for the buying or leasing process:

1. Know the terminology.
2. Narrow your choices and choose your vehicle.
3. Determine the dealer invoice and use it to calculate the vehicle's total price.
4. Finance the vehicle.
5. Enjoy your purchase and keep it well maintained.

While the process of buying a used car is similar to the process of buying or leasing a new car, there are additional challenges to purchasing a used car that are important to consider, including locating, evaluating, negotiating, and financing the used car.

Leasing has become a popular way for many people to have a car because the up-front costs of leasing are lower than the up-front costs of buying. Additional challenges of leasing include negotiating, calculating the costs, and understanding lease warranties.

Finally, we discussed the importance of having an auto and adult toy strategy to ensure that our most important goals are not relegated to a lesser importance because of poor choices for things that are not as important.

Assignments

Financial Plan Assignment

Transportation Plan. As you think about your transportation needs, it is important to develop your own transportation strategy. Include this as part of your PFP Education, Mission, Home and Transportation Template (LT01-15).

What auto(s) are you currently driving or using? What monthly expenses and fees are you paying, including gas, maintenance, repair and insurance? Are you within your budget?

What is your transportation strategy for now and in the future? Ideas may include:

- How often you will get a new vehicle?
- Will you buy new versus used?
- Will you pay cash or go into debt?
- What negotiation strategies will you use to obtain your vehicles?
- What are your strategies for extended warranties and repair?

- How long you will keep each of your vehicles?

Adult Toy Plan. What is your adult toy vision and goals for now and in the future? While toys can be enjoyable and fun individually and for the family, they can cause havoc on budgets and other more important long-term goals when not purchased properly. How will you ensure that goals are kept in their proper perspective?

What are your plans and strategy for adult toys, i.e., boats, RVs, ATVs, etc.? Do you have these? How will you ensure these do not take over more important areas of your budget such as saving for retirement, missions, and education?

Learning Tools

The following Learning Tool may be helpful:

Lease versus Buy Analysis (LT22)
This spreadsheet closely approximates the costs of buying a vehicle versus leasing a vehicle. It includes most of the lease costs and shows how they are calculated.

Review Materials

Terminology Review

Average Amount Borrowed. This is the average amount borrowed over the life of the loan. In leasing, it is the (Net capitalized cost + residual)/2.
Average Monthly Interest Rates. This is the Annual Percentage Rate (APR) divided by 12.
Capitalized Cost Reduction: Any reductions in capitalized cost, such as rebates, down payment, dealer incentives, trade-in, etc.
Capitalized cost: The cost to which you agree or negotiate when purchasing a vehicle.
Interest or finance costs. This is the average amount borrowed times the monthly interest rate. In calculation form, it is the (Net capitalized cost + residual value) / 2 times your average interest rates which is the APR/12.
Lease Cost: The total cost of a vehicle's lease. It has three parts:

1. *Usage* (also called *depreciation*): The amount of the value of the vehicle that is used over the lease life. (Net capitalized cost – residual value).
2. *Interest* (also called *finance costs*): The average amount borrowed times the monthly interest rate. (Net capitalized cost + residual value) / 2*average interest rates : APR/12.
3. *Taxes* (also called *government costs*): (Usage + Interest)*tax rate.

Lease Term: The number of months the vehicle is leased.
Lease: A contractual arrangement calling for the lessee (user) to pay the lessor (owner) for the use of an asset.
Money Factor: A way of expressing interest rates, calculated by taking the APR and

dividing it by 24.
MSRP: The price the manufacturer hopes to get for the sale of a product.
Net Capitalized Cost (also called **adjusted capitalized cost**): The final amount paid. Found by taking the capitalized cost and subtracting capitalized cost reduction.
Residual Value: Expected value of a vehicle at term end. Often used as purchase price after a lease has ended.
Taxes (also called government costs). It is the tax on the usage and interest in a lease. It is calculated as (Usage + Interest) times your tax rate.
Usage (also called depreciation). This is the amount of the value of the vehicle that is used over the lease life. It is calculated at the Net capitalized cost – residual value.

Case Studies

Case Study #1

Data

Maxine negotiated the price of a car with a dealer and now wants to decide whether she should lease or buy the car.

Manufacturers Suggested Price (MSRP)	$25,000
Negotiated cost/Capitalized cost	22,000
Down Payment	2,000
Lease Term and residual	3 Years, 55%

Fees: Acquisition $500, Registration $150, License $35, Documentation $200, Termination $300

Rent charge and Loan rate (APR)	8.35%
Sales tax	6.25%

Calculations

Help her decide based solely on costs. She will pay cash for the down payment, taxes on down payment, and fees but will finance the remainder (including other taxes). Assume the value at term end is the residual value

Case Study #1 Answers

Solution: Cost of Leasing

Down Payment and fees	$2,000
Taxes on Down Payment (2,000*.0625)	125
Fees (Acq + Reg + Lic + Doc+ Term)	1,185
Total Paid Outside the Lease	$3,310

Total Lease Payments:

1. Usage: [20,000 – 13,750 (55% of MSRP)]	$6,250
2. Interest: (Average outstanding * average rate) [(Net Cap. Cost + Residual) * Money Factor] (20,000 + 13,750) / 2 * .0835/12 * 36 months)	4,227
3. Taxes: (6,250 + 4,227)*.0625	655

Total lease payments of		$11,132
Total Cost of Leasing (DPF+LP)		$14,442
Monthly lease cost: 11,132 / 36 =		$309.22

Solution: Cost of Buying

Down Payment and fees		$2,000
Taxes on down payment		125
Upfront Fees (Reg. + License + Doc.)		385
Total Paid Outside the Loan	$2,510	
Remaining Amount		$20,000
Remaining taxes (20,000)*.0625		1,250
Total Amount to Finance including taxes		$21,250
Total Payments over holding period		
-21,250 PV, 8.35%, 36 N, PMT=669.33*36		24,096
Total Cost of Vehicle (Financed + DP + fees)		$26,606
Market value of car at end of the loan (residual)		(13,750)
Total Cost of Buying DP+UF+TP+T-MV		$12,856
Monthly Purchase Payment		$669.33

Maxine wants to make this decision based only on costs:

They are:

Cost to lease	$14,442.01
Monthly Cost	309.22
Cost to buy	$12,856.03
Monthly Payment	669.33
Cost savings from buying	
$14,442.01 - $12,856.03 =	$1,585.98

Lease versus Buy Analysis (LT22)

Updated 2019-02-26

This tool helps to compare leasing versus buying as a potential method of acquiring a vehicle. The lease interest charge is a close approximation. This example assumes that down payment, taxes on down payment, and fees are paid outside of the monthly lease payments. Below it gives the reason why either lease or buy is cheaper.

tual and Negotiated Costs:			Finance Charges and Residual :		
Manuf. Silly Retail Price (MSRP)	25,000.00		Interest Rate (rent charge)	8.35%	
Capitalized/Negotiated Cost	22,000.00		Sales Tax	6.25%	
Other Taxable Fees/Options	-		Lease Period (months)	36	
Gross Capitalized Cost	22,000.00		Residual Value in %	55.0%	
Cap. Cost Reduction. (Down Paym	2,000.00		Residual Value in $	13,750.00	
Cap. Cost Reduction. (Rebates/Other)			Taxable Fees		
Trade In Allowance			Acquisition/Termination	800.00	
Balance Owed on Trade In (-$)			Document Fee	200.00	
Remaining Amount (Net Cap. Cost)	20,000.00		License & Registration	185.00	

Lease Analysis (DP & Fees paid outside the lease)			uy Analysis (DP, Tax on DP & fees paid outside the loa		
Costs:	**Overall Costs**	**Monthly Payments**	**Costs:**	**Overall Costs**	**Monthly Payments**
Gross Capitalized Cost	$ 22,000.00		Negotiated Cost with Fees/Op	$ 22,000.00	
Cap. Cost Reductions (CCRs)	2,000.00		Cap. Cost Reductions (CC	2,000.00	
Net Capitalized Cost	20,000.00		Net Capitalized Cost	20,000.00	
Taxable Fees/Options	-		Taxable Fees/Options	-	
Tax on Down Payment	125.00		Tax on Down Payment	125.00	
Fees:			**Fees:**		
Acquisition/Termination	800.00		Document Fee	200.00	
Document Fee	200.00		License & Registration	185.00	
License & Registration	185.00		Total Paid Outside Loan:	2,510.00	
Total Paid Outside Lease:	3,310.00		**Total Amount to Finance:**	20,000.00	
Total Amount to Finance (NCC):	20,000.00		Taxes on Net Amount	1,250.00	
Note: Residual Value	13,750.00		Total Amount to Finance	21,250.00	
Lease Payments:			**Loan Payments:**		
Depreciation: (NCC-RV)	6,250.00	173.61	PV = $21,250, I = 8.35%,	24,096.03	$669.33
			N = 36, P/Yr = 12, PMT = ?		
Interest (NCC+RV)*MF*LP	4,227.19	117.42	Note: Loan Interest Paid	2,846.03	1,381.16
Taxes	654.82	18.19	Note: Taxes Paid	1,250.00	(595.18)
Total Lease Costs	11,132.01	309.22	Total Loan Costs	24,096.03	
Fees Paid outside the Lease	3,310.00		Fees Paid outside the Lease	2,510.00	
Total Lease Costs	14,442.01		Total Buy Costs	26,606.03	
			Less Residual Value	(13,750.00)	
Total Payments (inc. Trade in):	$ 14,442.01	309.22	**Total Payments:**	$ 12,856.03	669.33
			Savings of buy over lease:	Buy beats Lease by $1,586	

Case Study #2

Data

Andrea is considering the costs of owning a vehicle valued and sold for $30,000. Auto Loan Amount: $30,000, Duration: 4 years, APR: 8.65%
Property taxes: 2% of the vehicle value per year
Sales Taxes: 3% of the sales price
Title and Tags: $40 per year
Maintenance and Usage Costs: $1,500 per year
Insurance: $2,000 per year

Calculations

Calculate the total first year cost of ownership.

Case Study #2 Answer

$30,000	4 years APR 8.65% will have payments of $741.58 x 12 =
$8,898.91	Payments in year 1
$600	Property Tax
$900	Sales Tax
$40	Title/tags

$1,500	Maintenance/usage
$2,000	Insurance
$13,938.91	for the total cost for the first year

Note: If you include your sales tax in the loan, the payment is $30,000 * (1.03) = PV = $30,900, N = 48, I = 8.65, PMT ? = $763.82 * 12 = $9,165.87

Case Study #3

Please note that this section was originally in the text, but I rarely had enough time to get to this topic. As such, I have included it here in the problem section.

Bill is thinking about getting a used car. What questions you should he ask before he buys a used car? What advice can you give on each of the questions?

Case Study #3 Answers

- Can I afford this car?
- Will this car fit into my monthly budget?
- Is this car a want or a need?
- Does this car meet my current driving needs?
- What type of driving do I do?

Make sure you are shopping for a car that will meet not only your current needs but also your future driving needs. Consider how you will feel about this car a year from now or several years from now. Will your family be growing or shrinking? What extra features do you want your car to have? What about gas mileage? Do you want two doors or four doors? What safety features are important to you?

While the process of shopping for a used car is similar to the process of buying or leasing a new car, this next chapter will address additional aspects of purchasing a used vehicle: locating, evaluating, negotiating, and financing the vehicle.

Locating Used Cars

Good sources of used cars include private owners, new- and used-car dealerships, rental car companies, auctions, and auto brokers.

Private owners: Many used cars are sold by private parties. Often, these cars are the most reasonably priced, but they don't have warranties. Do your research. Ask friends, neighbors, and relatives about used cars they know are for sale. If you buy from people you know, you should be able to find out more about a vehicle's history. Watch for cars with "for sale" signs in the windows. Look at newspapers, classified ads, and bulletin boards. Keep in mind that cars that are closer to your geographical location are generally easier to inspect and evaluate. Use Internet sites, such as www.autotrader.com, www.classifieds2000.com, and www.usedcars.com to help

you. Follow the procedures for buying a new car listed above, including getting a Carfax report on vehicles you are thinking of buying.

New- and used-car dealerships: New-car dealerships may also be a source of used cars. Dealerships often keep trade-in vehicles on their lots if they think they can resell them. Dealerships may be an attractive option for buying a used car because they sometimes offer special deals or warranties that are not available from private sellers.

Rental car companies: Other used-car lots are run by rental companies that are trying to sell vehicles that have just come off leases. Some of the cars sold on these lots may be backed by warranties as well. For newer used cars, part of the manufacturer's warranty may still be in effect.

Auctions and auto brokers: For those who know how to evaluate vehicles, auto auctions are options for purchasing vehicles for a reasonable amount. The risk with auto auctions and auto brokers is that once a vehicle is purchased, there is no warranty or guarantee. The rule of thumb is *caveat emptor*, or "Buyer beware."

You may also want to look into purchasing a used car through auto brokers, who for a fee (usually around $500) will find the make, model, and year of car you are looking for and purchase it at an auto auction.

Evaluating Used Cars

Contacting the seller: Call the seller before you go to see a car. Create a list of questions before calling and then use those questions to decide whether you want to see the car. Ask for the price, because it may have been lowered since the date of the advertisement. Ask about the mileage, the number of previous owners, and how often the oil has been changed. Before you buy, ask to see receipts for oil changes and other major services. If the car doesn't fit your criteria or the seller seems uneasy answering questions, skip the visit and keep looking for other vehicles.

Verifying the vehicle history: Ask for and verify information about previous owners. With a $30 two-month subscription to Carfax (www.carfax.com), you can determine how many previous owners a particular car has had and where each owner was located. To obtain this information, you must input the vehicle's VIN number on the site. Carfax will then give you a detailed vehicle history, including mileage listed on the odometer and a title check, to make sure the vehicle was not stolen. Check out the vehicle history of every potential purchase.

Determining a fair price: Know the blue book price, or recommended price, for the car you are calling about (pay attention to the specific year and the specific options you want). If possible, come to an agreement with the seller on the quality of the vehicle (fair, good, or excellent) before you go see the car. Coming to this agreement will allow you to determine a fair price beforehand.

Examining the vehicle: When you see the car, note your first impressions. Does the car appear

to be well cared for? Although you are probably not a mechanic, you should look for potential problems anyway. The following is a list of some of the things you should look at as you evaluate a used vehicle:

Exterior:

- Look for rust.
- Examine the paint. New paint may be a cover-up for serious damage.
- Look for dents, mismatched paint areas, or poorly fitting parts.
- Check for ripples in door panels. Ripples may indicate previous accidents.
- Check for body filler, which is a plastic used to fix dents. It can be painted over, so use a refrigerator magnet to test suspicious spots.
- Check the underside of the car for evidence of fluid leaks. Coolant is a greenish color, oil is black, transmission fluid is pink, and gasoline is clear and can be identified by its smell.
- Wipe the inner surface of the tail pipe with a rag—white or gray dust is normal. A thick greasy film means the car burns a lot of oil, which can be a serious problem.
- Check the shock absorbers. Bounce the car up and down at each corner of the car. When you release the car, you should not feel the car bounce back more than twice.
- Examine the tire treads. A tread that is unevenly worn may indicate poor alignment or balance. All tires should be the same size, especially on a four-wheel-drive vehicle.
- Check the CV joint boots on the ends of the front axles. CV joint boots are expensive to replace.
- Push the top of one rear tire toward the car. If it moves too much, there may be bearing problems.

Under the Hood:

- Check for mismatched bolts or offset paint. These mismatches may indicate a front-end accident.
- Look at the underside of the hood. A black film on the underside usually means there is an oil leak.
- Check the levels of oil, brake fluid, and transmission fluid. Levels should be adequate, but if it looks like all the fluids have just been changed, this may indicate there is a problem with the car. A low oil level may indicate either a leak or that the owner didn't have the oil changed regularly.
- Take out the transmission dipstick and smell the fluid. Does the fluid smell burned? With a well-maintained transmission, the fluid should not have a burnt smell.

Interior:

- Look inside the car for wear and tear on the seats and pedals. Make sure the amount of wear looks consistent with the mileage on the odometer.
- Start the car: it should start right away. Listen for any unusual noises.

- Verify that all gauges report information accurately.
- Examine the emergency lights. Make sure no emergency lights are on when the engine is running.
- Test all lights—brake lights, headlights, reverse lights, turn signals, and so on.
- Check for play in the steering wheel, clutch, and brakes. Play is the amount a part can move before it engages.
- Hold the brake pedal down as far as possible for 45 seconds. If the pedal doesn't hold firm, there may be a leak in the brake fluid. There should be very little play in the pedal.
- Look for a jack and lug wrench in the trunk. If they aren't there, ask the seller to provide them with the vehicle.

Test drive:

- Test-drive the vehicle personally. Notice how the vehicle feels and fits you.
- Evaluate how quickly the car accelerates from a complete stop. Does the car hesitate, or does it accelerate as it should?
- Listen to the engine while accelerating. Is it smooth or rough?
- Check for hill-climbing power, braking power, cornering, suspension, and seat comfort.
- Check for rattles and squeaks from interior controls.
- Play the radio and CD player.

Qualified mechanic inspection: If you are interested in buying the car, take it to a qualified mechanic for a more complete inspection. Choose a mechanic who regularly works on the type of car you are considering; such a mechanic can generally be found at a dealership that sells that particular make and model. Mechanics that do not specialize in the specific vehicle you wish to buy may be only guessing about potential problems. Dealers may also have the car's history on their computers, which is also helpful.

Have the mechanic do an engine compression check and look for oil leaks and other fluid leaks. For cars with automatic transmission, take the car to a transmission specialist to have the transmission examined.

Negotiating for Used Cars

Once you are comfortable with the idea of buying a vehicle, negotiate a deal. If you plan to pay in cash, let the seller know this. Cash can do wonders for an agreement.

Know the fair value of the car beforehand. Negotiate politely. If you think the price is too high, make a persuasive case to support your argument. For example, you could point out that the vehicle needs some work, that the body or paint doesn't justify the price, or that you have seen lower prices elsewhere. If you want to test the price, you can explain that the car isn't exactly what you're looking for, but at a lower price, you might be interested. You can also let

the seller know that the car is worth the price but that you can only afford a lower price because of budgetary constraints. Make an opening offer that is low but in the ballpark of the seller's asking price—do not be unrealistic. Expect to spend about an hour negotiating. Don't be afraid to walk away if you're not getting anywhere: you don't have to buy the car.

Only enter into negotiations with a salesperson who makes you feel comfortable and who can make a deal. Before you go to see the vehicle, decide how much you can spend and walk out if the seller cannot meet this price. Leave if you get tired or hungry or if you feel pressured. Don't be hurried into a decision. Don't be distracted by pitches for related items. Expect the salesman to try to improve the deal before you reach a final price.

Close the deal at the dealership. At a dealership, the person who deals with financing and insurance will probably try to sell you a number of additional products, including service warranties and other dealer-installed options. Most, if not all, of these products are unnecessary. Review the contract thoroughly before signing. Ask questions about anything that dramatically increases the price. You will be asked to provide proof of insurance before you drive away in your car. Finally, you should inspect the car before you take possession of it. If any work is required or any repairs have been promised by the dealer, get the promise in writing in the form of a due bill—a written acknowledgement that the dealer will provide service at a future date.

Close the deal with a private owner. Before any money changes hands, make sure you will be able to register the car in your name. No registration means no deal. Request the title, sometimes called the pink slip, and have it signed over to you. No title also means no deal.

If the seller has not paid for the car in full, the lender still owns the title to the car. One way to deal with a seller who still owes money on the car is to close the sale at the office of the lender, where the title is held. Once all of the paperwork is complete, relax and begin enjoying your new purchase—a good used car.

Financing Used Cars

If you must finance your used car (I don't recommend doing this), get your financing approved before you look for cars. There are several different lenders who can provide funding for a used-car loan. Banks and credit unions usually offer lower rates than dealerships do, so don't use in-house financing unless you get a special deal or unless the in-house interest rate is very competitive. Also, make sure your credit is approved before you leave the dealership. Banks and credit unions will usually finance a car only if it is less than five years old; however, auto dealerships will finance basically any car.

When looking for a lender, it is important to consider the maximum length of the loan. The good news is that most banks offer 60-month programs for late used car models, or cars that are less than five years old. However, the older the vehicle, the less likely it is to run without problems for the full 60 months. In general, banks offer shorter length loans for older vehicles because older vehicles are not good collateral for loans.

Regardless of which lender you choose, make sure you understand exactly what you are getting into before you sign a loan contract. Once you have signed, you have committed yourself. Once again, you should know your credit score before you attempt to get a loan. If you know whether or not you have a good credit score, a dealer will not be able to insist that you need a higher interest rate because of your poor credit. Knowing your credit score will give you greater freedom to choose a lender that offers a lower interest rate.

Final Thoughts on Used Cars

Even if you follow the pattern explained above when buying a used car, there is still a good chance you will have to make some repairs you did not anticipate. Repairs are one of the risks of buying a used car. However, the more closely you adhere to the process outlined in this chapter, the less likely it is that you will have major problems with your vehicle.

18. Intermediate Investing 1: Principles

Introduction

The previous chapters have been successful if they have helped you put personal financial management into perspective. These chapters have taught you the "why's," "what's", and "how's" of personal finance and the creative process of how to live on a budget, keep track of where your resources are going, manage your cash and cash equivalents wisely, protect yourself from loss by owning insurance, and make big-ticket purchases wisely. Now we begin a discussion on long-term investing.

Please be aware that this class approaches the subject of investments differently than other textbooks approach this subject. Most books take an asset-based approach: in other words, they talk about stocks, bonds, mutual funds, and other assets. These assets will change over time as new assets are developed and sold. I take a principles-based approach to discussing investments because the principles will not change over time.

Objectives

When you have completed this chapter, you should understand the key aspects of investing including:

A. Understand what to do before you invest and the investing factors you control
B. Understand the principles of successful investing
C. Understand asset classes
D. Understand what makes a good mutual fund
E. Understand and select your investment vehicles

Know What to Do Before You Invest

Once you have some basic information, there are some other important questions to ask yourself before you start investing in financial securities. This is important as there are things we should do first before we begin investing for retirement and other goals.

- Are there bills or debts you should pay before beginning your investment program? Are there covenants we have made which help us realize our financial priorities?
- Are there certain products or services you feel you should never do without? Should you have health and life insurance before you begin investing?
- What should you do about your high-interest debts such as credit cards and consumer loans? Does it really make sense to earn 6 percent annually on an investment when you

are paying 24 percent annually for credit cards and other forms of debt?

- How does investing fit in with your personal vision, goals, plans and budget? Do you have a plan for investing? What is that plan?

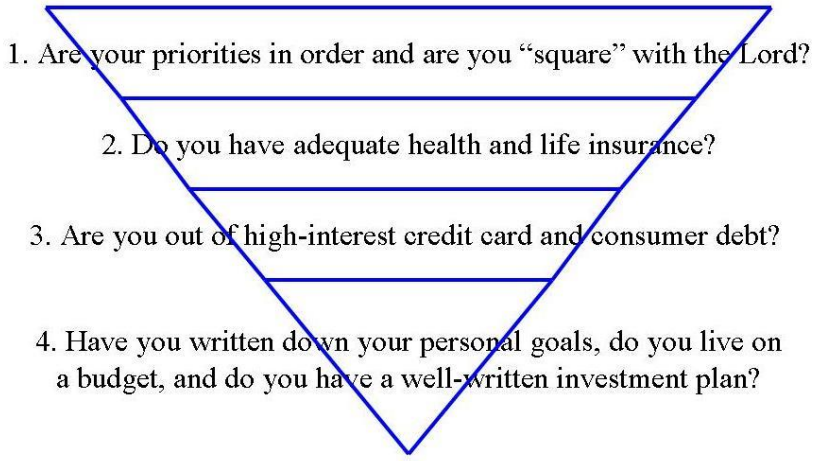
As I have worked with families and students, I have developed a helpful framework for teaching investing. I call this framework "the investment hourglass." This tool helps relate priorities and risks to the goals you want to accomplish.

The investment hourglass is divided into two parts: the top of the hourglass, which represents questions you should consider before you invest, and the bottom of the hourglass, which represents how you should invest.

The hourglass is designed to help you prioritize your goals and objectives. Since investing is a means to an end—and not an end in itself—you should base your investment decisions on your vision, goals and plans. If you can answer each of the questions listed in the top of the hourglass affirmatively (see Picture 2), you are ready to invest. If you cannot answer affirmatively with any of these statements, you have other important things to do before you begin your formal investing in securities markets.

The top of the hourglass teaches about priorities. What are your most important priorities, and how do we make sure we put first things first? First and foremost, your most important priority is being "square" with the Lord, who I believe is your most important creditor. Before you invest, ask yourself if you have paid your tithes or other contributions to your local church or religious organization consistent with your belief in God and desire to obey His commandments.

Picture 2. Top of the Investment Hourglass—Before You Invest



Your second priority is your family. If something were to go wrong with your health, or if you were to die, who would take care of your family? Make sure you have adequate life insurance

and health insurance in place before you begin investing. Disability or death is not a valid excuse to stop providing for the needs of your family.

Your third priority is yourself. Personal responsibility has two parts: the first involves getting out of credit card and consumer debt. When there is no guarantee that you will make a return on your investments in the stock market, it does not make sense to pay 24 percent interest on credit cards. The second part of personal responsibility involves knowing your vision, goals and plans, including living by your budget and Investment Plan. Figuratively speaking, before you drive to a new location, you must understand where you are, where you want to be, and how to get there. Your budget represents where you are, your vision represent where you want to be, and your Investment Plan represents how to get there.

If you can answer "yes" to each of the questions from the top of the investment hourglass, you are ready to invest. This hourglass can help you keep your priorities in order: God first, family second, and personal responsibility third.

Factors Controlling Investment Returns

Reinhold Niebuhr in the Serenity Prayer wrote, "God grant me the serenity to accept the things I cannot change; courage to change the things I can; and wisdom to know the difference"[1] (see Picture 3).

Picture 3. Serenity Prayer

Jim Seaberg reminds us of the six factors that control investment returns.[2] Five of those factors are within your personal control, while only one is outside of your control. The five factors you control are

- How much you save,
- How long your investments grow,
- Your mix of investments, i.e., your asset allocation,
- How much you pay in expenses, and
- How much you pay in taxes.

The only factor you do not control is

- Your investment returns.

If you want to do well on your investing, spend your time and efforts on the things you can control!

Focus on:

- Saving money each week or month by reducing your spending and sticking to your budget.
- Keeping your investments in the market at your acceptable risk level. This will allow your investments to compound over time.
- Understanding your risk level, and then keeping your asset allocation, your stock and bond mix, consistent with that risk level.
- Being wise and keeping fees, expenses, and transactions costs at the lowest possible level.
- Being wise and investing so that you minimize taxes and maximize after-tax returns.

Successful investors spend their time on the areas that are within their personal control while spending a minimal amount of time on areas outside their personal control. In the area of investment returns, we recommend the use passive management/indexing as an investment strategy to minimize risk and give some control over their of investment returns. On the other hand, many novice investors spend their time on areas they cannot control and fail to be concerned with areas they can control.

Once you have a basic understanding of investing and the things you can and cannot control, it is necessary to understand how most investors have done and the principles of successful investing.

Understand and Follow the Principles of Successful Investing

The purpose of principles is to give us guidelines to help us manage and accomplish our personal and family vision and goals. If you understand the "correct principles" that relate to successful investing, you will be able to "govern," or manage, your investment portfolio better. Dallin H. Oaks said:

> We live in a complex society, where even the simplest principle can be exquisitely difficult to apply. I admire investors who are determined not to obtain income or investment profits from transactions that add to the sum total of sin and misery in the

> world. But they will have difficulty finding investments that meet this high standard. Such complexities make it difficult to prescribe firm rules. *We must rely on teaching correct principles*, which each member should personally apply to govern his or her own circumstances.[3]

Once you are ready to invest, you must recognize that there is not just one right way to invest. There are multiple methods of investing, depending on your vision, goals, budget, and Investment Plan. The key to successful investing is to know yourself and what you are trying to accomplish.

How have Most Investors Done?

An important question to ask about investing is "how have most investors done?" By answering this question, it can help us to see if the current methods used by most investors have been successful in helping them attain returns in excess of their benchmarks—what they could accomplish with an indexing strategy.

Table 1. Historical Analysis of Equity Investor's Return (Dalbar 2015-2019)

Year	Investor Period	Investor Returns	Benchmark Returns	Difference
2015	1995–2014	5.2%	9.9%	-4.7%
2016	1996–2015	4.7%	8.2%	-3.5%
2017	1997–2016	4.8%	7.7%	-2.9%
2018	1998–2017	5.3%	7.2%	-1.9%
2019	1999–2018	3.9%	5.6%	-1.7%

Table 2. Historical Analysis of Fixed Income Investor's Return (Dalbar 2015-2019)

Year	Investor Period	Investor* Returns	Benchmark Returns	Difference
2015	1995–2014	0.8%	6.2%	-5.4%
2016	1996–2015	0.5%	5.3%	-4.8%
2017	1997–2016	0.5%	5.0%	-4.5%
2018	1998–2017	0.4%	4.6%	-4.2%
2019	1999–2018	0.2%	4.6%	-4.4%

Table 3. Historical Analysis of Asset Allocation Investor's Return (Dalbar 2015-2018)

Year	Investor Period	Investor Returns*	Benchmark Returns**	Difference
2015	1995–2014	2.5%	8.4%	-5.9%
2016	1996–2015	2.1%	7.0%	-4.9%
2017	1997–2016	2.3%	6.6%	-4.3%
2018	1998–2017	2.6%	6.2%	-3.6%
2019	1999–2018	2.9%	9.7%	-2.3%

* DALBAR 2015– 2019 ** Estimate of 60% equity and 40% fixed income

To understand how most equity investors have done in investing, you must compare their returns to their benchmarks or indexes. A benchmark is a yardstick to see how a group or portfolio of assets

have performed. One of the longest surveys of how investors have done is provided by Dalbar (Dalbar.com). Each year DALBAR puts out an annual survey called *Quantitative Analysis of Investor Behavior* (QAIB), which discusses how the average investor in equities, fixed income and asset allocation funds have done compared to his or her benchmarks over the past 20 years. It covers returns over the past 20 years and it is updated every year.

Interestingly, with all the information available at our fingertips via the internet and with our abilities to buy and sell stocks instantaneously, most investors have not had very high returns in comparison to their benchmarks (see Table 1). Realize that the negative sign is the shortfall per year, not the shortfall over the 20 year period, and it is significant.

Have bond investors done any better in comparison to their bond benchmarks? Sadly, the returns were even less and the difference between the average bond investor's return and the bond benchmarks was even greater (see Table 2).

What about those who participate in an asset allocation strategy (actively moving between equity markets and bond markets based on which seems most attractive)—how have they done? Again, the results are not encouraging (see Table 3).

As the saying goes, "If you do what everyone else does, you will get what everyone else gets."[4] Based on the DALBAR studies, it seems that whatever people are doing regarding investing is not working very well for equity or fixed income investors compared to benchmarks. Perhaps there are better ways to invest than what others have done in the past or are doing now.

How have most actively managed mutual funds performed compared to their benchmarks? If they have performed better, we could conclude that the active managers are adding value over and above the return that an investor could receive by investing in a low-cost, tax-efficient index fund or ETF.

In general, most actively managed mutual funds have not beaten their benchmarks over the long term (see Chart 1). While in some years actively managed funds outperform their index fund counterparts, the support for actively managed funds for longer periods of time is low.

Another paper that examined mutual fund performance on both a total return and after-tax basis reported:

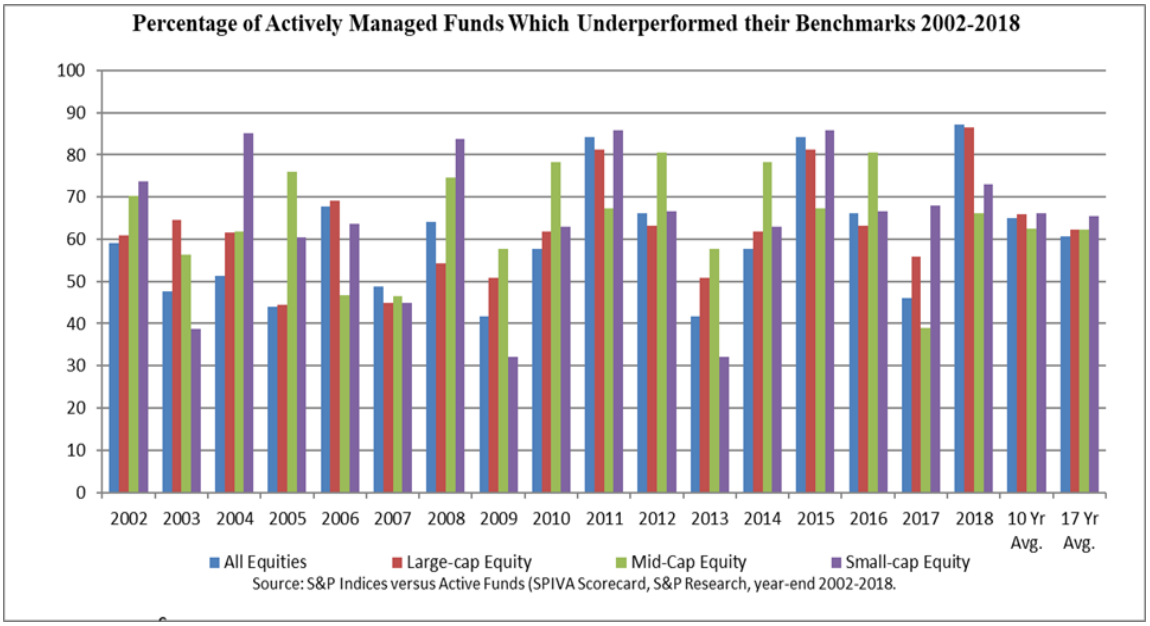
> In general, we find that index funds outperform actively managed funds for most equity and all bond fund categories on both a total return and after-tax total return basis, with the exception of actively managed small company equity and international funds. These results should be viewed with caution, however, as there is evidence that actively managed funds outperform the index funds during periods when the economy is either going into or out of a recession.[5]

Recent experience is not much different. In the last 10 years, the percentage of actively managed funds that failed to beat their benchmarks was in excess of 60-65%, depending on asset class (see

Chart 2).

Whatever you decide to invest in, and whatever phase of investment you are in, it is critical that you adhere to correct principles. Following are the principles that I believe, if followed, will help you to minimize that difference between investor returns and benchmarks and will likely help you to have a successful portfolio.

Chart 1. Percentage of Actively Managed Funds That Failed to Beat Their Benchmarks[6]



1. Know Yourself, your vision, goals and plans. Investing is not an end in itself; rather, it is a means of reaching your vision and your personal and family goals. Consequently, you need to know yourself as an investor. You should have well-written and well-thought-out vision, goals and plans. Goals are critical because they help you determine what you want to accomplish with your investment program. For help on writing your goals, see Chapter 2. Creating Your Personal Financial Plan and Setting Personal Goals.

You also need to know your budget. A critical part of successful investing is having a well-planned budget; a percentage of your income should be earmarked for savings and investment. You cannot invest without funds, and you should not invest with borrowed money. For help on budgeting, see the chapter on budgeting.

You also need to understand your ability to tolerate risk. You want to develop a "sleep-well portfolio"—a portfolio that is planned so that even when investments go wrong, as they often do, you can still sleep well at night.

Beware of overconfidence in your portfolio. One sign of overconfidence is frequent trading. A study found that men trade 45 percent more often than women trade and that men's annual returns were, on average, 2.7 percent lower than women's annual returns. The study also found that single men trade 60 percent more often than single women trade and that single men's annual returns were 1.4 percent lower than single women's annual returns.

You must be especially wary of overconfidence when trading online. The same study showed that the same group of investors beat the market by 1.9 percent before online trading. However, when the same group of investors switched to online trading, the group underperformed by 3.6 percent. [7] While online trading may appear to give you more control, it can result in lower overall returns if it leads to greater overconfidence and more frequent trading.

3. **2. Seek, receive and act on the Spirit's guidance**. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received. Carlos E. Asay said,

> When the Spirit is with us, we can think thoughts we've never thought before, we can say words we've never said before, we can perform beyond our natural abilities. That power is related to truth, to the scriptures, to the stirring of the Spirit within. And the power won't come unless we're actively courting the influence of the Holy Ghost.[8]

3. Understand the key areas of investing and especially risk. Risk is inherent in all investment activities. Some risks include inflation, business, interest-rate, financial, market, political and regulatory, exchange-rate, call, and liquidity risks. The key to managing risk is to understand the different types and to invest at a risk level that is comfortable for you. Often, taking a risk tolerance test will help you discover the level of risk that is right for you. One such test is included in the Learning Tools section of the website A Risk-Tolerance Test (LT16).

4. Stay Diversified. Diversification is your best defense against risk. Diversification does not mean simply investing in 10 different banks; rather, to be properly diversified, you should invest in different companies, industries, and perhaps even countries that won't be subject to the same economic factors or risks. Make sure you understand the risks of each of your investments.

Many people review the portfolio returns from various asset classes over the last 10, 20, or 50 years to get an idea of an asset class's performance history. However, these people often invest in only one or two single assets instead of in a portfolio of 500 or more stocks and are often disappointed when they do not get the returns they expected. Remember, the returns from asset classes are from portfolios of hundreds of assets—not

from individual assets. To see the effects of diversification, see Historical Return Simulation for Asset Classes (LT23).

5. Make Low-Cost and Tax-Efficient Investments. Watch your investment costs carefully, including costs for transaction fees, management fees, and taxes. Remember that when investing, a dollar saved is worth more than a dollar earned.—you have to pay taxes on every new dollar you earn, but every dollar you save is already taxed and can earn interest on income. Be aware that frequent trading incurs significant transaction and tax costs; avoiding this will help you keep your costs low.

Defer or eliminate taxes as much as possible. Mutual funds are required by law to distribute 90 percent of all capital gains, dividends, and interest to their shareholders each year. That means you must pay taxes on the distributions from your mutual funds each tax season, even though you may not have sold a single share. Mutual funds are pass-through accounts for tax purposes, which means that the tax consequences of the mutual fund are paid by the investor, not the mutual fund. The portfolio manager's decisions can have a significant impact on your tax bill.

Make tax-efficient investments to avoid paying more taxes than necessary. Remember, it is not the amount of money you make but the amount of money you keep after taxes and inflation that makes you wealthy.

6. Invest for the Long Run. Invest for the long run; this is how you will achieve your goals. There are no "get-rich-quick" schemes that work.

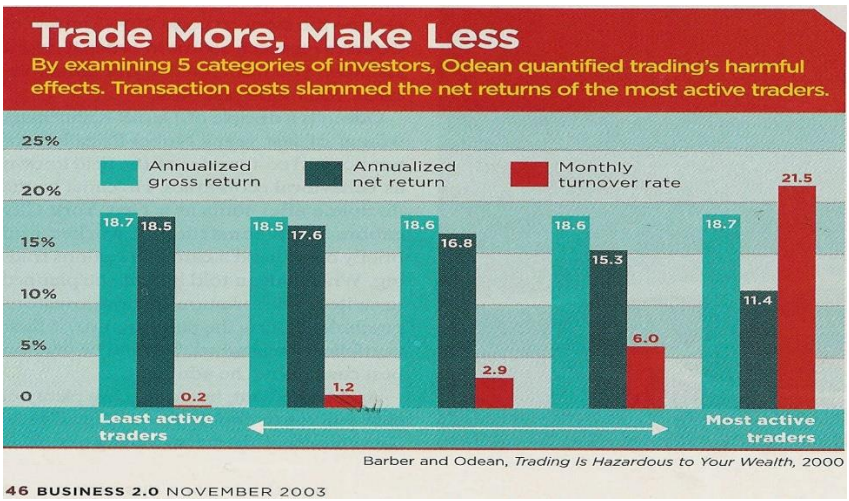
Avoid short-term trading. Short-term trading is expensive and incurs transaction costs and taxes. Be sure to keep at least part of your funds in the market for the long run—taking money out of the market may not only slow your progress but could stop it altogether. A recent study found that those who traded more often, using the turnover ratio as a proxy for trading, had lower returns than those who traded less often and used a buy-and-hold strategy (see Chart 2).[7]

7. Use Caution If You Are Investing in Individual Assets (which I do not recommend). If you want to invest in individual assets (which is not necessary for a successful portfolio), do your homework and know what you are investing in and who you are investing with. Learn about the company, its financial statements, its management, its short- and long-term strategies, its domestic and global industry, and its competition. It takes many hours of diligent, careful research to investigate a company thoroughly. Do not take others' word for it: do the research yourself. Of course, finding a great company is not enough—the stock must also be priced right. A great company whose stock is overpriced can still be a lousy investment.

If you do not have time to research individual companies, invest in mutual or index funds that contain many individual assets. If your mutual fund has 10 stocks, you need to know

those 10 stocks well. However, if your mutual fund has 500 or more stocks, you do not need to know those 500 stocks as well because each stock has such a small impact on your total portfolio.

Chart 2. Trade More, Make Less



If you want to try to beat the market, try for a short period of time and compare your returns after taxes to your benchmarks. Do not waste too much time and energy trying to beat the market because you will be able to match the market return with little or no effort through no-load, low-fee index mutual funds or exchange traded funds (ETFs).

If you feel you must trade actively, try to trade efficiently in terms of taxes. Trade in tax-deferred or tax-eliminated retirement accounts such as a 401(k), Roth IRA, or traditional IRA accounts so your taxes are eliminated or deferred until you take the money out at retirement.

8. Monitor Portfolio Performance against Benchmarks. Thomas S. Monson stated, "Where performance is measured, performance improves. Where performance is measured and reported, the rate of improvement accelerates."[9]

How can you know how your investments are doing if you do not monitor their performance? To understand the performance of your investments, you will need to learn how to use benchmarks. Benchmarks are passively managed portfolios of financial assets that indicate how well your financial assets are performing. Set your own portfolio benchmarks and then monitor your portfolio performance on a monthly, quarterly, and annual basis.

If you choose to invest in actively managed mutual funds, compare the assets' after tax performance against the benchmarks you have set. If the return on these assets is consistently lower than the benchmarks, consider investing in no-load (no sales charge),

low-fee index funds, which are discussed later in this course. The returns on index funds are generally more consistent in matching the performance of selected benchmarks than actively managed funds.

9. Do Not Waste Too Much Time and Energy Trying to Beat the Market. It is difficult, expensive, and time-consuming to try to beat the market, or gain returns in excess of the returns on the major asset classes. While it may be possible on a short-term basis, it is difficult to consistently beat the market on a long-term basis. You are competing against hundreds of thousands of professional money managers with much more time, money, and access to information than you have.

10. Invest Only with High-Quality, Licensed, Reputable People and Institutions. When you need help, do not be afraid to ask for it. However, be sure to get help from good people whose actions and beliefs are consistent with the principles discussed in this chapter. Good help from qualified, licensed, and experienced financial planners, financial advisors, and brokers may help you with your Investment Plan.

Make sure you invest with mutual fund companies that have a tradition of meeting the needs of their investors. Work with good companies that offer good products. Be careful with your money and invest it wisely.

Use the best resources available to help you invest, but be aware of how much you pay to use those resources. In addition, make sure your advisors are licensed to counsel you on the broad range of investment assets you are (or should be) considering. Work only with licensed and registered advisors. In some circumstances, fee-only financial planners or advisors may be a better choice than financial planners or advisors that are paid on commission.

11. Develop a Good Investment Plan and Follow It Closely. Develop a good Investment Plan that is consistent with your goals, your budget, and the principles discussed in this chapter. Follow this plan closely. An Investment Plan is a detailed road map of your investment risk and return, constraints, investment strategy, and reporting and evaluation methodology. For an example of an Investment Plan, see Investment Plan Example Template (LT05A).

Your Investment Plan should outline the amount of return you are seeking and the risk level you are comfortable with for investments. This plan documents constraints—such as taxes, liquidity, and time horizon—that affect your portfolio. It details which asset classes you will or will not invest in and includes your view on active versus passive management. It lays out your plan for the percentage of gross income you will invest each month, the amount you will invest in each of your chosen asset classes, the maximum percentage of your assets that you will invest in any single new investment, and the ways your strategy will change as you get older. Finally, your Investment Plan

details how often you will rebalance your portfolio and how often you will report the portfolio performance to others.

Think of your Investment Plan as a road map to successful investing. Your plan should be consistent with the principles discussed in this course.

Finding Balance

As you work on understanding and developing your how you will investment, finding balance among doctrines, principles and application is important in helping you become better investors. We have shared some ideas for principles, although you can find others. Below are a few ideas for doctrines on which the principles are based. As you strive to increase your ability and effectiveness in investing wisely, I recommend you study and ponder the doctrines and principles supporting this application.

Principles	Doctrines
Know yourself, your goals, vision and budget	Identity
Seek, receive and act on the Spirit's guidance	Obedience
Understand risk – there is lots of it	Stewardship
Stay diversified	Accountability
Invest low-cost and tax efficiently	Stewardship
Invest long-term	Stewardship
Know what you invest in	Accountability
Monitor performance versus benchmarks	Accountability
Don't waste time trying to beat the market	Stewardship
Invest with good people and firms	Stewardship
Develop a good Investment Plan (IPS) and follow it	Stewardship

From Obedience to Consecration

From the principles and doctrines, we can see that we are not just working on being wise with our liquid assets, which is an application. From a higher perspective, or increased vision,

> We are children of the Creator (identity), striving to live worthy of the Spirit (obedience), learning to understand ourselves and our risk tolerance (agency), and learning to understand financial markets and instruments (accountability). We are developing our investing talents carefully (stewardship), so we can invest our resources carefully and wisely (agency), to accomplish our personal missions and our individual and family vision and goals.

If you plan wisely and invest accordingly, you will save yourself from heartache and problems in the future, and you will likely achieve your personal and family goals.

Understand Asset Classes

We have already shared that asset classes are broad categories of investments with specific (and similar) risk and return characteristics. Asset classes are distinguished by characteristics specific to particular groups of securities, such as type of financial instrument, market capitalization, maturity, geographic location, etc. The major asset classes are cash and cash equivalents, fixed income, and equities.

Always be diversified in your investing—don't put all your financial assets or "eggs" in one basket. What this means is to invest in many different asset classes in your portfolio such as equities: large cap, small cap, international, emerging markets, etc.; bonds: taxable, tax-free; short-, med-, and long-term corporates; short- and long-term governments, etc.; and cash: money market, CDs, savings, MMMFs, etc.

Investing entails risk, which means different things to different investors. Risk could mean the possibility of losing all your money. It could also mean the possibility of losing principal. Risk could also entail the possibility of not achieving a specific holding-period return.

Risk is measured in many different ways. In the past, the main risk of investing was considered "default risk," or the risk that a company would not be able to pay back an investment due to default or bankruptcy. Government securities were considered risk-free investments because investors knew the government could always print money.

In more recent years, analysts began to use variance, or standard deviation, to better measure risk; using this measurement, they found that even government securities are risky. This measure of risk is not concerned with the possibility of default but with the volatility of the investments—the risk that the investment's return may be lower than expected. Currently, investors also use a metric known as "beta," which measures the way a specific stock moves in relation to a specific market or benchmark.

Generally, most investors prefer to use variance or beta to measure risk. Both are measures of how volatile a stock is—how much it moves both up and down. In the case of beta, risk is also measured by how much the stock moves in comparison to a specific benchmark. A lower variance indicates that the price does not move very much. A higher variance indicates that the price moves a lot in comparison to the benchmark. A beta higher than one indicates that the stock is more volatile than the market; a beta less than one indicates that the stock is less volatile than the market; a beta of exactly one indicates that a stock moves with the market. When you look at a stock's returns, you should always look at the variance of the stock as well. Generally, higher returns carry higher risks because investors must be compensated for taking on additional risk.

There are a few important concepts you should understand related to risk:

- *Investment risk* is the probability of not achieving some specific return objective.
- The *risk-free rate* is the rate of return that will definitely be obtained through an investment in a short-term government security.
- The *risk premium* is the difference between the expected return and the risk-free rate.

- *Risk aversion* is the reluctance of an investor to accept risk.

The Importance of Asset Classes

Understanding asset classes is critical if you are to invest. You should invest at a level of risk that you are comfortable with and that will help you to achieve your personal and financial goals. The way you manage risk is by managing the amount of your portfolio in the respective asset classes (or baskets of investments).

Asset classes are broad categories of investments with specific and similar risk and return characteristics. They are distinguished by characteristics specific to particular groups of securities, such as type of financial instrument, market capitalization, maturity, geographic location, etc. The major asset classes are cash and cash equivalents, fixed income, and equities. We will discuss each asset class simply to help you understand the benefits and risks of the specific asset class.

Cash and Cash Equivalents. The major goal of this asset class is liquidity and to preserve capital. This asset class includes Certificates of Deposits (CDs), money market funds, T-bills, and commercial paper, etc. For an individual investor, it would also include your savings, checking account, money market deposit accounts. It offers a fixed rate of return.

Cash includes money market funds which seek to preserve the value of your investment and still offer a somewhat competitive return. Short-term interest-bearing investments include Treasury bills and Savings Bonds, loans to the U.S. Government, and commercial paper, loans to corporations.

The advantages of cash and cash equivalents is liquidity and stability of principal. You can turn these securities into cash quickly and easily. They are generally low risk. There is little risk of losing principal since the borrowers have good credit and loans are for short periods of time. These are good investment assets for money you plan to use in less than 3-5 years and don't want to take risks with losing principle.

The disadvantages is that they are less attractive as medium-to-long-term investments (> 5 years) as returns on cash and cash equivalents are unlikely to keep up with taxes and inflation. Cash assets are generally fully taxable—make sure you take taxes into consideration.

Fixed Income (or Bonds). The major goal of fixed income is to provide income and to hopefully earn returns in excess of inflation. There are many different types of fixed income assets including taxable bonds include U.S. Treasuries, corporate bonds and agency issues (bonds issued by U.S. government agencies, like Ginnie Mae); tax-free bonds include revenue or general obligation bonds issued by local or state governments and agencies. Such bonds are generally free from federal and state taxes on income.

Short-term bonds (or short term bond mutual funds) include bonds that mature in less than five

years. Short-term bonds are less vulnerable to interest rate risk than long-term bonds as there is a shorter time period before the bonds mature. Short-term bonds are generally considered good investments for anyone needing a dependable stream of income (dividends) in an environment where interest rates are not likely to rise.

Intermediate-term bonds/bond funds are bonds with a maturity of 3–10 years. Because of their longer maturity, they are more susceptible to interest rate risk, the risk that interest rates rise during the period you own the bonds.

Long-term bonds (or junk bonds or bond mutual funds) are bonds with a maturity of 10 or more years. These bonds generally have the highest yields, but are the most vulnerable to interest rate volatility.

Inflation protected securities are securities whose yield is linked to the rate of inflation as measured by a specific inflation index. These bonds have the benefit that when interest rates rise, the yield on the bond rises as well.

The U.S. Government also sells savings bonds to investors whose earnings fall within specific income limits. I Bonds (or inflation linked bonds) have their interest rate linked to inflation that changes every six months. EE Bonds pay a fixed interest rate over a specific period of time.

Bond mutual funds are different from buying individual bonds. Mutual funds buy and sell bonds before they mature. Investing in a bond mutual fund means you are buying a share in thousands of different bonds in a changing portfolio, and so you are more diversified than in buying an individual bond. The income from a fixed-income mutual fund fluctuates as mutual funds buy and sell bonds. The market value of the mutual fund changes depending on whether the fund is selling bonds at a loss or gain. The longer the maturity of the bonds (see the average maturity) the more dramatically your principal will gain or lose value as interest rates change.

The advantages of fixed income investments is that they offer greater potential return than cash, but at greater risk. They are a good diversification tool when holding a diversified portfolio of assets, as bonds generally move differently than stocks.

The disadvantages are that returns have been historically lower than stocks. They are very susceptible to interest rate and other risks. Generally, fixed income assets alone are not good long-term investments because they don’t provide enough growth to beat inflation over long periods of time. They should be part of an overall diversified portfolio.

Equities (or Stocks). The major goal of this asset class is to provide growth and earn returns in excess of inflation. Over long periods of time, the stock market historically has been the only major asset class to consistently outpace inflation.

An equity share is ownership in a businesses’ earnings and assets. You get a proportionate share of the profits by receiving dividends, and also benefit from increases in the company’s share

price as well. Mature companies are a likelier source of dividends (rapidly growing companies often prefer to reinvest profits).

Equity asset classes are generally delineated by market capitalization (which is shares outstanding multiplied by the stock's current market price), type of company (growth versus value), or geographic area. The benchmarks for each asset class tend to change over time, but equity asset classes can be generally defined as follows:

Market capitalization is one measure of the size of a company. It is calculated by multiplying the market price of the stock by the number of shares (i.e. ownership pieces) outstanding. The greater the capitalization, the larger the company. It is used to weight companies in various benchmarks by the size of the company, i.e. large-capitalization (or large cap), mid-capitalization (or mid-cap), or small-capitalization (or small-cap) firms.

Large caps are stocks with a market capitalization greater than $10 billion in the US, and smaller capitalizations for international companies. These are the generally the largest, most well established companies in the US, with a history of sales and earnings as well as notable market share which has allowed them to grow and expand. Traditionally, large cap was synonymous with "dividend-paying company," but this is no longer a standard for classification. These are generally mature corporations with a long track record of steady growth and dividends.

Mid-cap or mid-capitalization stocks are stocks with market capitalization between roughly $2 billion and $10 billion. These stocks tend to grow faster than big cap companies, and are generally less volatile than small cap companies. Mid-caps generally perform somewhere between small-cap and the large-cap asset classes. For asset-allocation purposes, mid-caps are generally not considered a major asset class.

Small-cap or small capitalization stocks are companies with a market capitalization less than $2 billion. These are smaller, sometimes newer, US and global companies that are still developing and may have a smaller market share than their large-cap counterparts. Small-cap stocks are subject to greater volatility and may fail more frequently than companies in other asset categories, but are generally expected to grow faster than bigger companies.

Within the equity stock categories are three separate types of stocks: growth, value and blend.

Growth stocks are companies whose earnings are expected to grow very rapidly. Frequently these are companies developing new technologies or new ways of doing things.

Value stocks are companies which are inexpensive in terms of the market (in terms of low PE and low P/BV ratios). These are companies that have potential for good long-term return through both appreciation and dividends.

Blend stocks are stocks that include part of both value and growth components.

International/Global/Emerging Market stocks are stocks of companies based entirely outside the U.S. or throughout the world. These can be of any size (small-cap, large-cap), any type (value, growth) and from any part of the world. Funds that contain a mixture of U.S. and foreign holdings are called global funds.

International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets.

Stock mutual funds are funds that own stock in specific groups or types of companies. When you but a mutual fund, you are buying a share in multiple companies which change over time depending on the fund manager's decisions. You are responsible for paying taxes on all distributions by the mutual fund, which are taxed at your level—not at the mutual fund level.

Mutual funds are delineated by investment objective, which can be any of the equity asset classes discussed above.

The advantages of equities is that when purchased as part of a diversified portfolio they offer highest return of the major asset classes. Growth and value stocks tend to perform in alternating cycles—it makes sense to own both types. A portfolio of diversified stocks have generally been a good investment for long-term investing—they have consistently beat inflation over the long-term.

The disadvantages of equities are they offer less stability of principal than other asset classes, and subject to short-term price fluctuations. Equities are risky for short-term investments. If you're investing for less than 3-5 years, only a small portion (if any) of your investments should be in stocks due to their volatility.

Understand Asset Class Risk and Return History

It is important to understand how the various asset classes have performed historically. Remember that an asset class is a group of financial assets with similar risk and return characteristics. From a historical analysis, we can learn much about a particular asset class (see Chart 3).

I believe it is important to study history, including the history of investments and investment returns. Some have questioned the importance of learning an asset class's performance history because they reason that the future will not be like the past. Gordon B. Hinckley stated the following regarding this notion, "All of us need to be reminded of the past. It is from history that we gain knowledge which can save us from repeating mistakes and on which we can build for the future." [10]

What have been the characteristics of risk and return historically? Chart 4 and Table 4 show that from 1926 to 2018 (90 years), large-capitalization stocks (as represented by the S&P 500) have

yielded a return of about 9.0 percent per year and have a standard deviation of 19 percent. Small-capitalization stocks have yielded a return of about 11.0 percent per year and have a standard deviation of 29 percent. *T-bonds* have yielded a return of 5 percent per year and have a standard deviation of 9 percent. *T-bills* have yielded a return of about 3 percent per year and have a standard deviation of about 1.0 percent, while inflation has increased 3 percent with a standard deviation of 2%. Note that while different asset classes have different risk and return relationships, there is generally a positive relationship between risk and return (see Chart 3). Moreover, these numbers will change every year.

Chart 3. Asset Class Returns

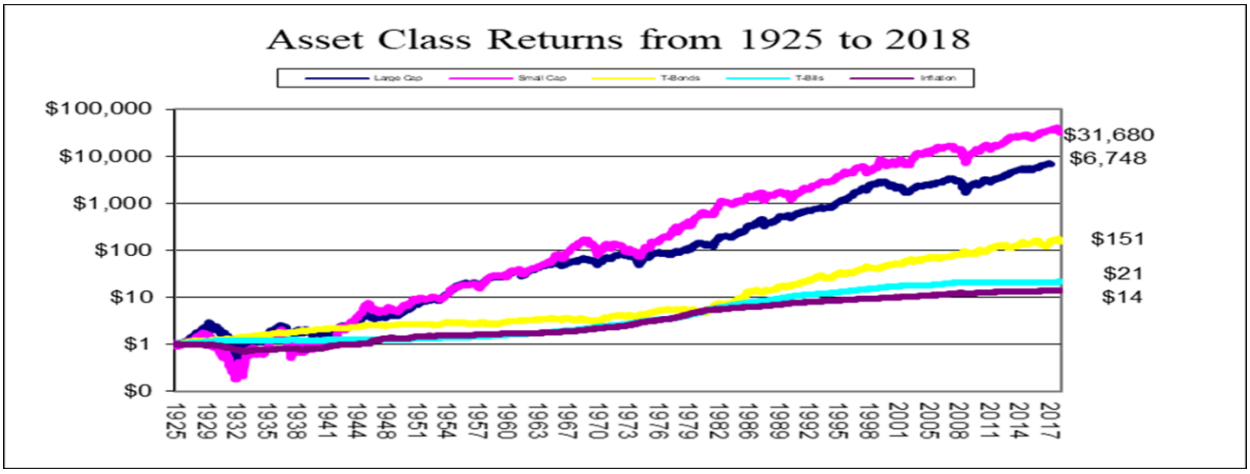


Chart 4. Annual Risk versus Return

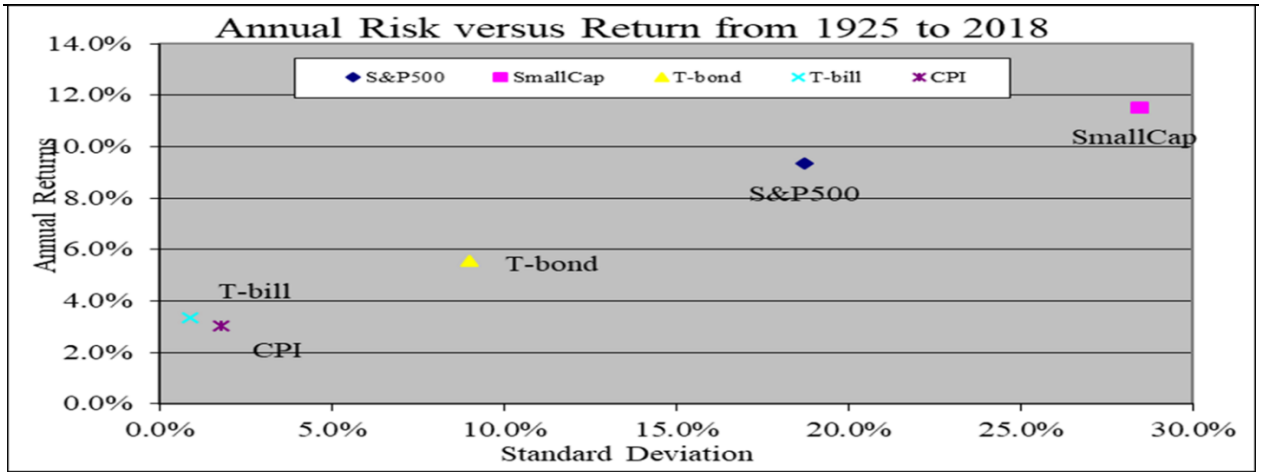


Chart 5, which shows the S&P 500 annual return since 1926, shows that the annual return appears to be very volatile—there are many years of high returns and many years of negative returns. However, looking at the return in terms of 5-year periods instead of 1-year periods shows that there are only a few major periods of time which had a negative return. If you follow

the return trend over a 10-year period, you will likewise see that there have been very few times when the 10-year return was not positive (see Chart 7).

We will now look at risk, or standard deviation. Table 4 shows the *geometric return* and the standard deviation for each of the major asset classes. As you look at the large-cap (the Standard and Poor's 500 Index) return and risk, note that over 5, 10, 25, 50, 75, and 90 years, the return was volatile, yet over longer periods has been around 7 to 10 percent. The standard deviation has ranged from approximately 15 percent to 20 percent.

Chart 5. S&P 500 Annual Returns

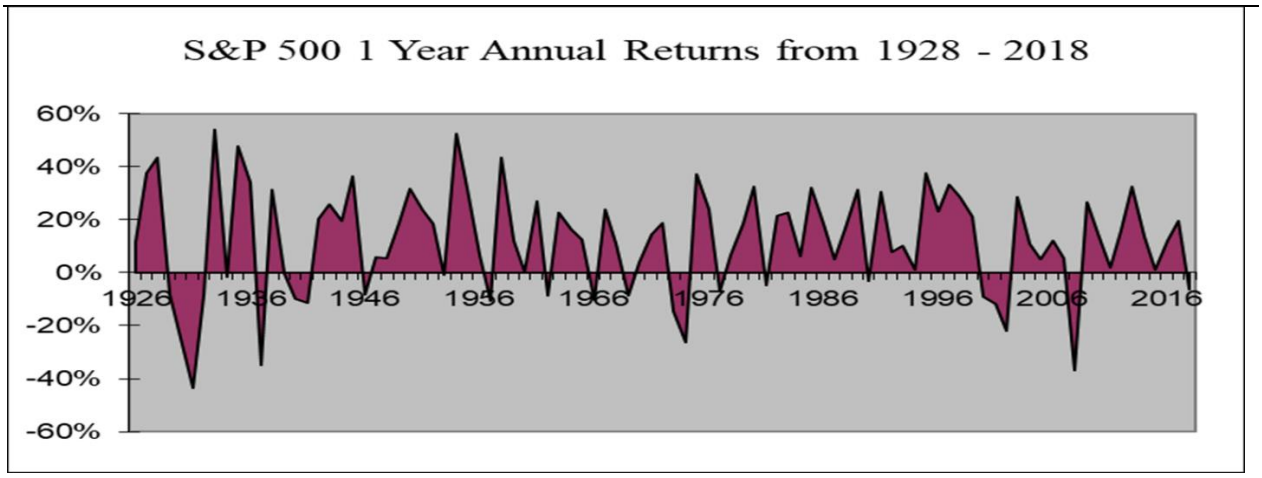
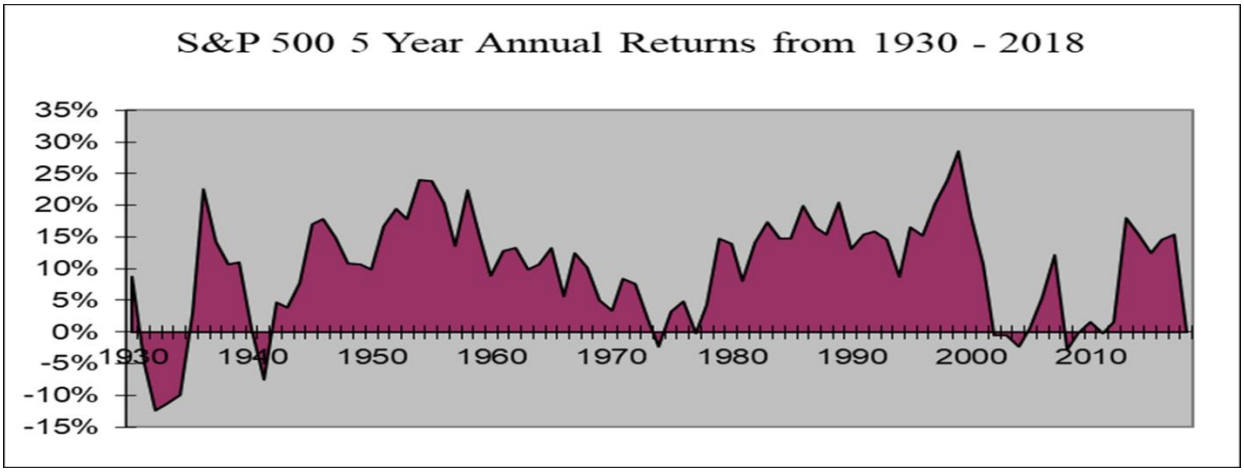


Chart 6. Five-Year Annual Returns

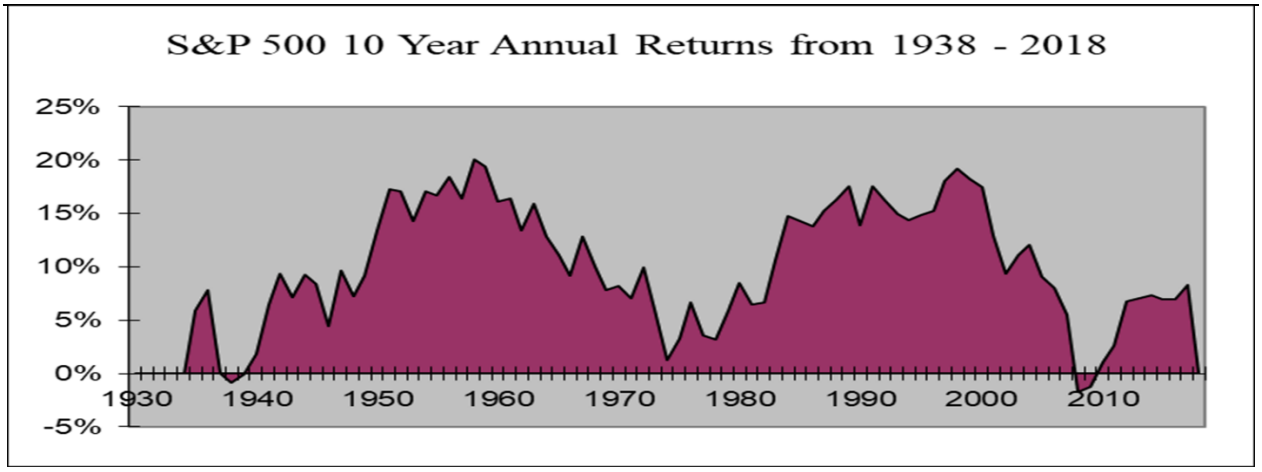
If you look at small-cap returns over the same periods of time, you will see that same volatility, particularly in recent years. Though over longer periods the return has been between 10 to 14 percent, notice that the risk levels of small-cap returns (the standard deviation) are between 20 percent and 30 percent.



If you look at fixed-income investments (T-bonds), you will see that they have, on average over longer periods, yielded a return ranging from 5 percent to 9 percent; the variance for T-bonds during this time period was between 8 percent and 12 percent.

If you look at T-bills on the chart, you will see that they have yielded a range of approximately 0.1 to 5 percent interest over the various periods of time; T-bills have had a standard deviation of between 0.1 and 0.9 percent.

Chart 7. 10-Year Annual Returns



Inflation (as measured by the CPI) has been between 1.5 and 4.1 percent with a standard deviation of between 0.5 and 1.9 percent.

Table 4. Geometric Return and Risk over Specific Time Periods

Total Returns For the Periods Ending December 31, 2018

	1 Year	5 Years	10 Years	25 Years	50 Years	75 Years	90 Years
S&P500							
Compound Return	-6.2%	7.6%	12.7%	8.9%	9.7%	11.2%	9.3%
Standard Deviation	14.7%	10.9%	13.6%	14.4%	15.0%	14.2%	18.7%
SmallCap							
Compound Return	-12.2%	3.5%	12.7%	10.3%	11.0%	13.6%	11.5%
Standard Deviation	18.5%	15.2%	18.9%	20.1%	21.2%	19.9%	28.5%
T-bond							
Compound Return	11.6%	6.2%	4.3%	7.0%	8.0%	5.8%	5.5%
Standard Deviation	21.7%	15.2%	14.1%	11.6%	11.3%	9.6%	9.0%
T-bill							
Compound Return	1.9%	0.6%	0.3%	2.4%	4.7%	3.9%	3.3%
Standard Deviation	0.1%	0.2%	0.2%	0.6%	1.0%	0.9%	0.9%
EAFE (International)							
Compound Return	25.6%	8.4%	2.4%	6.9%			
Standard Deviation	4.3%	11.7%	18.5%	16.0%			
Emerging Markets							
Compound Return	37.8%	4.7%	2.0%	8.0%			
Standard Deviation	6.7%	12.3%	22.7%	22.4%			
REITs							
Compound Return	5.1%	9.3%	7.4%				
Standard Deviation	6.8%	15.0%	39.1%				
CPI							
Compound Return	2.1%	1.5%	1.8%	2.2%	4.0%	3.6%	3.0%
Standard Deviation	0.0%	0.8%	1.0%	1.1%	1.3%	1.5%	1.8%

Inflation (as measured by the CPI) has been between 1.5 and 4.1 percent with a standard deviation of between 0.5 and 1.9 percent.

In order to invest successfully, you must understand the risks and benefits of each of the major asset classes. This chapter has attempted to share some risk and return history over the past 85 years.

Source: Ibbotson Associates for large cap, small cap, T bond, T bill and Inflation up to 2014 with Bloomberg for 2015 and beyond, and Morgan Stanley Capital International for the remainder, 2015 and beyond.

Understand What Makes a Good Mutual Fund

You already determined the asset classes your portfolio should contain and the appropriate benchmarks for these asset classes in previous chapters**.** Therefore, you have already completed steps one and two. This chapter will discuss steps three and four; you will learn how to determine key parameters for evaluating mutual funds of specific asset classes, and you will learn how to use a database program to set those parameters and evaluate potential candidates.

There are a number of important criteria you should consider when selecting mutual funds. Seven of the key criteria include diversification, low cost, tax-efficiency, low turnover, low levels of un-invested cash, no manager style drift, and small (or positive) tracking error.

1. Wide Diversification

Diversification is your most important defense against market risk. Select mutual funds that include many different companies in each portfolio category. Avoid investing in sector funds or industry funds, individual stocks, or concentrated portfolios of any kind until you have sufficient education, experience, and assets. Even then, keep the percentage of these assets low in relation to the amount of your overall assets.

2. Low Cost

Investment returns are limited, and investment costs of all kinds reduce your returns. If you have two funds with the same return, the fund with the lower expense ratio will give you the higher actual return. Keep costs low!

I recommend you invest in low-cost, no-load (i.e., without a sales charge) mutual funds. You should rarely (if ever) pay sales charges of any kind. Because you are a long-term investor, it may be acceptable to invest in funds with back-end loads or funds with a sales charge for selling within a specific period of time, as long as that period of time is under 180 days. You should also minimize management fees as much as possible. Remember, a dollar saved is a dollar you can invest to earn more money.

3. Tax Efficiency

If you are investing in a non-retirement investment vehicle, taxes are another important expense you should analyze. Look at the tax cost ratio in the section entitled "Returns: Tax Analysis." Too many investors fail to account for the impact taxes will have on their returns: taxes typically reduce returns by about 25 percent each year.

When investing in taxable funds, choose funds with an eye to obtaining high returns while keeping taxes low. Taxes reduce the amount of money you can use for personal and family goals. Watch the historical impact of taxes for the fund because it is likely to be similar in the future. Remember, it is not what you earn, but what you keep after taxes that makes you wealthy.

4. Low Turnover

Look for funds with low turnover. Turnover is a measure of the amount of trading activity that takes place during a given period of time; turnover is shown as a percentage of the average amount of total assets in the fund. Calculate turnover by adding the fund's sales and purchases and dividing by two. High turnover, or excessive trading, increases the amount of taxes and transaction costs you will have to pay. Many costs associated with turnover are hard to quantify and are therefore not disclosed in the prospectus. Other costs that stem from high turnover include commissions, bid-ask spreads (the difference between what buyers are willing to pay and what sellers are asking for in terms of price), and market impact costs (a jump in price that occurs when a manager tries to buy a large block of shares). Remember that each transaction generates a taxable event, and the cumulative taxes can be very expensive.

5. Low Un-Invested Cash Low

Un-invested cash is cash the mutual fund has not yet invested in securities. High levels of un-invested cash are drags on a mutual fund's performance. For example, if the fund's portfolio has a small percentage of large-cap stocks and a large percentage of cash, the low rate of return on the cash will dilute the higher rate of return on the large-cap stocks. Look for funds that keep the percentage of cash in their portfolios low. Some mutual funds hold large amounts of cash to fund potential redemptions or to comply with their investment policy. Choose funds that are fully invested (95 to 99 percent, depending on the asset class and fund size) in the market segment you are targeting. Do not pay the mutual fund to manage cash. While it is acceptable for open-end mutual funds to have some frictional cash, this cash should comprise less than 5 percent of the fund.

6. No Manager Style Drift

The law requires that mutual funds have a prospectus available for individual clients to review. This prospectus states the investment objective of the fund (whether the fund will invest in large-capitalization stocks, international bonds, real estate, etc.). Manager style drift relates to the fund manager's style and the types of companies the fund will buy or sell. Over time, portfolio managers may change the types of companies they choose to invest in; this change is called manager style drift. Changes in the size, geographical location, or relative valuation of the

companies included in the fund can alter a manager's investment style. Since this investment style affects the performance of the fund, a portfolio manager should generally remain consistent in the types of companies he or she selects for the fund.

7. Small (or Positive) Tracking Error

Tracking error (or trailing return, as defined by Morningstar) is the difference between the return on the fund and the return on the fund's benchmark.[11] Tracking error should be small, meaning that the fund return should be very close to the benchmark return. Generally, the smaller the tracking error, the more consistent the performance of the fund is compared to its benchmark. If the tracking error is negative, the fund has yielded lower returns than the benchmark. Most people do not complain too much if the tracking error is positive, or in other words, if the fund has yielded higher returns than the benchmark.

Using Databases to Select Funds

Now that you understand the parameters you should adhere to when selecting mutual funds, you can set your criteria and then use a database to get a list of all the funds that meet your criteria. For example, you can use Morningstar and Using Morningstar to Select Funds (LT07) to set your criteria for stocks, bonds, and other financial assets. To aid you in your selection, we have created a Mutual Fund Selection Worksheet (LT07B) that includes the criteria discussed and where to find it on Morningstar.

While there are many different resources for finding mutual funds, the Premium Fund Screener from Morningstar is one of the better resources. You will need to set up an account and a password. The cost of using Morningstar on the Internet is $125 per year. This service is available for free for some college students, such at BYU.

Understand and Select Investment Vehicles Carefully

Before you can build a successful investment portfolio, you must understand the difference between investment vehicles and investment (or financial) assets. *Investment vehicles* are special types of investment retirement accounts that provide a tax-advantaged framework that allows you to invest in various financial assets. Tax advantages include the deferral of current taxes or the elimination of future taxes on earnings. These accounts are useful because they provide specific tax advantages that are not available when financial assets are purchased individually. Investment vehicles are like shopping carts in the grocery store.

Investment, or financial, assets are specific classes of financial securities in which you may invest, including stocks, bonds, mutual funds, real estate, money-market mutual funds, CDs, and so on. As you have learned, these financial assets are grouped into asset classes and are associated with different levels of risk. Investment assets are like the groceries you put in your shopping cart.

Table 1. Select Investment Vehicles for 2019 (Before Catch-Up)

Plan	***Tax-Deferred***	***Tax-Eliminated***	***Maximum Amount***	***For Employees of:***
401(k)	Yes		$19,000	Businesses w/ Plans
Roth 401(k)		Yes	$19,000	Businesses w/ Plans
403(b)	Yes		$19,000	Non-profit, tax-exempt
Roth 403(b)		Yes	$19,000	Non-profit, tax-exempt
457	Yes		$19,000	State/Municipalities
SEP IRA	Yes		$56,000	Small Businesses
SIMPLE IRA	Yes		$13,000	Small Businesses
IRA	Yes		$6,000	Individuals
Roth IRA		Yes	$6,000	Individuals
Education IRA		Yes	$2,000	Individual Education
529 Plans		Yes	$485,000 per child	Individual Education

There are many types of investment vehicles. Many investment vehicles are geared towards helping you build a retirement account and most are named after a specific line in the Internal Revenue Code. For example, a 401(k) plan is a retirement plan offered to employees of private companies, a 403(b) plan is a retirement plan offered to employees of public companies, a Simplified Employee Plan (SEP-IRA) is a retirement plan designed for employees of small businesses, and an Individual Retirement Account (IRA) is a retirement plan designed for individuals. Table 1 shows characteristics of select investment vehicles for 2018.

Understanding the process can help you identify the tax benefits and other benefits that different investment vehicles offer. The process is divided into three sections: free money; tax-advantaged money; and tax-efficient and wise investments. Understanding the process can help you determine which investment vehicles you should use first in working toward your financial goals.

Priority 1: Free Money

The first priority is *free money*: free money is the money provided by your company when you participate in a company-sponsored retirement plan or a reduction in taxes for investing in specific education vehicles for your children and family. Free money is often provided through a *matching plan*, in which your company offers to match a percentage of the money you invest in your retirement plan. A matching plan is used as an incentive to encourage employees to remain with the company and to invest in a retirement plan. Some states allow a tax deduction for your contribution to that state's 529 Plan for education, which is also a form of free money

Free money is your first priority because it is free and the percentage matched by the company is usually higher than any rate of return you could earn in the market. The risk of investing in a company-sponsored plan is that you are usually required to stay with the company for a certain number of years to become fully vested, or in other words, take full ownership of the free money.

Priority 2: Tax-Advantaged Money

There are two different types of tax-advantaged vehicles or accounts: tax-eliminated accounts and tax-deferred accounts. Your choice of which account is better mainly depends on your current tax rates and your estimation of your future tax rates. If you expect your tax rates to be higher in the future than they are now, you will save a greater amount for retirement if you choose a Roth retirement account versus a traditional, and pay the taxes now. However, if you expect your tax rates to be lower in the future than they are now, you will save a greater amount for retirement if you choose a traditional retirement account in which you pay taxes when you take the money out at retirement. To help you decide which type of IRA is more beneficial for you, see Roth versus Traditional: Which Is Better for You (LT28). It allows you to set an annual contribution, an estimate for a rate of return on earnings, and your current and future tax rates. By changing your future tax rates, you can determine if your balance in the future would be higher or lower, all other areas being held constant.

Tax-eliminated accounts: Tax-eliminated accounts require you to pay taxes on principal before you invest it; however, you do not have to any pay any taxes on the capital gains or earnings in the future. There are several different tax-eliminated investment vehicles and assets that can help you save for retirement (i.e., Roth IRAs or Roth 401(k)) or for education (i.e., 529 funds, Education IRAs and Series EE or I bonds when the principle and interest are used for qualified educational expenses). When tax-eliminated accounts are used for qualified purposes, withdrawals can be made without penalty and without taxes.

With a Roth IRA or a Roth 401(k), you pay taxes on the principal before you deposit the money into your retirement account. Once you reach age fifty-nine and a half, you can take both the principal and interest out of this retirement account without paying taxes on the money. By paying taxes beforehand, you eliminate taxes on all capital gains and earnings in this account. Roth IRAs have an additional advantage: if you need to use the funds in your account before retirement, you can withdraw the *principal* without penalty because you have already paid taxes on the principal. The disadvantage of a Roth IRA is that, like all retirement accounts, you cannot withdraw your *earnings* without penalty until you are at least fifty-nine and a half years old.

With many 529 funds and Series EE and I bonds, you are investing with after-tax dollars. If you use your earnings to cover qualified educational expenses for your children, you do not have to pay taxes on the earnings. However, if you do not use the earnings for qualified educational expenses, you must pay a 10-percent penalty on your earnings, as well as federal and state taxes on the amount withdrawal as it is considered ordinary income for tax purposes.

Tax-deferred accounts: Tax-deferred accounts allow you to invest without first paying taxes on the principal; then, when you withdraw money from the account at retirement, you pay taxes on both the principal and the earnings. This type of account is advantageous because it allows you to invest a larger amount of money using a smaller percent of your net income. Examples of tax-advantaged investment vehicles include Individual Retirement Accounts (IRAs); 401(k), 403(b), and 457 plans; and Simplified Employment Plan Individual Retirement Accounts (SEP-IRAs).

Suppose your gross income last year was $50,000, and you invested $3,000 in a traditional IRA. Your adjusted gross income (the income on which you pay taxes) would be $47,000 ($50,000 less the $3,000 contribution). Contributing to an IRA reduces the amount you must pay in taxes today (the amount of your tax savings would be equal to $3,000 multiplied by your tax rate). However, when you retire after age fifty-nine and a half and take this money out of your retirement accounts, you are not only required pay taxes on your $3,000 investment, but you must also pay taxes on any earnings the IRA investment has produced as well. Note also that although your investments were long-term investments, both earnings and principle will be taxed at ordinary tax rates.

The risk of using tax-deferred investment vehicles is that you must be at least age fifty-nine and a half to make withdrawals. If you withdraw funds before you reach this age, you must pay taxes on the funds at your ordinary income-tax rate, and you must also pay a 10-percent penalty fee. Thus, if you make early withdrawals, you may lose up to 50 percent of your investment in taxes (a 10-percent penalty charge plus 40 percent in taxes if you have the highest marginal tax rate possible). Tax-deferred earnings that have remained in your retirement account for more than twelve months are still taxed as ordinary income, which is taxed at a higher rate than capital gains.

Priority 3: Tax-Efficient and Wise Investments

The third priority is tax-efficient, wise investments. Wise investors know they will have to pay taxes and transaction fees on any investment they make, so they work to minimize these costs as much as possible. They also monitor their investments' performances by comparing their returns after taxes and transaction fees to the appropriate benchmarks. The following are five important suggestions for investing tax-efficiently and wisely.

> **1. Know the impact of taxes.** As an investor, you must be particularly concerned about the effects of taxes, because taxes are one of the largest expenses you will have to pay when you invest. Every dollar you pay in taxes is a dollar you will not be able to invest. To invest in a tax-efficient manner, you must understand how taxes influence your returns (capital gains, dividends, and interest). You can use the following formula to calculate your after-tax return:
>
> $$\text{Return}_{\text{after tax}} = \text{Return}_{\text{before-tax}} * (1 - \text{marginal tax rate})$$
>
> Your after-tax return is equal to your before-tax return multiplied by the result of one minus your marginal tax rate. Your marginal tax rate is the tax rate you pay on your last dollar of earnings. Your marginal tax rate encompasses your federal, state, and local taxes. It is important for you to know your marginal tax rate. Remember that different types of earnings are taxed differently. Bond interest is taxed at your marginal tax rate, stock dividends are taxed at preferential 15 percent (if your marginal tax rate is higher than 15%) or 0 percent (if your marginal tax rate is 15 percent or less), and more if you make taxable income over $400,000. Unrealized capital gains (the capital gains on assets

that have not been sold yet) are not taxed at all until the assets have been sold.

To understand the impact of taxes, you must calculate the estimated after-tax return of each asset you are considering.

2. Reduce taxes and defer earnings and taxes to the future. Capital gains are taxed at a much lower rate than ordinary income (15 percent if your marginal tax rate is 25 percent or more, or 0 percent if your marginal tax rate is 15 percent or less. Earn as much of your income as possible in the form of long-term capital gains.

Invest in your qualified and individual retirement plans. This way you are getting a tax break now, and will not have to pay taxes until retirement. You could also invest in Roth retirement vehicles where you pay taxes now, but never pay taxes on the investments ever again.

You can replace ordinary income with capital gains by using a buy-and-hold strategy when you invest. This strategy means that you hold on to your assets for as long as possible and do not trade in your accounts. By holding on to assets for extended periods of time, you defer earnings to the future and avoid paying taxes now.

3. Minimize turnover and taxable distributions. Minimize turnover on all assets and minimize taxable distributions on your mutual funds. Every time you sell an asset, you set up a taxable event (a transaction that has tax consequences). By using a buy-and-hold strategy, you minimize the impact of taxes and reduce your transaction costs as well.

The law requires that mutual funds distribute 90 percent of all capital gains and interest to shareholders annually. You will have to pay taxes and fees on these distributions, even if you do not sell your mutual fund. As an investor in a mutual fund, you must sometimes pay taxes because of the actions of the mutual fund's portfolio manager.

You can minimize turnover and taxable distributions by selecting your mutual funds wisely. Invest in funds that do not have a history of trading actively (i.e., funds that have low turnover or trading). These funds will reduce the amount you must pay in taxes each April.

4. Replace interest income with stock dividend income. Because of changes in the tax law in 2004, taxes on dividends from individual company stocks or stock mutual funds were reduced to 15 percent or 0 percent, depending on your marginal tax rate. However, interest earned on bonds or bond mutual funds is taxed at your ordinary income rate. If you put more emphasis on stock dividend income than interest income, you will potentially increase your portfolio's return and pay less in taxes as well. These steps should only be taken if they are appropriate for your risk-tolerance level.

5. Invest tax-free. If you are in a high marginal tax bracket, you can invest in assets that

do not require you to pay federal or state taxes. For example, municipal bonds are federal tax-free; they may also be state tax-free if you are a resident of the state that is issuing the bonds. Treasury bonds are state tax-free, and certain government savings bonds, such as Series EE and Series I bonds, are both federal and state tax-free if the proceeds are used solely for qualified educational expenses.

Using the Process

Some investment vehicles are preferred over others because they provide tax advantages and other advantages. Unfortunately, some of the investment vehicles that are high money priorities also have lower maximum contribution limits. For example, in 2018 the maximum amount you could contribute to a Roth IRA was $6,000, while there was no limit on how much you could invest in taxable individual financial assets.

Although some investment vehicles have limitations, it is still a good idea to adhere to the process discussed. You should first invest money in vehicles that are the highest priority on the list. When you have reached the maximum amount you can invest in these vehicles, or when you have invested as much money as your company is willing to match, then you should invest in the next highest priority. Continue to invest until you have utilized all of your available investment funds.

When selecting financial assets to include in your retirement account, remember that you will not have to pay taxes on the principal or earnings until you take the money out, or not at all. If you own financial assets that are actively traded or that generate a lot of income, these assets should be held in your retirement accounts; you will not have to pay taxes on the assets until you take them out at retirement, if at all. Assets that you may want to hold in your retirement account include actively traded accounts, taxable bonds, and high-turnover mutual funds.

Financial assets that you are managing with a buy-and-hold strategy should be kept in taxable investment accounts. Such assets include tax-free bonds, tax-efficient indexes and mutual funds, and other financial assets that you do not plan to sell for a long time. Although you may be required to pay taxes on these funds each year for dividends and other short-term distributions, it is usually tax efficient to hold these assets for extended periods of time. The taxes that you must pay on these funds will add little to your yearly tax bill.

Summary

I approach the topic of investments differently than other textbooks. Most books take an asset-based approach. I take a principles-based approach because the principles of good investing will not change over time. There are important investing principles that, if followed, will result in a quality investment plan and lead to a successful investment portfolio.

We must understand what we should do before we invest, which is to:

1. Be square with the Lord,
2. Have adequate health and life insurance to care for the needs of your family in the event that something were to happen to you,
3. Be out of high-interest credit card and consumer debt, and
4. Write down your goals, be living on a budget, and have a well-written and well-thought-out investment plan.

These steps help you prepare a "priorities-based" investment plan. There is no better way to start investing than to have your priorities in order.

We then discussed the factors you control in investing. We must understand the factors we control and work on those areas.

We shared the 10 principles of successful investing. These are critical if you are to achieve your goals. We shared how most investors have done with their investments, which isn't positive. That is why the principles are so important. They are:

1. Know yourself.
2. Understand risk.
3. Stay diversified.
4. Invest low-cost and tax-efficiently.
5. Invest for the long run.
6. Use caution if you must invest in individual assets.
7. Monitor portfolio performance against benchmarks.
8. Don't waste too much time and energy trying to beat the market.
9. Invest only with people and institutions that are high-quality, licensed, and reputable.
10. Develop a good investment plan and follow it closely.

Follow these principles and you will have a much better chance of having a successful portfolio.

Finally, we finished with understanding asset classes and how to use investment vehicles wisely for saving and investing.

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[10] "Reach with a Rescuing Hand," *New Era*, Jul. 1997, 4.
[11] http://library.morningstar.com/Education/MLE_Glossary_T_Z.html#TrailingReturnCategory

19. Intermediate Investing 2: Application

Introduction

You have an understanding of key investment basics, why you invest, factors you control, how most investors have done with their investments (performance has not been good compared to benchmarks). You understand what you should do before you invest, and you have reviewed the principles of successful investing. You understand asset classes and you have reviewed the risk and return characteristics of the various asset class. These principles we discussed are critical to understanding, developing, and implementing a successful investment portfolio. In addition, you have reviewed the investment hourglass, a learning tool to help you understand that investing is a means to an end, not an end in itself. Investing is a way to achieve your personal and family financial goals.

Objectives

When you have completed this chapter, you should be able to do the following:

6. Understand risk tolerance and determine your risk level
7. Set your asset allocation consistent with your risk
8. Create your investment plan
9. Carefully choose your mutual/index funds
10. Select your financial assets wisely, rebalance tax-efficiently, and hold your assets for 40 years

Understand Risk Tolerance and Determine Your Risk Level

One of the key challenges of investing is to invest at a risk level you are comfortable with. Different investors can accept different levels of risk as they work to achieve their personal and family goals. This view and understanding of risk is not an easy thing to determine.

If you choose to invest at lower risk levels, you will have a greater probability of not losing money, yet because of the lower risk, your returns are likely to be lower as well. There is a tradeoff between risk and return. If your risk level is too low, you will need to save more money for retirement and other goals as your returns will likely be less.

If you take too much risk in your investing, there are concerns as well. With higher risk, you have higher volatility and hopefully higher returns. However, if you invest at a higher risk level than you are comfortable with, you will be very concerned every time the market declines.

Interestingly, most investors are torn between “fear” and “greed.” When the financial markets

decline, the "fear" kicks in. We think we should take our investments out of the market, and that we will know and be able to put them back in before the market goes up again (this is called market timing). I personally know of no investor that can consistently time the market.

Likewise, when the markets are going up, the "greed" kicks in. We think we should put all our assets into one or two "sure things", which are anything but sure.

Our challenge then is to find a median point between fear and greed, so that we can build a portfolio that will give us the amount of risk that we are comfortable with and that will help us to achieve our goals. That is where risk tolerance comes in.

Risk Tolerance

Risk tolerance is an investor's willingness to accept risk. It is related to the holdings of the investor's investment portfolio or their expected holdings in their investment portfolio, particularly their asset allocation or asset mix. Generally, a higher risk tolerance indicates a willingness to take on more risk, while a lower risk tolerance indicates a willingness to take on less risk.

Your risk tolerance is determined in two main ways: 1. It can be derived from an investor's age and their current portfolio holdings, i.e., an implied risk tolerance, or 2. It can be estimated by an investor answering specific questions regarding investor demographics including age, characteristics, spending habits, history, and investment experience.

When we define risk in the determination of risk tolerance, risk in this case is generally considered the volatility of investment returns. Investors with a lower risk tolerance will have more assets in less risky or less volatile asset classes such as bonds and cash. Investors with a higher risk tolerance will have more assets is more risky or more volatile asset classes such as equities or stocks including small caps, international, REITs, etc.

Table 2. 90 Year Return and Volatility of Asset Classes from 1927 to 2018

Asset Class	Annual Return*	Standard Deviation*
US Small Cap	11.5%	28.5%
US Large Cap	9.3%	18.7%
Treasury Bonds	5.5%	9.0%
Treasury Bills	3.3%	0.9%
Inflation	3.0%	1.8%

Source: Calculated from Ibbotson Data 2016 and Bloomberg afterward. Note that each of these asset classes are portfolios of financial assets, not individual assets.

Some have wondered if risk tolerance is more an absolute number or a general category. For the purposes of this class and lecture, risk tolerance is considered more a general category. In this class, we divide risk tolerance into five general categories: very conservative, conservative, moderate, aggressive, and very aggressive.

The purpose of risk tolerance is to enable an investor to determine an appropriate asset allocation or investment mix based on the investor's willingness to accept risk. This allocation is critical because it determines the amount of risk an investor is willing to accept. A lower risk tolerance should lead to a lower risk portfolio, with more invested in bonds and cash. A higher risk tolerance should lead to a higher risk portfolio with more equities.

The challenge of risk tolerance is that it is not an exact science, and can mean different things to different people. Risk tolerance varies from one individual to another.

Please note that there are many different risk tolerance tests and categories that may lead to slightly different results. There are lots of different risk tolerance tests available online, many of which are more to sell investment products than to really help people understand how they should invest their assets. Luckily, we are not selling anything with this manual or this website.

Take A Risk tolerance Test

To come up with your asset allocation, I recommend you take a risk tolerance test. There are a number on the internet, but for the ease of use, we will use our risk tolerance test from the website. A Risk-Tolerance Test (LT16) is a tool we developed to help students understand and determine their asset allocation and risk tolerance. The process is:

1. Read through the entire test to familiarize yourself with what you are doing (it is included below).
2. Review each of the 8 questions and answer each of the questions carefully based on your views, experience and opinions.
3. Then add up your points from each question. There are five potential responses to each question, worth 1 to 5 points.
4. Add up the point next to the correct response and sum your total points from each of the 8 questions.
5. From your total points, we will have recommended actions for your asset allocation.

Question 1: Demographics. What is your age currently?

1. 65 and over
2. 45 to 64
3. 35 to 44
4. 25 to 34
5. 24 and under

The younger you are generally, the more willing you should be to tolerate risk and the longer time horizon in which to grow assets. If you are younger, should think about taking a little more risk.

Question 2: Time Horizon. What is your investment time horizon for this money?

1. 1 year
2. 2-5 years
3. 5-10 years
4. 10-20 years
5. 20 years or longer

Your time horizon will impact on how much risk you take. You will have different time horizons for different "buckets" (remember that money in the stock market is subject to more risks). If your time horizon is less than 3-4 years, it may not be a good idea to invest in market, particularly equities.

Question 3: Investment Goals. What is your primary objective for this money?

1. Preservation of Principal
2. Current Income
3. Growth and Income
4. Conservative Growth
5. Aggressive Growth

Your goals will, to a degree, drive your willingness to take on risk and will make a big difference on where you invest. If your goal is safety, you should take on little risk. If your goal is aggressive growth, you should be willing to take on much more risk.

Question 4: Expected Personal Earnings: Regarding your current income, do you expect it to:

1. Decrease dramatically in the future
2. Decrease a slight amount in the future
3. Stay about the same
4. Increase with the pace of inflation
5. Increase dramatically

Income is an important driver of your investments. If you feel your income will decline, you will likely be much less willing to tolerate risk than if you think your income will increase dramatically. Expectations of your earning will have an impact on risk.

Question 5: Emergency Funds: What amount of money do you have set aside for emergencies? (This does not include borrowings or credit lines, but does include money you can access quickly)

1. None
2. Enough to cover three months of expenses
3. Enough to cover six months of expenses
4. Enough to cover nine months of expenses
5. Over twelve months of expenses

The larger your emergency fund, the more you are able to take on risk. Generally, with your first investments, you should take on very little risk. As your asset size increases, so should your willingness to increase risk.

Question 6: Investment Experience: What is your personal investment experience?

1. I have never invested any money in any financial market or instrument.
2. I am relatively new investor,--only a few years.
3. I have invested in IRAs and employer sponsored retirement plans (401 (k)) for some time, but now I am ready to develop additional investment strategies outside of that plan.
4. I have invested for quite some time and am fairly confident in my investment decisions.
5. I have invested money for years and have a definite knowledge of how financial markets work.

Generally, the more experience investors have with financial markets, the more risk they are able and willing to bear. However, this should be tempered by your willingness to accept risk.

Question 7: Investment Risk: Regarding your view of risk, which investment would you be more comfortable making?

1. I am comfortable investing in savings accounts, CDs, and other short-term financial instruments.
2. I invest in savings accounts/CDs, but I also own income-producing bonds and bond mutual funds.
3. I have invested in a broad array of stock and bond mutual funds, but only the highest quality.
4. I have invested primarily in growth stocks and growth stock mutual funds.
5. I like to pick out new and emerging growth companies and aggressive stock mutual funds.

What you own is an indicator of your risk level. If invested only in CDs/"safe" investments, you are likely risk averse. If in aggressive stocks/funds, you are willing to take on more risk.

Question 8: Investment Preference: Which investment would you be more likely to invest in? The investment has:

1. A 20-year average return of 0-1%, with infrequent downturns and no years of negative returns.
2. A 20-year average return of 2-3% with mostly positive returns but less than a year of negative returns.
3. A 20-year average return of 4-5% with a few downturns and more than one-year of negative returns.
4. A 20-year average return of 6-7% with several periods of negative returns

5. A 20-year average return of 8% or greater with several periods of substantially negative returns.

Higher returns require higher risk, If comfortable with lower returns, you can position your portfolio. If you want the higher returns (and risk), invest according to your risk level.

You should now have your total score. From your total score, it can help you understand what type of investor you are: Very conservative, Conservative, Moderate, Aggressive, and Very aggressive. Each score will have a recommended action regarding increasing or reducing risky assets (see Table 4).

Set Your Asset Allocation Consistent with Your Risk

Asset allocation it is the process of determining how the assets of a portfolio are divided, mainly into which asset classes. A well-diversified portfolio should have broad diversification across many asset classes to reduce overall portfolio risk. A broadly diversified portfolio is an investor's key defense against risk, a key to a "sleep-well portfolio," one that is not torn between fear and greed. Asset allocation is a three-step process:

Step 1: Set your initial bonds and cash allocation to equal your age as a percent of your overall portfolio allocation. For example, if you are 40 years old, you should have 40% of your portfolio in bonds and cash, and 60% in equities

Step 2: Take this risk tolerance test. Based on your results, you will adjust that allocation to take into account your individual risk tolerance and come up with an risk-appropriate asset mix. If you are more conservative you will increase your bonds and cash allocation and decrease your equity allocation. If you are more aggressive, you will do the opposite

Step 3: Determine your preferred asset classes based on risk within your major asset classes. If you are a conservative investor, you will likely have many different bond asset classes (short-term, long-term corporates, governments, municipals, etc.), but likely only large cap equities, and perhaps a small amount of other equity asset classes. If you are more aggressive, you will do the opposite, have more small cap, international, emerging markets, REITs, etc. and less allocation to bonds and cash.

Asset allocation is important for two reasons:

1. Research has shown that most of the returns from financial assets are mainly a function of returns from the specific asset class decision, and not from the individual stock selection decision. Asset class choice influences returns.

2. In the process of selecting your asset allocation, you are selecting your risk level for your overall portfolio. Selecting asset classes is selecting the risk or risk level for your

portfolio.

Table 3. 10 Year Return and Volatility of Asset Classes from 2007 to 2018

Asset Class	Annual Return*	Standard Deviation*
Other: US REIT	7.4%	39.1%
Equity: Emerging Markets	2.0%	22.7%
Equity: US Small Cap	9.1%	20.3%
Equity: International	2.4%	18.5%
Equity: US Large Cap	8.3%	15.0%
Government Treasury Bonds	5.6%	13.3%
Government Treasury Bills	0.3%	0.2%
Inflation	1.6%	1.3%

Source: Calculated from Ibbotson and Bloomberg. These are portfolios of financial assets, not individual assets.

While we cannot know which asset classes will be the most risky over the upcoming years, we can use historical data to determine the most risky asset classes over the past 90 years ending December 2018 in terms of volatility (or standard deviation). The higher the standard deviation the more volatile the asset class (see Table 2).

As you know, time periods change. What were the most risky asset classes over the past 10 years ending December 2018 (see Table 3)? Notice that generally the higher risk asset classes had the higher return, but it was not necessarily the case.

So if risk tolerance is important then the challenge becomes the process of determining your asset allocation. How do we do that?

The challenge is to get from your risk tolerance to your asset allocation. Table 4 below helps you do that. Match your beginning allocation, which is your age in bonds, with your recommended action. Once you perform the recommended action, you will have your asset allocation or asset mix consistent with your preferred level of risk.

Investors are free to shift between the cash and bond allocations without any change in effectiveness of the test. I personally prefer to always have, at minimum, a 1-5% allocation to cash.

So how does this scoring work? For example, if you scored 35 points, you would be considered an “aggressive” investor. This is your risk tolerance or type of investor you are.

To get to your asset allocation or asset mix, you need to start with your age in bonds. For example, assume you are age 40 so assume 40% in bonds.

Next, do what the Asset Allocation Recommendations suggest. For an “aggressive” investor, you would add 10% to equities and subtract 10% to your bond and cash allocations from the above

charts. Your asset allocation at age 40 would be 30% bonds and cash, and 70% equities.

Table 4. Asset Allocation Results from the Risk Tolerance Test

Investor Type	*Asset Allocation*
Asset Classes:	*Recommendations:*
Very Conservative	8 to 12 points
Cash	+5%
Bonds	+15%
Stocks	-20%
Conservative	13 to 20 points
Cash:	+0%
Bonds:	+10%
Stocks:	-10%
Moderate	21 to 28 points
Cash	0%
Bonds	0%
Stocks	0%
Aggressive	29 to 36 points
Cash	-5%
Bonds	-5%
Stocks	+10%
Very Aggressive	37 to 40 points
Cash	-5%
Bonds	-15%
Stocks	+20%

You are likely wondering if you can have two individuals with similar asset allocations yet with different risk levels? The answer is yes. This is due to their different ages. For example, three investors each have a 60% equity and 40% bond allocations. Investor A is age 50 and is Aggressive; Investor B is age 60 and is Moderate; and Investor C is age 40 and is Very aggressive. Their overall allocations of 60% equity and 40% bonds the same. However, their allocations within the equity and bond allocations will likely be very different. Aggressive investors will have more small cap, international, and other risk equity asset classes. Conservative investors will have more in savings accounts, bonds, government securities, and municipal bonds.

Creating Your Personal Investment Plan

The most important financial-planning document you will prepare, besides your list of personal

and family vision and goals, is your Investment Plan. In finance terms, your Investment Plan is also known as your investment policy statement. An Investment Plan is important because it creates a framework for every investment activity in which you will participate. It states what you will invest in, how you will invest, why you will invest, what percentage of your money you will invest, and so on. In short, your Investment Plan significantly affects your investment returns. Write this plan well and then follow it carefully. An example of an Investment Plan is found in the Learning Tools directory of the website under Investment Plan Example Template (LT05A). Your Investment Plan is a detailed description of all the major components of your investment strategy. It will help you to do the following:

1. Represent yourself: It explains your personal investment characteristics, such as your risk tolerance and your personal constraints, and how those relate to your asset allocation and targets.

2. Articulate what you will and will not do: This plan clearly states what you will and will not invest in and how you will invest. It also includes investment guidelines that will help you invest your money wisely and achieve your goals.

3. Provide an investment framework and guidelines for making wise investment choices: If you clearly think through and plan how you will invest now that you have few assets (and are not influenced by fear and greed), you will have an investment framework and guidelines to help you reason through decisions that could have a major impact on future financial goals and retirement. If followed carefully, your plan will help you avoid poor investment decisions that could have major repercussions for your financial life. But you must write your Investment Plan carefully and then follow it.

Your Investment Plan is divided into four separate categories:

1. Risk and return objectives
2. Investment guidelines and constraints
3. Investment policy
4. Portfolio monitoring, reevaluation, and rebalancing

1. Risk and Return Objectives

This category describes your expectations for returns on your investments. These expectations will, to a large extent, determine your asset-allocation decisions. In other words, these expectations will determine how you will distribute your investments among different asset classes. This category also addresses your expectations for risk and outlines how much risk you are willing to accept.

Expected returns: You should not invest without specific goals in mind. For your first goal, you should decide what return you expect your total portfolio to make over a specific time period. You cannot know with certainty what the actual returns will be before you invest. However, you can estimate an expected return, or a goal you hope to achieve during a certain period of time

(such as a week, a month, or a year). Be aware that your expected return will have a major impact on what your portfolio looks like.

- An expected annual return of 1 to 2 percent will likely be the result of a diversified, very low-risk portfolio.
- An expected annual return of 3 to 4 percent will likely be the result of a well-diversified, low-risk portfolio.
- An expected annual return of 5 to 6 percent will likely be the result of a well-diversified, moderate-risk portfolio.
- An expected annual return of 7 to 8 percent will likely be the result of a less-diversified, high-risk portfolio.
- An expected annual return greater than 9 percent will likely be the result of an undiversified, very high-risk portfolio that is heavily dependent on high-risk assets.

Note that you will determine your expected returns for two periods of time: before retirement and during retirement.

There are several ways to estimate your expected returns. To give you an idea of how to estimate your expected returns over a period of time longer than one year, it may be helpful to look at the long-term history of the asset classes you have selected. Look at Historical Return Simulation for Asset Classes (LT23).

Expected risk: Since a higher expected return requires you to accept more risk, it is important that you know your risk-tolerance level, or your willingness to accept risk. Where you are in your life, as represented by your age, will likely have a big impact on how much risk you are willing to take. In general, when people are younger, they are more willing to accept risk because their investments will have more time to grow and overcome losses. As people grow older, they usually become less willing to accept risk because they will need their investment funds sooner for retirement and other purposes. Investors that have a low tolerance for risk should typically devote the majority of their portfolios to bonds and cash because these investments are the least risky of all asset classes; however, these investments also have the lowest returns. Investors that are willing to accept more risk may allocate more of their portfolio to U.S. and international stocks versus investments in bonds and cash. The challenge of wise investing is to balance your risk and return expectations with your situation in life and your personal goals.

Defining risk in your portfolio is a challenge. Professional investors usually state an annual standard deviation as the acceptable risk level for their portfolios—for example, 12 percent. From a financial standpoint, this means that 66 percent of the time the investor's risk will be within one standard deviation (plus or minus 12 percent) of his or her mean or average return. If an investor's average return is 8 percent, this means there is a 66-percent chance that the

investor's returns will be between –4 percent (8 percent – 12 percent) and 20 percent (8 percent + 12 percent). While using a standard deviation to define risk may be helpful for some, this method will not work for everyone. I would like to propose a more simple way of defining risk: using investment benchmarks.

Instead of defining your risk-tolerance level in terms of a standard deviation, you can simply define it by deciding that you are willing to accept the risk of the benchmarks you have chosen for your portfolio. You can determine how risky a particular asset is by looking at your investment benchmark. If you have a small-capitalization stock mutual fund or asset that has had a return of 6.5 percent over the last 10 years and a standard deviation of 19.3 percent, you can compare this asset to an investment benchmark for small-cap stocks. From Table 4 in the previous chapter, note that small-cap stocks have yielded a 7.2 percent return over the past 10 years with a 20.6 percent standard deviation. Your mutual fund or asset has a slightly lower return than the benchmark (6.5 percent versus 7.2 percent), but with slightly lower risk than the benchmark (19.3 percent versus 20.6 percent).

You can also determine a portfolio's risk level by comparing the portfolio to weighted individual benchmarks. For example, if you choose a portfolio that is made up of 50 percent U.S. stocks, 20 percent international stocks, 25 percent bonds, and 5 percent real estate (all percentages should add up to 100), then your risk is equal to the risk defined by the benchmarks of each of these asset classes. In this case, your risk would be equal to the benchmarks of each element in a portfolio that contains 50 percent U.S. stocks (as measured by Standard and Poor's 500 Index, a major benchmark for large-capitalization stocks); 20 percent international stocks (as measured by MSCI Europe Australia, Far East Index (EAFE), a major benchmark for international stocks); 25 percent bonds (as measured by the Barclays Aggregate Index, a major benchmark for bonds); and 5 percent real estate (as measured by Standard and Poor's REIT Index, a major benchmark for real estate investment trusts). A list of the major benchmarks for a portfolio can be found in the Learning Tools directory of the website under Possible Benchmarks for Investment Plans (LT15) and Expected Return Simulation and Benchmarks (LT27). Asset class performance over the past 1, 5, 10, 25, 50, 75, and 85 years can be found in Table 4 in the previous chapter of this manual.

2. Investment Guidelines and Constraints

The second category of your Investment Plan is investment guidelines and constraints.

Investment guidelines: Your investment guidelines are the road map for how you will invest over your lifetime. These guidelines and constraints explain the ways in which you will invest differently at different phases in your life. Generally, most individuals have three stages of their financial life cycle. Most investors who are younger than age 55 are in stage one, or capital accumulation and growth. Investors who are approaching or in retirement are typically in stage two, where the main goal is investment preservation, or maintaining the value of investments. The choice of the number of stages is arbitrary. You can add more stages if you choose.

Your investment guidelines should provide you with a general road map for investing money at different stages of your financial life cycle. These guidelines should integrate all of your financial goals to give you a complete financial perspective.

Investment constraints: Once you have decided on your investment guidelines, you should identify your investment constraints, constraining factors that you must take into account as you manage your portfolio. Your Investment Plan should address a number of important constraints: liquidity, investment horizon, tax considerations, and any special needs.

Liquidity is the speed and ease with which an asset can be converted into cash. As you create your plan, consider how important it is for you to have the option of turning your assets into cash quickly. Ask yourself how much money you will need at different times in your life and how quickly that money needs to be available. Examples of liquidity constraints include paying for graduate school, making a down payment on a house, and sending a child to college. To pay for these expenses, you will need to convert assets into cash.

Investment Horizon is the amount of time you are planning to keep an asset to save for a particular purchase. Consider how soon you will need to use the funds from a particular investment. Examples of short-term investment horizons include saving for a new car or making a down payment on a house. An example of a long-term investment horizon would be saving for retirement or saving for your children's college educations.

Tax considerations take into account your current tax bracket and your current tax rates. Consider your tax position: are tax-free or tax-deferred investments more advantageous than taxable investments? You cannot simply compare the stated returns of particular assets; you must compare assets by taking into account that certain investments eliminate federal or state taxes and those other investments are tax-free. For example, if you are comparing government I and EE savings bonds versus corporate bonds, you must take into account that government I and EE savings bonds are state tax-free (and federal tax-free if principal and interest are used for college tuition costs), while corporate bonds have no tax advantages.

Special-needs are constraints related specifically to your family, your business, and other areas of life that are important to you. Do you have a child with a disability? This may impose specific requirements on your Investment Plan because you will likely need life insurance to provide funds for a disabled child in case of your death. Is a large part of your wealth tied up in your company? This imposes constraints such as the decision of how much you should invest in your company's employee stock-ownership plans. You may have other special constraints that will influence your investment decisions. It is critical that you understand your special needs before you begin investing.

3. Investment Policy

Your Investment Plan also includes your investment policy, which is a written statement of what you will and will not invest in, how you will allocate your investments, and how you will

distribute your assets. Your investment policy is divided into six sections:

- Acceptable and unacceptable asset classes
- Investment benchmarks
- Asset allocation
- Investment strategy
- Funding strategy
- New investment strategy

Acceptable and unacceptable asset classes: It is important that you decide which assets you will invest in before you begin investing so that others will not be able to convince you to invest in asset classes that are not suitable for you at your stage in the financial life cycle. Invest where you have a particular expertise or where the odds are in your favor. You should plan to invest in asset classes that have a history of delivering long-term returns, not just high returns over very short periods of time. For example, I recommend that investors invest in stocks, bonds, mutual funds, and cash and cash equivalents; I do not recommend investing in futures, options, foreign currencies, or precious metals. The investments I have recommended have long-term histories of consistent performance, while the investments I do not recommend lack a history of consistent performance.

Review the historical performance of various asset classes to roughly estimate future performance. After reviewing the historical performance of the various asset classes, it is likely you will decide to invest in stocks and mutual funds, bonds and cash equivalents, and real estate.

Once you have identified which asset classes you will invest in, you must also determine which asset classes you will not invest in. Asset classes on this list may include those in which you do not have expertise or those in which the odds are against you. For example, most investors should probably not invest in asset classes such as foreign currencies. The foreign currency trades are controlled by large international banks, which employ hundreds of very experienced men and women with PhDs in finance. These banks have billions of dollars invested in computers and computing power as well as real-time databases to alert them immediately to economic changes that may affect currencies. The odds are not in your favor: investing in foreign currencies is known as a “zero sum game.” This means that for every winner, there must be a corresponding loser. You do not want to be that loser. Other asset classes that typically require a great deal of expertise include commodities (especially commodity futures contracts, which have very high levels of implicit debt), precious metals, and art. Be cautious of investing in these areas unless you have specific expertise to support your investment decisions.

Investment benchmarks: are hypothetical investment portfolios that show how a specific set of assets performed over a specific period of time. These portfolios can help investors evaluate how their investments are performing versus how the benchmark is performing over the same time period. Unless you have a benchmark by which you can judge your investments’ performance, you cannot know how your investments are doing. For example, if you invest in a mutual fund of

large-cap stocks and your annual return is 6 percent for 2016, how do you know if this is a good or bad return? You cannot know if you do not have anything to compare this information with. But if you know that your benchmark for large-cap stocks, the Standard and Poor's 500 Index, rose 12 percent during 2016, then you know that your investment underperformed in that year. Your investment was up 6 percent for the period versus a 12 percent return for the benchmark.

Investors select benchmarks based on asset classes, size or capitalization, geography, issuer, and investment style. Investment benchmarks are covered more thoroughly in later sections of this course.

Asset allocation is the process of determining how much you will invest in each specific asset class in your portfolio. Research has shown that the decision of how to allocate your assets is the most important factor affecting your portfolio's performance.[1] As you write this section of your Investment Plan, you should answer these questions:

- How much will you invest in each asset class?
- What percentage of your total investments will you invest in each asset class?
- What is the minimum allocation of funds you will invest in an asset class at any point in time?
- What is the maximum allocation?
- What is the target allocation?

Your target asset allocation will probably vary throughout your life. Again, the younger you are, the more likely it is that you will be willing to invest in riskier asset classes. Likewise, the older you are, the less likely it is that you will be willing to invest in riskier asset classes.

In general, the first decision you should make when determining your asset allocations is between stocks and bonds. One time-tested way to decide how much you should invest in bonds is to use your age as the percentage for the allocation. The logic behind this starting point is that the older you are, the more you should invest in bonds because bonds are less risky than other investments. The remainder of your portfolio would be allocated to equities.

The second step you should make when you are determining your asset allocations is to understand your risk tolerance. I recommend that you take a number of different risk-tolerance tests to help you decide how to make allocations in your portfolio. One example of a risk-tolerance test is found in A Risk-Tolerance Test (LT16) in the Learning Tools directory of the website. Based on the results from this test, you may either decide to increase your equity allocation above the time-tested approach if the test indicates you are an "aggressive" investor or reduce your equity allocation if the test indicates you are a "conservative" investor. The amount you increase or reduce for different allocations should be based on your individual tolerance for risk.

After you have decided on your portfolio's allocations, you should add different types of stocks and bonds to deepen your portfolio. You might add some small-cap stocks or some international stocks if you want to take on more risk. Or you might add some federal tax-free municipal bonds

or state tax-free Treasury bonds if you want to reduce the risk of your portfolio. You can then broaden your portfolio by adding additional asset classes, such as real estate, emerging markets, and inflation-linked bonds.

Once you know the asset classes you want to invest in, it is important that you decide on a minimum allocation, maximum allocation, and target allocation for each asset class. Having a set minimum allocation preserves diversity in your portfolio. Diversification is an important tool for reducing risk. Since your allocations will change over time, reaching your maximum allocation will be a signal that it is time to rebalance your portfolio back to your target allocation, which is your ideal allocation, based on your current expectations and the current market conditions.

When you are determining minimum, maximum, and target allocations, you should take into account where you want to be throughout your entire investing life. It is likely you will have to make different allocations for the different stages of your financial life cycle—for example, newly married, kids in college, retirement, and so on.

Your investment strategy describes how you will invest your money. It clarifies how you will manage, prioritize, and fund your investment; it also describes how you will evaluate new investments. The following paragraphs explain some of the questions you should answer about your investment strategy.

Will you use active management or passive management? Active management is a strategy in which you try to outperform your benchmarks by actively buying and selling stocks and bonds. This strategy requires considerable time and expense to maintain. Passive management is a strategy in which you invest in index funds, or exchange-traded funds, instead of trying to beat your benchmarks: index funds, or exchange-traded funds, simply mirror the performance of your benchmarks. This strategy is much cheaper in terms of time and costs, and it is often more tax-efficient as well.

You may also choose to use a combination of active and passive management for your portfolio. For example, you may choose to use active management for your tax-deferred accounts (these accounts do not require you to pay taxes until retirement, when you withdraw the money) and passive management for your taxable accounts (these accounts require you to pay taxes each year). Your choices will depend on your goals, your objectives, and your investment style.

Will you invest in mutual funds or individual assets? Mutual funds are professionally managed portfolios that are composed of similar assets; mutual funds offer the benefits of diversification and economies of scale. Investing in individual assets, such as stocks and bonds, allows you to control what you invest in and when you will realize capital gains. While it is much more exciting to invest in individual assets, these assets also involve much more risk and instability. You may choose to invest in a mix of assets: a combination of mutual funds and individual stocks or bonds.

Will you use leverage in your investing? Using leverage is the process of borrowing either

money or securities for your investment activities. Using leverage is not recommended. While leverage increases the potential for return on an investment, it also magnifies the potential for loss. Many investors have lost significant amounts of financial assets by using leverage. There are two types of leverage used by a few individual investors: buying on margin and short selling.

Buying on margin is borrowing to purchase a stock. The amount of borrowing you use is referred to as your "leverage." For example, you are sure the value of a stock you do not currently own will go up soon. You invest $10,000 of your own money and invest another $10,000 that you borrow from your broker—buying on margin. If the value of the stock goes up, you make a larger profit because you used leverage to invest more. However, if the value of the stock goes down, you incur a larger loss because you invested more, and you must still pay back the $10,000 you borrowed, regardless of the price of the stock. With leverage you can lose considerably more than the amount you put up of your own money.

Short selling is another type of leverage in which you borrow stock and then sell it immediately. For example, you are positive the value of a stock will go down. Before the stock goes down, you borrow a hundred shares of that stock from your broker and sell them. Again, you are borrowing, but this time you are borrowing stock instead of money. If the stock price goes down, you will be able to buy the shares back at a lower price; you make a profit by selling the borrowed shares at a higher price and buying them back at the lower price to replace the stocks you borrowed. However, if the value of the stock goes up, you will have to use your own money to buy back the more expensive shares; you must also repay any dividends paid during the period you borrowed the shares.

Using leverage is risky because you can lose much more than you originally invested. Do not take the chance. Joseph F. Smith stated the following:

> If there is anyone here intending to go into debt for speculation . . . I would advise him to hesitate, pray over it, and carefully consider it before he obligates himself by borrowing money and going into debt. In other words, keep out of debt if you can. Pay your debts as soon as you can.[2]

Funding strategy: You cannot invest without having the funds to invest, and you should not invest with borrowed money. Where will you get the funds for your investments? In a previous section, I recommended that you always pay the Lord first—that you pay tithes and other offerings before anything else—and then pay yourself a minimum of 10 percent, hopefully more (20 percent).

Most financial planners recommend that you save a minimum of 15 percent when you are young, and they recommend that this amount should increase as you get older. Once you have set aside the recommended 10–20 percent each month, invest this money wisely according to your personal Investment Plan. In this manual, I recommend that you save 20 percent of every dollar you earn after college.

How will you manage the funds for your various financial goals? One way to save for different financial goals is to set up different investment vehicles for each of your financial goals. You can use a 401(k) plan to save for retirement, a taxable account to save for your children's weddings, and 529 funds and Education IRAs to save for your children's educations. You can also set up investment accounts to save for an emergency fund, a house down payment, or a car fund. If you pay yourself at least 10 percent (hopefully more), you can divide this money among your financial goals; for example, you could allocate 5 percent to your 401(k) plan, 4 percent to your investment fund, and 1 percent to your 529 funds.

New investment strategy: How will you handle new investments? You need to decide the maximum percentage you will allocate to any new investment. Most experts advise that this amount should generally not be more than 10 percent of an investor's assets. Too often, people lose a great deal of money by putting all of their investments into one company or product that they think is a sure thing. There are no sure things. To avoid falling into this trap, decide now on the maximum amount you are willing to invest with a single investment: in other words, decide how much you would be willing to lose with a single investment.

You should also decide on the maximum amount of your company's stock that you will include in your 401(k) or other retirement account. For most people, this amount should not be more than 5 to 10 percent of the funds in their retirement account. Remember the principle of diversification. If your company does well, your job is secure and your retirement portfolio is strong. If your company does poorly, you may lose your job, and your retirement portfolio may be reduced substantially as well.

4. Portfolio Monitoring, Reevaluation, and Rebalancing

The final part of your Investment Plan is describing how you will monitor, reevaluate, and balance your portfolio. Monitor your performance. Compare the performance of each of your assets against benchmarks on a monthly, quarterly, and annual basis. How did your assets perform? Which assets had returns that were greater than their benchmarks, and which assets had returns that were less than their benchmarks?

Setting goals is not a one-time event. You should continually review and reevaluate your goals. Has your situation in life changed? Which goals need to be changed to accommodate your situation?

Finally, has your portfolio shifted away from your target asset allocations because of time or because of the performance of your assets? How will you rebalance your portfolio to regain your target allocations, while at the same time minimizing the tax effects of rebalancing? We will discuss the topic of rebalancing in more detail in later sections.

Final Thoughts on Your Investment Plan

To conclude our discussion on investment plans, I would like to offer a few final suggestions.

First, develop a good Investment Plan and stick to it. This plan is your road map to attaining your financial goals. Think it through, write it well, and follow it closely. An example of a good Investment Plan can be found in Investment Plan Example Template (LT05A). Feel free to copy this plan and personalize it based on your views of risk, return, constraints, investment policy, and portfolio monitoring and rebalancing. Instructions on filling this plan out are found in Investment Plan Example Instructions (LT5B).

Second, compare the performance of your assets to your chosen benchmarks on a monthly, quarterly, and annual basis. No one will watch your portfolio like you will.

Third, beware of following the investment crowd. It is unlikely that last year's best-performing asset classes will be this year's best-performing asset classes. In my experience with investing, I have found that winners rotate. Avoid chasing last year's winners.

Finally, remember that there are tax consequences for selling—try to minimize those tax consequences as much as possible. Beware of churning, or buying and selling too often. Rebalance your portfolio annually—perhaps even less often.

Carefully Choose your Mutual or Index Fund and Build Your Investment Portfolio

You already determined the asset classes your portfolio should contain and the appropriate benchmarks for these asset classes in previous chapters**.** Therefore, you have already completed steps one and two. This chapter will discuss steps three and four; you will learn how to determine key parameters for evaluating mutual funds of specific asset classes, and you will learn how to use a database program to set those parameters and evaluate potential candidates.

There are a number of important criteria you should consider when selecting mutual funds. Seven of the key criteria include diversification, low cost, tax-efficiency, low turnover, low levels of un-invested cash, no manager style drift, and small (or positive) tracking error.

1. Wide Diversification

Diversification is your most important defense against market risk. Select mutual funds that include many different companies in each portfolio category. Avoid investing in sector funds or industry funds, individual stocks, or concentrated portfolios of any kind until you have sufficient education, experience, and assets. Even then, keep the percentage of these assets low in relation to the amount of your overall assets.

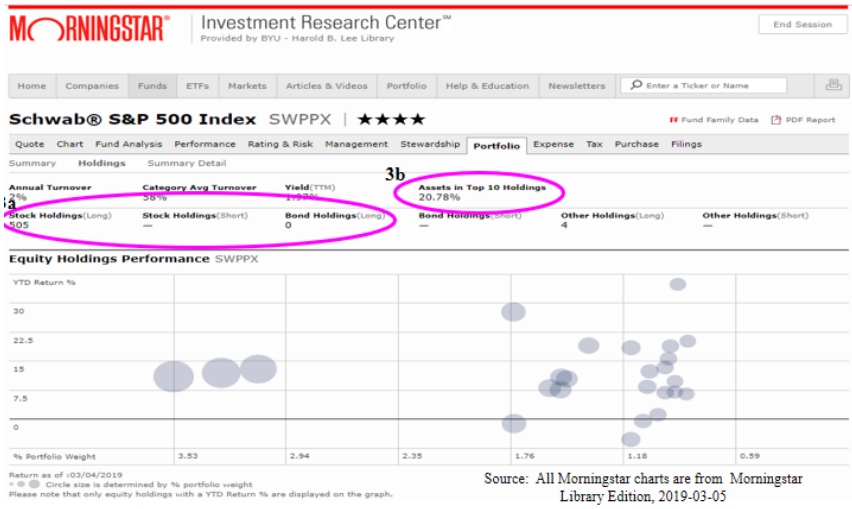
There are four main factors that determine whether a mutual fund is sufficiently diversified: numbers, concentration, types of assets, and location.

Numbers: What is the total amount of holdings, or securities, in the fund? You want to select a fund that holds many securities and industries. Check the number of holdings in the fund (see Table 1). If the fund has only 15 holdings, it is not very diversified and you should carefully

understand each of those 15 companies. If the fund has 504 holdings (as does the Vanguard 500 index fund), it is much more diversified. Since there are over 500 companies in the portfolio, and since no company is a significant portion of the portfolio, it is not as critical that you carefully understand each of the companies in the portfolio.

Concentration: What percentage of the fund is allocated to the top 10 holdings? If 50 percent or more of the fund is invested in the top 10 holdings, then the fund has a high concentration in these holdings. If only 17 percent of the fund is invested in the top 10 holdings, then the fund has a lower concentration in these holdings and your risk is most likely spread out over many companies.

Table 1. Morningstar Website: Diversification



Source: All Morningstar charts are from Morningstar Library Edition, 2019-03-05

In addition, by looking at the top 10 holdings of a mutual fund, you can see the percentage of net assets or of the value of the portfolio that the top 10 stock comprises. Generally, the lower the concentration in the top 10 holdings, the lower the risk of a problem with a single company, and the better for most investors.

Type of assets: What types of assets are in the fund? If the mutual fund is an equity fund or a bond fund, then all assets should be of the same asset class. However, if the fund is a balanced fund, an asset-allocation fund, or life-cycle fund, you should examine the percentage of the fund that is allocated to stocks, bonds, and cash. Again, the more diversified the fund is in terms of its holdings of different types of financial assets, the less volatile the fund will be.

Location: What is the location of the companies that are included in the mutual fund? The more diversified the locations, the less risk to the fund. Companies from different geographical areas are subject to different business cycles; hence, these companies should experience highs and lows at different times in the investment cycle.

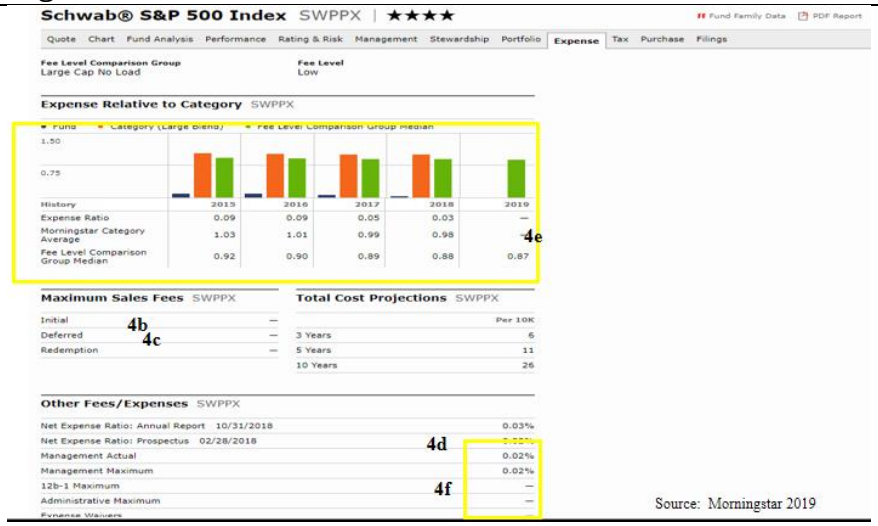
2. Low Cost

Investment returns are limited, and investment costs of all kinds reduce your returns. If you have two funds with the same return, the fund with the lower expense ratio will give you the higher actual return. Keep costs low!

I recommend you invest in low-cost, no-load (i.e., without a sales charge) mutual funds. You should rarely (if ever) pay sales charges of any kind. Because you are a long-term investor, it may be acceptable to invest in funds with back-end loads or funds with a sales charge for selling within a specific period of time, as long as that period of time is under 180 days. You should also minimize management fees as much as possible. Remember, a dollar saved is a dollar you can invest to earn more money.

Costs are explained in the mutual fund's prospectus (a document that describes all aspects of the mutual fund) in the section entitled "Fees, Management Fees, and Expenses" (see Table 2). This section details all administrative costs, management fees, 12b-1 fees, and other charges. The most important ratio listed in this section is the total expense ratio. This is the overall cost of the listed fees. Remember that the fund manager will reduce your investment by this amount every year. The lower this ratio, the more you will be able to earn for your personal goals. Note that the Vanguard Fund charges 0.16 percent a year for total expenses. Compare this to the average total expense of large-cap stocks, which is .92 percent. While you cannot change the management fee once you have invested in a fund, you can and should understand the management fee before you invest in any fund.

Table 2. Morningstar Website: Costs



If you are investing in a non-retirement investment vehicle, taxes are another important expense you should analyze. Look at the tax cost ratio in the section entitled "Returns: Tax Analysis." Too many investors fail to account for the impact taxes will have on their returns: taxes typically reduce returns by about 25 percent each year.

3. Tax Efficiency

If you are investing in a non-retirement investment vehicle, taxes are another important expense you should analyze. Look at the tax cost ratio in the section entitled "Returns: Tax Analysis." Too many investors fail to account for the impact taxes will have on their returns: taxes typically reduce returns by about 25 percent each year.

When investing in taxable funds, choose funds with an eye to obtaining high returns while keeping taxes low. Taxes reduce the amount of money you can use for personal and family goals. Watch the historical impact of taxes for the fund because it is likely to be similar in the future. Remember, it is not what you earn, but what you keep after taxes that makes you wealthy.

Your tax-adjusted return is the estimated return after the impact of taxes. There are two ratios to watch: the tax cost ratio and the potential capital gains exposure (see Table 3).

The tax cost ratio is the percent of nominal fund returns that is taxable, assuming the fund is taxed at the highest rate, and is calculated as (1 + return) * (1 – tax cost ratio) – 1. If a fund had an 8 percent return and the tax cost ratio was 2 percent, investors in the fund took home 6.00 percent, or (1.08 * .98) – 1. The potential capital gains exposure is an estimate of the percent of the fund's assets that represent capital gains. If this number is high, there is a high probability that investors may receive gains as capital gains rather than as ordinary income.

Table 3. Morningstar Website: Tax Efficiency

Schwab® S&P 500 Index SWPPX | ★★★★

Quote Chart Fund Analysis Performance Rating & Risk Management Stewardship Portfolio

Compare

Tax Analysis

	1-Mo	3-Mo	6-Mo	YTD	1-Yr	3-Yr	5-Yr	10-Yr	15-Yr	Since Inception
Pretax Return										
SWPPX	3.21	1.39	-3.07	11.46	4.63	15.20	10.58	16.57	8.26	7.61
Tax-adjusted Return *										
SWPPX	3.21	0.35	-4.06	11.46	3.56	14.41	9.86	16.00	7.71	7.07
% Rank in Category	48	44	38	48	27	15	8	11	13	–
Tax Cost Ratio										
SWPPX	–	–	–	–	1.02	0.68	0.65	0.48	0.51	–
Potential Cap Gains Exposure										
SWPPX	45.40									
(02/28/2019)										

Currency is displayed in USD.
* Post tax returns are load adjusted.

4. Low Turnover

Look for funds with low turnover. Turnover is a measure of the amount of trading activity that takes place during a given period of time; turnover is shown as a percentage of the average amount of total assets in the fund. Calculate turnover by adding the fund's sales and purchases and dividing by two. High turnover, or excessive trading, increases the amount of taxes and transaction costs you will have to pay. Many costs associated with turnover are hard to quantify and are therefore not disclosed in the prospectus. Other costs that stem from high turnover include commissions, bid-ask spreads (the difference between what buyers are willing to pay and what sellers are asking for in terms of price), and market impact costs (a jump in price that occurs when a manager tries to buy a large block of shares). Remember that each transaction generates a taxable event, and the cumulative taxes can be very expensive.

A mutual fund's turnover is described under the prospectus heading "Annual Turnover" (see Table 5). You want a mutual fund that invests long-term, consistent with the principles of good investing. The more turnover a fund has, the more the investor will spend on transaction costs and taxes (which are not included in the total expense ratio). The more costs the fund generates, the higher the fund's returns must be to offset these expenses.

You should also look at the section entitled "Potential Capital Gains Exposure in the Returns: Tax Analysis." You should avoid mutual funds that have a high potential for earning short-term capital gains because they are taxed at the highest marginal tax rate.

5. Low Un-Invested Cash Low

Un-invested cash is cash the mutual fund has not yet invested in securities. High levels of un-invested cash are drags on a mutual fund's performance. For example, if the fund's portfolio has a small percentage of large-cap stocks and a large percentage of cash, the low rate of return on the cash will dilute the higher rate of return on the large-cap stocks. Look for funds that keep the percentage of cash in their portfolios low. Some mutual funds hold large amounts of cash to fund potential redemptions or to comply with their investment policy. Choose funds that are fully invested (95 to 99 percent, depending on the asset class and fund size) in the market segment you are targeting. Do not pay the mutual fund to manage cash. While it is acceptable for open-end mutual funds to have some frictional cash, this cash should comprise less than 5 percent of the fund.

The percentage of un-invested cash in a fund is listed in the "Asset Allocation" section of the prospectus (see Table 5). Remember that the amount of un-invested cash in a fund may change over time, so monitor this amount. The Vanguard fund has 0.4 percent un-invested cash.

6. No Manager Style Drift

The law requires that mutual funds have a prospectus available for individual clients to review. This prospectus states the investment objective of the fund (whether the fund will invest in large-

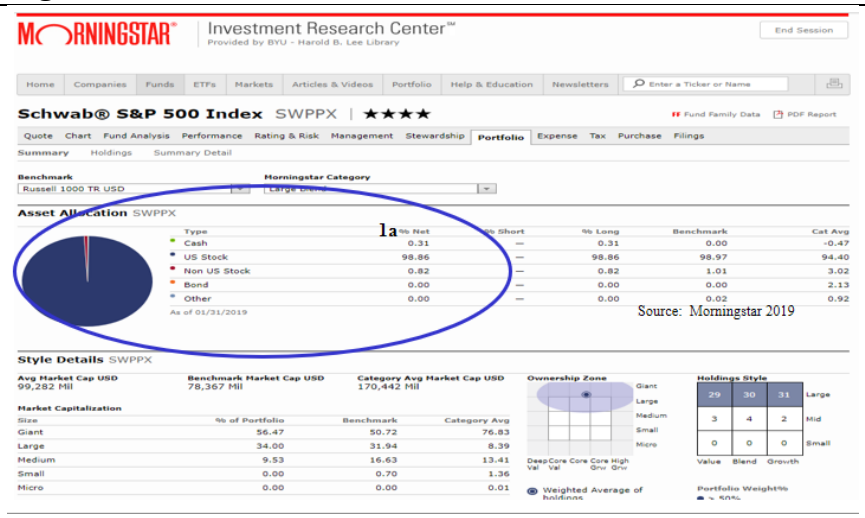
capitalization stocks, international bonds, real estate, etc.). Manager style drift relates to the fund manager's style and the types of companies the fund will buy or sell. Over time, portfolio managers may change the types of companies they choose to invest in; this change is called manager style drift. Changes in the size, geographical location, or relative valuation of the companies included in the fund can alter a manager's investment style. Since this investment style affects the performance of the fund, a portfolio manager should generally remain consistent in the types of companies he or she selects for the fund.

Table 4. Morningstar Website: Turnover

The fund's prospectus should clearly define the asset classes that will be included in the portfolio, the size of the target companies, and whether the portfolio has a growth or value tilt. A growth tilt means that the portfolio manager invests in stocks that have higher price-earnings and price-book ratios than the market and are likely to grow faster than the market. A value tilt means that the portfolio manager invests in stocks that are cheaper than the market and have lower price-earnings and price-book ratios than the market. A portfolio manager should not change the type of asset classes included in the fund. You are paying the manager to invest in the asset classes that are detailed in the prospectus, and this is what he or she should do. If you purchase a small company mutual fund, the fund manager should not purchase international or emerging market shares because these investments are not part of the fund's target asset classes. If you want exposure to these asset classes, you should invest in a mutual fund that specializes in international and emerging market shares.

The portfolio manager's investment style is described in the "Manager's Style" box in the section called "Portfolio: Style Box Details" (see Table 6). The diagram in the "Manager's Style" box lists the company valuation across the top and the company size on the side. The manager's style should not have changed over time. If you see that it has changed, find another fund where the style has remained consistent.

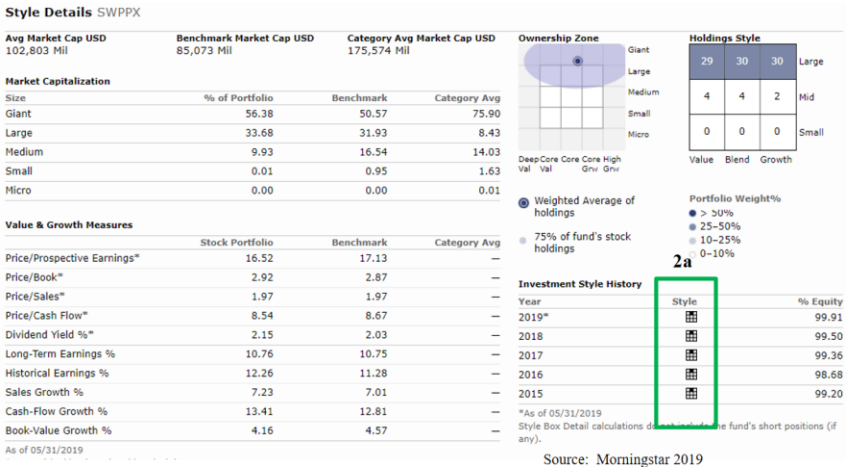
Table 5. Morningstar Website: Un-Invested Cash



7. Small (or Positive) Tracking Error

Tracking error (or trailing return, as defined by Morningstar) is the difference between the return on the fund and the return on the fund's benchmark.[3] Tracking error should be small, meaning that the fund return should be very close to the benchmark return. Generally, the smaller the tracking error, the more consistent the performance of the fund is compared to its benchmark. If the tracking error is negative, the fund has yielded lower returns than the benchmark. Most people do not complain too much if the tracking error is positive, or in other words, if the fund has yielded higher returns than the benchmark.

Table 6. Morningstar Website: Manager Style Drift



A fund's tracking error is usually listed in the prospectus section entitled "Tracking Error: Returns: Performance History" (see Table 7). You should look at three major parts of the section that deals with tracking error, "Tracking Error versus the Index," "Tracking Error versus the

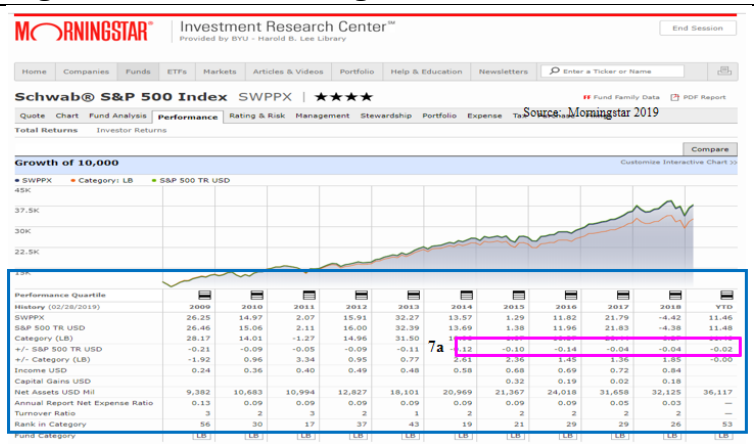
Category," and "Percent Rank in Category."

Tracking error versus the index (+/– index): This section shows the difference between the return on the fund and the return on the benchmark, or index. If tracking error is consistently small, it is likely you will consistently receive benchmark returns.

Tracking error versus the category (+/– category): Sometimes funds with similar objectives will have different benchmarks. This section combines all funds with similar objectives. This information indicates how well the fund performs in comparison with other funds in the same asset class (or category). A positive tracking error indicates that a fund has had higher-than-average returns as compared with other funds in the category.

Percent rank in category: This section shows the percentile in which a fund falls in a given category. A rank of 15 indicates that the fund is in the top 15th percentile of all funds; the lower the number, the better the performance of the fund compared to the performance of other funds in the category. Watch this percentage rank for consistency. A fund that is in the top-third of all funds year after year is a much better prospect than a fund that is the top performer one year and a mediocre performer for several years. Remember that winners rotate, and last year's best-performing fund is unlikely to be this year's best-performing fund. Consistency is a critical factor.

Table 7. Morningstar Website: Tracking Error



Using Databases to Select Funds

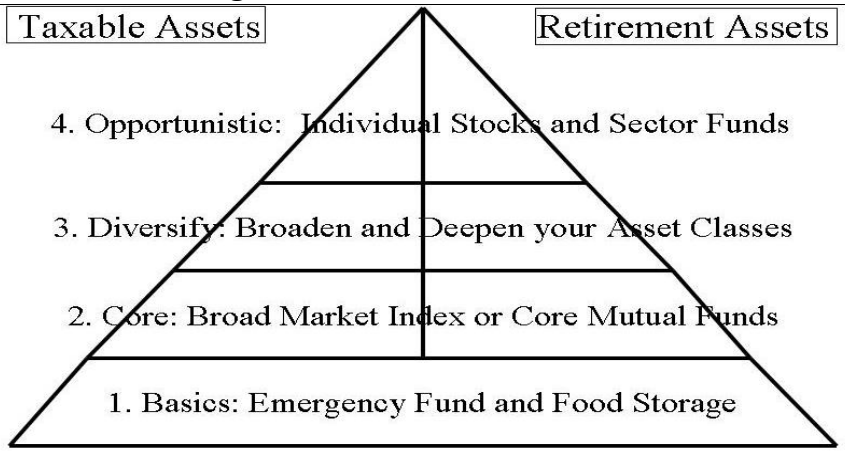
Now that you understand the parameters you should adhere to when selecting mutual funds, you can set your criteria and then use a database to get a list of all the funds that meet your criteria. For example, you can use Morningstar and Using Morningstar to Select Funds (LT07) to set your criteria for stocks, bonds, and other financial assets. To aid you in your selection, we have created a Mutual Fund Selection Worksheet (LT07B) that includes the criteria discussed and where to find it on Morningstar.

While there are many different resources for finding mutual funds, the Premium Fund Screener from Morningstar is one of the better resources. You will need to set up an account and a password. The cost of using Morningstar on the Internet is $125 per year. This service is available for free for some college students, such at BYU.

Building Your Investment Portfolio

Strategies for developing investment portfolios differ among individual portfolio managers and institutions. The strategy each investor prefers depends on the way he or she views the market; an investor's strategy also depends on his or her goals, budget, and experience in investing. It is impossible to discuss the strategies that every portfolio manager uses to build each portfolio; however, as I have reviewed successful portfolios, I have found that several critical phases of investment remain the same.

Chart 1: The Investment Hourglass Bottom



The top half of the investment hourglass detailed the steps you should take before you begin investing. Like the way we live our lives and decide on our goals, the way we invest should be based on our priorities.

The bottom of the investment hourglass contains a pattern of successful portfolios that I have seen in my experience as I have worked with students, families, and institutions (see Chart 1).

The bottom of the investment hourglass is divided into four levels, representing four phases of investment. The first level, or base, of the hourglass represents the phase in which you develop your emergency fund and food storage. I strongly recommend that you start this phase first. Generally, it is recommended that you have the larger of three to six months of income or expenses in very liquid cash or cash equivalents (i.e., savings accounts, internet savings accounts, money market mutual funds, short-term CDs, checking accounts, etc.) for your emergency fund. For information on cash management vehicles, see the chapter on Cash and Liquid Asset Management.

The second level represents the phase in which you develop your portfolio's core, or broad exposure. This level generally gives you exposure to the least risky of all the equity asset classes, mainly large-capitalization mutual funds. When you first begin investing, I strongly recommend that instead of purchasing individual stocks and bonds you follow the principles of investing discussed earlier and instead invest in low-cost, no-load index mutual funds. Doing so will give you broad diversification (I prefer a minimum of 500 securities per fund), market returns, and tax-efficient investments. For information on mutual funds, see chapter on Mutual Fund Basics.

The third level represents the phase in which you further diversify your portfolio by broadening and deepening your asset classes. If your core allocation is large-capitalization stocks, to deepen your portfolio you might include mutual funds which invest in small-capitalization or mid-capitalization stocks. If you were to broaden your asset classes, you might look to add no-load, low-cost, tax-efficient mutual funds which gave you exposure to new asset classes such as international (companies listed on stock exchanged located outside the United States), emerging markets (companies listed on stock exchanges located in the developing countries), or Real Estate Investment Trusts (portfolios of real estate investments that are developed and trade similar to mutual funds). There are many more other asset classes as well.

Finally, the fourth level represents the phase in which you develop your opportunistic assets, such as individual stocks and sector funds. Truthfully, you do not ever need to purchase individual stock or bond assets or sector funds.

Levels two, three, and four are also divided in terms of taxable assets and retirement assets. *Taxable assets* are assets on whose generated earnings you will need to pay taxes each year. *Retirement assets* are assets that you will not need until after you retire and on whose generated earnings you do not pay taxes ever or until you take the money out at retirement. The breakdown of your assets between your taxable and retirement accounts will depend on your personal goals and your available retirement vehicles.

The bottom of the investment hourglass illustrates three important principles.

First, it illustrates the importance of keeping risk in perspective. The base of the hourglass encompasses the least risky investments. As you move up the hourglass, you take on higher risk and, hopefully, higher returns.

Second, the hourglass teaches you the "how to" of investing. You should invest in lower-risk assets first and then expand your portfolio to increase its potential for greater risk and more return as the size of your assets increases.

Third, the investment hourglass separates taxable assets and retirement assets. The impact that taxes have on these two types of accounts is not the same, so retirement and taxable assets should be managed differently.

Why Index or Exchange Traded Funds

Index funds are mutual funds that hold the same proportions of specific shares as that held by a specific benchmark or index. Exchange-traded funds (ETFs) are mutual funds that are very similar to index funds, except that instead of being traded only once a day like a mutual fund, they can be purchased and sold at any time the market in which they trade is open. The goal of index funds and ETFs is to match the benchmark performance of a specific asset class. There are nearly 1,000 different index funds and over 500 different ETFs, and they all follow different indices or benchmarks related to geography, maturity, capitalization, and style.

Index funds and ETFs were created because some investors were concerned that actively managed funds were not always able to beat benchmarks after the effects of fees, taxes, and other expenses. By purchasing an index fund, investors stop trying to beat the benchmark: instead, they accept the benchmark's return and risk. Interestingly, index funds have tended to outperform most actively managed mutual funds over the long term.

ETFs were created because index funds trade only once per day at the fund's ending net asset value. Some investors wanted to trade index funds throughout the day. In addition, although the management fees on index funds were low, some people thought they should be even lower. Hence, many ETFs have lower management fees than many index funds. However, since ETFs trade on a market just like a stock, investors in ETFs need to factor in the additional cost of buying and selling the shares into the total cost calculation.

Active management tends to hurt a mutual fund's performance because excessive trading generates taxes and fees. Actively managed funds also have much higher management fees than index funds. (The average index fund charges 18 basis points, while the average actively managed mutual fund charges 80 to 200 basis points).

Index funds and ETFs use a passive investing strategy that requires very little time to maintain. Passive investment does not require you to know much about valuation, security analysis, or other company-specific information. You just need to be willing to accept the general market return for the asset classes included in your index fund or ETF. Although returns on index funds vary from year to year (just as returns on benchmarks vary from year to year), they still yield a consistent, respectable return. Jason Zweig, a senior writer for *Money* magazine, said the following about index funds:

> With an index fund, you are on permanent auto-pilot: you will always get what the market is willing to give, no more and no less. By enabling me to say "I don't know, and I don't care," my index fund has liberated me from the feeling that I need to forecast what the market is about to do. That gives me more time and mental energy for the important things in life, like playing with my kids and working in my garden.[4]

Index funds have become the standard against which other mutual funds are judged. If an actively managed mutual fund cannot perform better (after taxes and fees) than an index fund (index funds are very tax-efficient), then investors should lean toward purchasing the index fund. Warren Buffet wrote the following in 1993, and I believe his statement still applies today, "By

periodically investing in an index fund, the know-nothing investor can actually outperform most investment professionals. Paradoxically, when "dumb" money acknowledges its limitations, it ceases to be dumb."[5] He also said, "Doing reasonably well investing in stocks is very, very easy. Buy an index fund, preferably over time, so you end up owing good businesses at a reasonable average price. If you own a cross-section of American businesses, you are going to do well."[6]

In addition, the amount of time necessary to invest in index funds and ETFs is significantly less than the time needed to analyze, evaluate, value, and purchase individual stocks. In general, most actively managed funds and brokerage accounts tend to under-perform index funds in the long run after all taxes, costs, and fees. Invest accordingly.

The competition in stock-market research is intense and will get more competitive in the future. This will help make markets more efficient and indexing even more attractive. Market indexing or "passive investing" is a free ride on the competition; it takes very little time and contributes to a "sleep-well" portfolio.

Many dislike indexing because passive investing is boring, selecting stocks can be intellectually challenging, sharing investment "war" stories with friends is fun, and doing "nothing" about your investments is unnerving. Reasons to use index funds include immediate diversification, generally superior long-run performance, tax-efficient strategy, and time efficiency, which allows you to spend more time on the things that are important to you, such as family and friends, helping others, and doing well at work, instead of spending time analyzing individual companies.

Select Assets Wisely, Rebalance Tax-efficiently, and Hold your Assets 40 Years

Once you have done your research and have completed your Investment Plan, the process to pick YOUR mutual funds is simply:

1. Determine the asset classes needed for your Plan and choose the appropriate benchmarks. This you have already done.

2. Determine what makes a good mutual fund and which asset classes you need exposure. You have determined your criteria and know what makes a good mutual fund.

3. Using a database program (we use Morningstar in the class), set those criteria and evaluate each of the potential mutual funds.

4. Select the best mutual funds using Using Morningstar to Select Funds (LT07) and Mutual Fund Selection Worksheet (LT07B) (with hints on the "Filled in" tab).

5. Now put your Investment Plan together.

Assume your asset class was Large Cap, and you choose SWPPX for your fund. What next?

1. Go to Morningstar, and type the ticker "SWPPX" in upper right box

- Where it says PDF Report (if available), print off this report. If there is no PDF Report, just print off the entire "Quote" Page. Include these in your Investment Plan as Exhibit III. Fund Support Exhibits. If you need help, see Mutual Fund Selection Worksheet (LT7B), Filled In for possible fund ideas and tickers

2. Download the Investment Process Spreadsheet (LT13)

- For most, the first 4-10 asset tab will be sufficient.
- Put in your Salary and emergency fund goal and percentage.
- It will automatically determine your target portfolio fund size (your emergency fund amount divided by your bonds/cash percentage).
- Assuming a salary of $60,000 and a 25% allocation to bonds and cash. Your target portfolio size would be $100,000.

3. Add data to the Investment Process Spreadsheet (LT13)

- Put in your asset classes and benchmarks, and percentages in Panel I. Use the dropdown boxes for asset classes and benchmarks
- Then put in the tickers and Fund names

4. Print off all your Exhibits

Print off your filled in Exhibit I. Expected Return Simulation and Benchmarks (LT27)

- Print off your filled in Exhibit II. Investment Process Spreadsheet (LT13)
- Print off Exhibit III. Mutual Fund Pages from Morningstar. There should be a minimum of 4 funds from 4 different asset classes
- Include these with your completed and filled in Investment Plan and you should be good.

Rebalancing Tax-efficiently

Portfolio rebalancing is the process of buying and selling assets to align your portfolio with the target asset-allocation percentages you determined in your Investment Plan. Over time, a portfolio can become unbalanced, or different from your target asset allocations, due to changes in asset and asset class performance, changes in your personal objectives or risk-tolerance level, and the introduction of new capital or new asset classes that you consider attractive.

It is important to rebalance your portfolio to ensure you continue moving toward your personal goals at an acceptable level of risk. The challenge of rebalancing is that each time you sell a security, you incur transaction costs; if the account is taxable, you also create a taxable event.

Portfolio Rebalancing Strategies

There are many different strategies for rebalancing a portfolio. In this chapter we will discuss two strategies: periodic-based rebalancing and percent-range rebalancing.

In **periodic-based rebalancing** (also called calendar-based rebalancing), you must decide how often you will rebalance your portfolio—monthly, quarterly, or annually. After each designated period of time, you will rebalance your portfolio to make it consistent with the target asset-allocation percentages listed in your Investment Plan. Allowing longer periods of time to pass between each rebalancing entails lower transaction costs but higher tracking error (the difference between the return you actually receive and the return you would have received if your portfolio had been at its target asset allocations).

The advantage of periodic-based rebalancing is that it is a simple method. The disadvantage is that it does not account for current market performance, which influences overall portfolio performance.

In **percent-range rebalancing** (also called volatility-based rebalancing), you rebalance your portfolio every time the portfolio's target asset-allocation percentages stray a predetermined percentage from your target percentages (e.g., plus or minus five percent). A higher percentage will reduce transaction costs but raise tracking error, while a smaller percentage will reduce tracking error but raise transaction costs.

The advantage of this method is that it is easy to implement because asset performance will indicate when you should rebalance. The disadvantages include that it is difficult to set an ideal range and that assets with higher target percentages and more volatility will have to be rebalanced more often than assets with lower target percentages and less volatility.

New money/donations (NMD) addendum: Regardless of which rebalancing strategy you use, I recommend you also consider using an NMD addendum. Since most of you pay yourselves monthly, donate to charities on a monthly basis, and use caution in your selection of assets, you are in a strong position to combine the aforementioned strategies with an NMD strategy.

An NMD addendum may be used when the following situation applies: in the process of rebalancing, you may find that you need to sell assets on which you have large capital gains. If this is the case, you may want to use the NDM addendum to donate the appreciated asset instead of selling the asset and paying taxes on the capital gains.

You can donate appreciated assets to churches and other qualified charities tax free. For members of the Church of Jesus Christ of Latter-day Saints, you can donate to tithing, fast offerings, missionary fund donations, and almost any other type of donation listed on the ward donation slips. This may be the same for other churches as well. The "donation-in-kind" of an appreciated asset can take the place of your tithing, fast offerings, or other charitable contributions. Then, since you have paid your tithes and offerings through donated securities, you can use the cash you would have paid for your contributions to buy securities to rebalance your portfolio back to your asset-allocation target percentages. (For more information on how to

donate appreciated assets to the Church of Jesus Christ of Latter-day Saints, please see the website at ChurchofJesusChrist.org.) Within about four to six weeks of donating an asset to the Church, you will receive a donation-in-kind receipt (see Tithing Share Transfer Example (LT08)). Keep this receipt as well as a copy of the *Wall Street Journal* to verify the value of the assets on the day you made your donation. You can then use these two documents to report a charitable donation on your tax return next year.

The key to rebalancing is minimizing market impact, transaction costs, and taxes due. By donating assets "in-kind," you eliminate capital gains taxes on your donated assets, minimize transaction costs and market-impact costs, contribute to a reputable charity (the charity must be a 501(c)(3) organization), and get a tax deduction.

Which rebalancing method is best? For most people, the strategy that is easiest for them will likely be the strategy that is most useful for them. A combination of periodic-based rebalancing and percent-range rebalancing usually works well, especially for smaller portfolios. These strategies can also be combined with the new money/donations addendum to minimize tax implications.

Hold Assets for 40 Years

As you choose good mutual or index funds, and rebalance tax-efficiently, the final point is to hold them for 40 years. The purpose here is two-fold. First, it is to encourage you not to buy and sell on every hiccup of the market. Fortunes are lost on transactions costs for those who buy and sell a lot. Second, if you take a buy and hold strategy, you will be paying much less taxes on your transactions. Finally, as you hold your assets for a long-time, particularly index funds that offer exposure to your various asset classes, you will enjoy to power of the market to help you achieve your personal and family goals.

Summary

We took a risk tolerance test which helped you to understand which type of an investor you are: very conservative, conservative, moderate, aggressive, and very aggressive. This test had two purposes: to help you understand what type of investor you are and to help you understand a recommendation for your asset allocation, how risk is brought into your portfolio. The riskier the assets in your portfolio, the riskier the portfolio.

We then, based on your age and risk tolerance, helped you to determine your risk tolerance. We also shared how different people with different ages and risk tolerance can have similar portfolios.

We shared how you put together an Investment Plan that details how you will invest, your objectives, constraints, strategies and evaluation. Those who carefully put together their investment plan will find a greater ability to weather the ups and downs of the market.

We discussed how you build an investment portfolio using the bottom of the investment hourglass. As you begin to save and invest, review the bottom of the investment hourglass. Start with the basics: build your emergency fund and food storage, then work up the pyramid. As you go up the pyramid, you will be adding risk to your portfolio. When you build your portfolio, it is critical that you take risk into account.

We discussed how you select financial assets for your portfolio. We discussed why it is a poor idea to buy individual stocks and bonds initially, especially when your portfolio is less than a $500,000. Easier and wiser investments would be no-load, low-cost index and mutual funds which offer immediate diversification, low cost, low taxes, and generally good performance.

We finished with some final cautions. Don't go into debt to invest. This includes borrowing against your home equity, buying on margin, or selling short. Don't move assets from one vehicle to another, i.e., take money from your 401(k) to buy a cash value insurance policy. Be careful of people selling assets—make sure they are licensed and the products are registered. If it sounds too good to be true, it likely is.

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[1] Robert G. Ibbotson and Paul D. Kaplan, "Does Asset Allocation Policy Explain 40, 90 or 100 Percent of Performance?", *Financial Analyst Journal*, Jan./Feb. 2000, 2633.
[2] Conference Report, Oct. 1911, 128–29
[3] http://library.morningstar.com/Education/MLE_Glossary_T_Z.html#TrailingReturnCategory
[4] "Indexing Lets You Say Those Magic Words," *CNN Money*, Aug. 29, 2001.
[5] *Letter to Berkshire Hathaway Shareholders.*
[6] "Warren Buffet: Top 3 Investment mistakes to Avoid," USA Today, October 26, 2013.

20. Your Future 1: Learning to Give

Introduction

We have spent a significant amount of time together during this course working on your vision and goals and learning about budgets, credit, debt, insurance, investing, retirement, and other important subjects. These topics are critical to self-reliance and getting our financial houses in order. However, there are two more important areas we have not yet discussed. These topics are often left out of traditional personal finance courses, but they are critical to a complete study on personal finance. The last two chapters in this manual discuss learning to give and deciding to decide.

Why should we learn about finance (we talked about this the first day of class)? This is an important questions as you can only manage your finances in one of two ways:

- With an eternal perspective, which says that everything is the Lord's and that we are stewards over these resources to bless His children, or
- With the world's perspective, which is any other way.

How we answer this question will have a big impact on what we do with our lives and resources

Objectives

When you have completed this chapter, you should be able to do the following:

A. Understand giving and the myths and realities of giving
B. Understand the principles of wise giving
C. Understand how to give effectively
D. Understand how to create your individual/family giving plan.

Understand Giving and the Myths and Realities of Giving

We all wrestle with learning to give. A good starting point is defining "giving." We can take a number of perspectives here, as usual. From a narrow (i.e., temporal) perspective, some may say it is sharing what they have with others. But where did they get it? Where did they get the intelligence to get it? Who gives them their breath to work for it to get it? Who gave them their bodies that they could use for it?

From our broader (i.e., eternal) perspective, it is the sharing of the things we have been given by God with our families and our fellow men. It is sharing God's gifts with others.

Some have wondered if giving was inherited or learned. The Lord through the prophet Joseph said: "See that ye love one another; cease to be covetous; learn to impart one to another as the gospel requires."[1]

Elder Mark E. Petersen said: "Instead of taking from our fellowmen, we must learn to give—to be good Samaritans in very deed; to share with our less fortunate neighbors, and in reality show love for our fellowmen."[2]

Some have wondered whether giving was expected or required. The Lord has said: "For of him unto whom much is given, much is required"[3] and "For unto whomsoever much is given, of him shall be much required."[4] "But behold, they have not learned to be obedient to the things which I required at their hands, but are full of all manner of evil, and do not impart of their substance, as becometh saints, to the poor and afflicted among them."[5]

This chapter will discuss our covenantal obligations to share with others. It has been said, "We make a living by what we get, but we build a life by what we give."[6] Any discussion on giving takes us back to the first chapter of this course, where we discussed the key doctrines and principles of personal finance. Those principles were ownership, stewardship, agency and accountability.

Once we understand these principles, giving becomes easier. I also find comfort in the scripture "See that ye love one another; cease to be covetous; learn to impart one to another as the gospel requires."[7] We are not born as givers; rather, we learn to give as we become more committed Christians. We also come to understand that giving is not a one-time event but a Christ-like attribute. Mark E. Petersen wrote:

> Instead of taking *from* our fellowmen, we must learn to *give*—to be good Samaritans in very deed; to share with our less fortunate neighbors, and in reality show love for our fellowmen. So He said, "Remember the poor, and consecrate of thy properties for their support . . . And inasmuch as ye impart of your substance unto the poor, ye will do it unto me."[8]

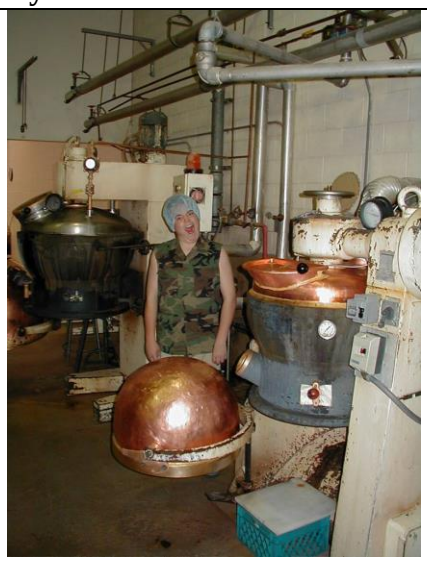
An Illustration

A while ago I took the some young men from Church to the Peppermint Place in Alpine, Utah. The owner of the store, Taz Murray, is a good friend and colleague of mine. Taz invited us to bring the young men aged 12–18 to his store so he could spend time talking with the young men about careers, potential jobs, and other topics, including marketing, finance, production, and human resources (see Picture 1).

Taz gave the young men instructions to put on their hairnets and shoe mitts to protect the production floor and products and took them to the various parts of the factory: the candy heaters (see Picture 2), the cutting machines, the drying racks (see Picture 3), and the packing tables (see Picture 4).

Picture 1. Introduction to Candy Making

Picture 2. Candy Heaters



The highlight of the trip came when Taz showed the young men the retail side of the candy store (see Pictures 5 and 6). Here he gave them instructions about what they should and should not do. He said the young men could eat any candy he made in his factory. Any candy or related products that he did not make in his factory were off-limits because he had to purchase them. Then he gave each of the young men a bag and said, “Fill them up.” He warned the youth that if they put things in their bags that were off-limits, they would be escorted outside until the other youth were done.

The youth had a great time. They were so excited. They filled their bags with gumdrops, chocolate-covered nuts and raisins, gumballs, gummy candies, and suckers (see Picture 7).

Picture 3 The Drying Rack

Picture 4. The Packing Tables

Picture 5. The Candy Store

As I have thought about the subject of giving, I have decided that life is like Taz Murray's candy store. We each fill our own bags—our lives—with the experiences we have while here on earth. We have been given instructions by Heavenly Father as to what is good and what is bad, the commandments. If we choose wisely, we will be able to enjoy the good things in life. If we fail to choose wisely, we must reap the consequences of our actions. Interestingly, the more we share with others, the greater our joy will be later on.

Myths and Realities of Giving

There are five myths of giving that need to be recognized:

Myth 1. Giving Makes Us Poorer. While people who give to others may initially have less financially, giving really makes them richer in the long term. Givers are happier. Research has shown that happy people make more money, have better marriages, and contribute more to society. Givers are also healthier. Research has shown that when people are happier, they put less stress on their bodies and hence tend to live longer. Finally, leaders give. Research has shown that those who give are perceived to be leaders by those who observe.[9]

Myth 2. People Are Naturally Selfish. Selfishness is a learned behavior. Arthur Brooks said, "People are selfish, it's true, but they're not naturally selfish; people are unnaturally selfish. When we are our best selves, when we are in equilibrium, when we are where we're supposed to

be cognitively, neuro-chemically, and spiritually, then we are giving people."[3]

Picture 6. Youth Helping Themselves in the Candy Store

Picture 7. Youth in the Candy Store

Myth 3. Giving Is a Luxury. Giving is not a luxury. Brooks also said "[Giving is] a necessity—the first 10 percent, not the last 10 percent. And the reason is that if we want to be better, we have to give."[3]

As Christians, we have been commanded to give, yet we know it is something we need to learn. "Every man shall give as he is able, according to the blessing of the Lord thy God which he hath given thee."[10]

Myth 4. If the Government would do its job correctly, We would not need to give. The purpose of giving is not just to help those in need, it is also to help us. We need to give as much as others need to receive. Remember the words of Mosiah, "When ye are in the service of your fellow beings, ye only in the service of your God."[11]

Brooks said, "The day the government takes over for you in your private charity is the day we become poorer, unhappier, and unhealthier. We must demand to take our place as givers and support the communities and people who need the services we can provide."[3]

Myth 5. You Must Have Money to Give. Giving doesn't depend on the checkbook but on the heart. What you do is more important than what you have. I believe that if you don't learn to give when you are poor, it will be very difficult for you to give when you are rich.

While the myths are many and varied, the realities are far different.

Reality 1. We have been commanded to give. The prophet Jacob taught: "Think of your brethren like unto yourselves, and be familiar with all and free with your substance."[12]

Reality 2. Givers make more money. Research has shown when comparing similar people, ages, family size, religion, race, etc., giver's make more money than non-givers (and that is statistically attributable to the gift). People who do volunteer work to better financially than non-volunteers. Even those who give blood do better than non-givers.[13]

Reality 3. Giving shows our Love for God. King Benjamin stated: "And behold, I tell you these things that ye may learn wisdom; that ye may learn that when ye are in the service of your fellow beings ye are only in the service of your God."[14]

Sister Carol B. Thomas commented: "Sacrifice is an amazing principle. As we willingly give our time and talents and all that we possess, it becomes one of our truest forms of worship. It can develop within us a profound love for each other and our Savior, Jesus Christ."[15]

Reality 4. Giving helps others. King Benjamin further counseled: "But ye will teach them to walk in the ways of truth and soberness; ye will teach them to love one another, and to serve one another. And also, ye yourselves will succor those that stand in need of your succor; ye will administer of your substance unto him that standeth in need."[16]

Reality 5. Giving helps us change to become more like Christ! Marion G. Romney taught: "The Lord doesn't really need us to take care of the poor, but we need this experience; for it is only through our learning how to take care of each other that we develop within us the Christ-like love and disposition necessary to qualify us to return to his presence."[17]

Reality 6. Giving helps us repay an un-payable debt. There is one final debt, a debt we can never repay. And while we can never repay the debt, we can try.

> I say unto you, my brethren, that if you should render all the thanks and praise which your whole soul has power to possess, to that God who has created you. . . I say unto you that if ye should serve him who has created you from the beginning, and is preserving you from day to day, by lending you breath. . .I say, if ye should serve him with all your whole souls yet ye would be unprofitable servants.[18]

Our recommendations for giving include:

- Be a Christian in word and deed
- Be a diligent full tithe-payer
- Be generous with fast offerings
- Be generous with other offerings
- Be generous by contributing to missionary work
- Be generous by blessing the poor with your help
- Look for other ways to share your resources and bless God's children
- Share your resources anonymously with friends
- Share yourself along with your resources
- Bless your family/extended family with resources

Understand the Principles of Wise Giving

There is a different type of accounting done in heaven—not an accounting of dollars and cents, but an accounting of our capacity and willingness to give. Lynn G. Robbins said, "The truer measure of sacrifice is not so much what one gives to sacrifice as what one sacrifices to give."[19]

The following are a few principles we should remember as we give:

- **1. Understand Yourself, Your Vision, Goals and budget.** What is your vision for giving? What would you like to accomplish? Make sure what you are planning to do is in the best long-term interest of those you love, and that you take care of your own needs first. What are your resources? We cannot become like our Savior without giving. "Inasmuch as you have done it unto one of the least of my brethren, ye have done it unto me."[20]

2. Seek, receive and act on the Spirit's guidance. This includes seeking diligently through study and prayer, living worthy of the Spirit's guidance, and then acting on it once it is received. God know things we do not. As we seek the Spirit diligently through study and prayer, live worthy of the Spirit's guidance, and then act on it once it is received, we will be the most effective in our giving. For behold, again I say unto you

that if ye will enter in by the way, and receive the Holy Ghost, it will show unto you all things what ye should do."[21]

3. We Are to Give Out of Love. We must give to those in need because we have a concern for their well-being and happiness. We should not give out of pride because we have abundance. We are to give out of gratitude for all God has done for us. Paul said, "And though I give all my goods to feed the poor, and though I give my body to be burned, if I have not love, it profits me nothing."[22]

4. We Are to Give Sacrificially. Joseph Smith taught, "A religion that does not require the sacrifice of all things never has power sufficient to produce the faith necessary unto life and salvation."[23] Giving should be a sacrifice where our pocketbooks show where our hearts really are.

C. S. Lewis wrote: "If our charities do not at all pinch or hamper us, … they are too small. There ought to be things we should like to do and cannot do because our charitable expenditure excludes them."[24]

5. We Are to Give Wisely. We are to give wisely and within our capacity. King Benjamin gave the following counsel:

> And again, I say unto the poor, ye who have not and yet have sufficient, that ye remain from day to day; I mean all you who deny the beggar, because ye have not; I would that ye say in your hearts that: I give not because I have not, but if I had I would give. And see that all these things are done in wisdom and order; for it is not requisite that a man should run faster than he has strength. And again, it is expedient that he should be diligent, that thereby he might win the prize; therefore, all things must be done in order.[25]

6. We Are to Give of Our Abundance. As mentioned earlier, there is a different type of accounting done in heaven. Luke records:

> And he [Christ] looked up, and saw the rich men casting their gifts into the treasury. And he also saw a certain poor widow casting in thither two mites. And he said, Of a truth I say unto you, that this poor widow hath cast in more than they all: For all these have of their abundance cast in unto the offerings of God: but she of her penury hath cast in all the living that she had.[26]

Robert D. Hales stated, "You have received much in your life; go forth and freely give in the service of our Lord and Savior. Have faith; the Lord knows where you are needed. The need is so great, brothers and sisters, and the laborers are so few."[27]

7. We Are to Give Freely According to What We Have Been Given. We are to give of our own free will. Alma counseled:

> The people of the church should impart of their substance, every one according to that which he had; if he have more abundantly he should impart more abundantly; and of him that had but little, but little should be required; and to him that had not should be given. And thus they should impart of their substance of their own free will and good desires towards God, and to those priests that stood in need, yea, and to every needy, naked soul.[28]

Finding Balance

As you work on giving, finding balance among doctrines, principles and application is important in helping you become better at giving. We have shared some ideas for principles, although I am sure you can find others that are important to you. Below are a few ideas for doctrines on which the principles are based. As you strive to increase your ability and effectiveness in giving, in addition to what you are learning, I recommend you study and ponder the doctrines and principles supporting giving.

Principles	Doctrines
Know yourself, your vision and goals	Identity
We should give as the Spirit directs	Obedience
We are to give out of love	Agency
We are to give sacrificially	Accountability
We are to give wisely	Gratitude/Agency
We are to give of abundance	Stewardship
We are to give freely	Stewardship

From Obedience to Consecration

Giving is not an activity to be checked off as part of a daily checklist; rather, it is part of a Christ-centered life. The key is what we become. As such, we are not just giving to help others; rather,

> We are children of Christ (identity), living worthy of the Spirit (obedience), using the blessings that God has shared with us wisely (stewardship) to take care of our spouses and family (stewardship and accountability). Then using of our abundance, we help build the kingdom of God (Plan of Salvation) through loving, serving and helping our fellowman (accountability), to accomplish our personal missions and our individual and family vision and goals.

Understand How to give Effectively

To give effectively, we should follow correct principles. Principles I follow when choosing a charity are as follows:

- They help in harmony with my personal vision, goals and values.
- They help people both locally and worldwide and make the world a better place.

- They are effective in their use of "the widow's mite." These charities will make wise use of my funds and make sure most funds go to the recipients, not marketing and administrative expenses.

Outlining principles to follow when selecting a charity will help you ensure that you are making effective and wise donations.

I remember as a young college student, recently returned from a mission, teaching a lesson in church on the subject of fast offerings. Spencer W. Kimball said.

> Sometimes we have been a bit penurious (stingy) and figured that we had for breakfast one egg and that cost so many cents and then we give that to the Lord. I think that when we are affluent … we should be very generous and give, instead of the amount we saved by our two meals of fasting, perhaps much, much more—ten times more where we are in a position to do it. I know there are some who couldn't."[29]

When we consider charitable giving as a percent of income, we see some surprising data. The following statistics from 1991 depict the average amount individuals gave to charity, according to salary brackets:

> Individuals earning $20,000 to 30,000 gave $1,207, or 4.8 percent.
> Individuals earning $30,000 to 40,000 gave $1,318, or 3.8 percent.
> Individuals earning $50,000 to 100,000 gave $1,837, or 2.5 percent.

Why did those who earned more money give half as much (in percentage terms) as those who made less? Why should our giving decrease as our blessings increase? Although the data is old, the trend has not changed much in the succeeding years.

The decision as to how much we should give should be made individually or as a family. C. S. Lewis made an interesting comment on this subject:

> I am afraid the only safe rule is to give more than we can spare . . . If our charities do not at all pinch or hamper us . . . they are too small. There ought to be things we should like to do and cannot do because our charitable expenditure excludes them.[30]

I thought "ten times nothing is still nothing" and decided to give 10 times the cost of that day's meals. Later, when I got married, my wife and I decided to give fast and other offerings as a percentage of our income. I later went back, and found that the percentage we chose to give was the same percentage I had chosen while in college.

Since then, what has been helpful to my family has been the habit of giving in percentage terms rather than in dollar terms when trying to determine the amount we should give. For many people, paying tithing is easy but making other contributions is much harder. If you put your contributions in percentage terms, God will know that regardless of how great or how small your

financial blessings, the amount you give will always be the same. Remember, do not let your giving decline as your income increases. The amount you are able to give should increase over time. Gordon B. Hinckley commented:

> You know, as I know, that when you pay your honest tithes and offerings, the windows of heaven are opened and blessings are showered down upon you. That which you give is never missed; it becomes not a sacrifice but an investment under the wondrous powers of the Almighty to bless you.[31]

My Personal Priorities

Although there are many wonderful charities, the last part of this chapter is an overview of my personal giving priorities. Please note that since I am a member of the Church of Jesus Christ of Latter-day Saints, my giving tends toward this organization. Your giving will likely be the same and will largely be directed toward your church or synagogue. This list is not all inclusive, but it is provided as a good place to start.

1. Tithing. Tithing is my first priority. Tithing is a debt of thankfulness for all that the Lord has given me. God has given me everything—He is my most important creditor.

I firmly believe in the blessings of paying an honest tithe. Doctrine and Covenants teaches us the following, "Behold, now it is called today until the coming of the Son of Man, and verily it is a day of sacrifice, and a day for the tithing of my people; for he that is tithed shall not be burned at his coming."[32]

To me, tithing is not a sacrifice: it is an investment. As it has been humorously pointed out, "the returns are out of this world."

2. Fast Offerings. Fast offerings are offerings given from the practice of fasting for 24 hours once each month and giving the money you would have paid for food to the Church to care for those in need. Fast offering is my second giving priority. I believe that fast offerings are a form of payment for the blessing of living on this earth. Paying these offerings is a covenantal obligation I made of my own free will and choice. Marion G. Romney made the following statement:

> Caring for the poor is a covenantal obligation. It follows, then, that we look after our poor and distressed not only because it is convenient, or exciting, or socially acceptable; we should do it first and foremost in fulfillment of our covenant with the Lord that we will do so.[33]

The Lord said, "And behold, thou wilt remember the poor, and consecrate of thy properties for their support that which thou hast to impart unto them, with a covenant and a deed which cannot be broken."[34]

Remember, at some point in the future, we will be accountable to Heavenly Father and

Jesus Christ regarding the way we have used our financial resources.

3. Latter-day Saint Charities (Humanitarian Services/Perpetual Education Fund). Latter-day Saint Charities helps with humanitarian aid throughout the world, regardless of the recipient's religious orientation. They are among the first to help with natural and other disaster aid. The Perpetual Education Fund gives very low-cost loans to individuals to help with education expenses. With Latter-day Saint Charities and the Perpetual Education Fund (PEF), every penny of every dollar you give goes to those in need. Latter-day Saint Charities gives to everyone, whether they are Church members or not, and the PEF gives to returned missionaries from other countries to help them gain an education.

4. Ward, Stake, and Church-Wide Missionary Funds. I believe the Lord helps those who help missionaries who preach His gospel. I have found that when I am trying to help in the service of the Lord, through both personal, family, and financial efforts, not only are others' lives blessed but my life and the lives of my family are blessed as well.

5. Deseret Industries, Goodwill, and the Salvation Army. What better way is there to get rid of belongings that are still good than to allow someone else to use them? Give the best you have to offer to help the Lord's poor.

6. Other Charities. Other good charities include college annual funds, university scholarships, Boy Scouts of America, United Way, and Habitat for Humanity.

Understand and Create Your Giving Plan

As a final part of this class and textbook on personal finance, I recommend we all put together an individual or family Giving Plan. We have plans for insurance, budgets, investing, retirement, and estate planning, should we not also include plans for how we will give back and make the world a better place?

As you put together your Giving Plan, I would hope you would think through how you will give, both institutionally, which is through your Church and other institutional contributions, as well as personally, which entails more direct personal and family contributions and service. I believe both types of giving are important. As a final part of this plan, think through how you intend to teach your children to give, for your children learn from you, and unless you teach them, it may be difficult for them to learn.

Giving is an intensely personal act. As such, it is not reported to me nor handed in, but I do recommend that you develop your Giving Plan individually and with your spouse if married. Build it consistent with your Vision, Mission, and Values statement. Make it meaningful, because next to what we do with our families, this will likely be one of the most meaningful things we will do over our lifetime.

As you put it together, visualize how you will feel at the end of your life as you accomplish the things you are planning. Is this truly what you want to do? Then make this Plan part of your personal and family goals, and work toward them as hard as you do your other goals.

As I think of giving, I think of both institutional (or indirect) and personal/individual (or direct) giving.

Institutional giving is giving through Church, through organizations set up to do good, and to help and serve in times of emergency and need. It is indirect giving, but giving none-the-less. This giving to me is giving of tithes, fast and other offerings, supporting missionaries, supporting 501(c)(3) organizations, helping financially in emergency situations, and helping financially with local food kitchens and other good causes.

Personal giving is giving directly to those in need, which includes personal and family contributions and service. This includes helping families in need, helping my friends, helping at Christmas time with Christmas giving, quarterly family service projects, helping at soup kitchens and other food drives, donating time at local genealogy libraries to find ancestors, participating in Church pageants and other faith-building activities, and providing service in local congregations and scout troops to help youth.

As you notice, it is important that we give both institutionally and personally. I like to think that whereas most goals are what you want to accomplish, giving is what you want to give back. I recommend you talk this over with your spouse and children. Help get them engaged and involved in the things you are doing to give back. Try to make this Giving Plan the culmination of your Personal Finance Plan. Use it to tie in your goals and values with your actions and efforts you are willing to give. Then finally, include in it how you will teach your children to give.

Institutional Giving Examples. Following are a few ideas shared by other students and faculty on institutional giving.

- We will pay our tithing of 10%, with additional contributions to Fast Offering of _% and the Ward Missionary Fund of _%.
- We will help support our own children as missionaries and will set apart $___ each year to help other missionaries not as fortunate.
- We will give blood twice a year.
- We will go on a senior mission at age 65.
- We will participate in the _____ Pageant if and when accepted. We will apply every other year.
- We will work at the Genealogy Library or do indexing for two hours each week.

Personal Giving Examples. Following are a few ideas for personal giving.

- We will set apart $___ each Christmas and work with our children to help a family who is in need.

- Each Christmas we will prepare "homeless bags" of food, clothing, and change to give to those in need.
- We will set aside $____ each year to give back to BYU and other Church schools.
- We have set a goal to save $___ for a school scholarship to allow others who are not as fortunate go to school.
- We will have a "Family Service Saturday" four times a year where we will go and do service for others, i.e., food kitchens, school work days, etc.

Giving Plan Example

Family giving plans are as individual as the families putting them together. The key is to catch your vision, set goals with the Lord's help and then to do it. Here are a few ideas in each of the areas.

Vision

- This is likely from your Plan for Life. Other ideas include:
  - We will have made giving an important part of our lives, budgets and characters. It is through serving and giving that our children will know what we truly believe and that we are truly Christians.
  - We will be "Christ's hands" wherever we live, and will strive through our service to have "His image" in our countenances.[35]
  - Many missionaries and friends who could not have served or done without our help will be there to express appreciation for the help we gave.
  - We will have kept the faith and our covenants.

Goals

- We will be generous in giving back to God in terms of our time, talents and resources since it is all His anyway.
- We have and follow our plans for institutional, personal, individual and family giving.
- We will teach our children to give through both word and example, in serving others and family service projects.
- We will serve in our local congregations in whatever way we are needed.
- Our resources will be God's resources in our family and other service projects.

Plans and Strategies

- We will be observant and listen to the Spirit for opportunities to help and serve.
- We will do a family service project quarterly, and will help out with all Young Men and Women service projects.
- We will attend the temple each week, and will spend 1-2 hours a week doing genealogy or indexing
- We will give blood as often as we can

- We will create a "Family Foundation," where children are all board members, and we distribute 5% of the assets each year to needy people.
- We will serve formally in the temple beginning at age 60.
- We will go on our first senior mission at age 65.
- Institutionally, We will pay annually 10% tithing, __% for fast offering, __% for missionary work and __% to our favorite college for scholarships.
- Personally, We will set aside $____ a month to help others.
- We will have a family personal giving budget and will involve the children in deciding its use
- We will teach children about finance through our Family Foundation

Constraints

- Key constraints are living on a budget and saving 20% of every paycheck, with 15% going to retirement and __% earmarked for personal giving.
- On personal giving, our family will jointly decide who we will help, how much, and how that help will be given, as well as the service projects each quarter.
- Institutional giving will come directly from our paycheck each month for tithes and other offerings.
- Sin will be a big constraint, so we need to always keep our promises and covenants.

Accountability

- We will share our vision and goals with Heavenly Father in prayer each day
- My accountability partners will be my spouse and children.
- We will discuss as a family our giving plans in Family Home Evening (a weekly meeting of the family to teach and have fun together).
- We will also discuss and schedule our quarterly family service projects.
- Moreover, we will also discuss the criteria as a family on who we will help with our personal giving, how much we will give (which will change depending on the situation) and the process of giving.
- I will be held accountable for this giving by my spouse and children.

Summary

We all wrestle with learning to give. This chapter discusses our covenantal obligations to share with others. Any discussion on giving takes us back to the first chapter of this course, where we discussed the four key principles of personal finance: ownership, stewardship, agency, and accountability. An important part of learning to give is developing an understanding of these four principles.

There are five myths of giving that are incorrect:

- Giving makes us poorer. Those who give are happier and healthier and are considered leaders by others.

- People are naturally selfish. Selfishness is a learned behavior. When we are at our best in all our faculties, we are givers.
- Giving is a luxury. Giving is a necessity. We need to give to be the best people we can be and to become more like our Savior Jesus Christ.
- The government provides assistance, so we do not need to give. We must take our place as givers and support the communities and people who need the services we can provide. We need it as much as they do.
- You need money to give. Giving is a state of your heart, not a state of your checkbook.

The realities of giving are:

- We have been commanded to give.
- Givers make more money.
- Giving shows our love for God.
- Giving helps others.
- Giving helps us change to become more like Christ.
- Giving helps us repay an unrepayable debt.

Much is written in the scriptures about money and giving. A number of parables in Matthew and Luke illustrate the principles Jesus taught about material wealth during his earthly ministry.

There is a different type of accounting done in heaven—not an accounting of dollars and cents but an accounting of our capacity and willingness to give.

Finally, just as we have a vision and goals for what we want to accomplish, we should have a vision and goals for what we want to give. It is important for us to "learn to give" and to prepare our individual/family "Giving Plan."

Remember we each fill our lives with our experiences. We have been given instructions as to what is good and what is bad. If we choose wisely, we will be able to enjoy the good things in life. If we fail to choose wisely, we must reap the consequences of our actions. The more we share with others, the greater our joy will be later on.

Assignments

Financial Plan Assignments

Your financial plan is not complete until you have determined the ways in which you are going to share your blessings with others. How well are you using your resources in your families to help build the kingdom? What goals will you set regarding how you will bless the lives of those

around you? Think about the goals you wrote down in an earlier chapter, particularly in response to the question, "What does Heavenly Father want me to do or to be?" What can you do to achieve these goals?

Think about your family/individual Giving Plan. Please note that this is not to be handed in now but to be included in your PFP after it is returned. Include your vision, goals and plans on your personal and family "giving plan." How will you handle both your institutional (through Church and other institutional contributions) and personal (individual and family contributions and service) giving?

Develop your Action Plan. What is your giving plan for tithes, offerings, and other contributions? What is your giving plan for door-to-door, phone, and other solicitors? How will you teach your children to give?

Learning Tools

The following Learning Tool may be helpful to you as you learn to give:

Tithing Share Transfer (LT08)
This document is an example of a form you can use to pay your tithes and other offerings with appreciated stocks or mutual funds.

Review Materials

Terminology Review

Family Giving Plan. A family plan which states how the family will give, to whom it will give to, as well was what the family will or will not do or give to.
Giving Plan. A plan on your thoughts on your personal and family giving. It discusses how you will handle both your institutional (through Church and other institutional contributions) and personal (personal and family contributions and service) giving.
www.charitynavigator.org. a website on information about various charities which file Form 990 with the IRS. However, they do not include religious organizations listed as "church or convention or association of churches" which are exempt from filing Form 990.

Review Questions

1. Learning to give takes us back to the doctrines and principles of finance. What are the key doctrines of finance from the different perspectives, and the key principles of finance?
2. A large majority of the parables in the New Testament are related to what topic?
3. What are at least five different reasons for giving?
4. Based on the quote from C. S. Lewis, what is the only safe rule of giving?
5. When you give to charities, it is important to give wisely and to know where that money is going. What are two resources you can use to learn more about different

charities?

[1] D&C 88:132.
[2] "Honesty, a Principle of Salvation," Ensign, Dec. 1971, 72.
[3] D&C 82:3.
[4] Luke 12:48.
[5] D&C 105:3.
[6] Monson, Thomas S. " A Gift Remembered," *New Era*, Dec. 2001, 4
[7] D&C 88:123.
[8] Honesty, a Principle of Salvation," *Ensign*, Dec. 1971, 72.
[9] Brooks, Arthur C. "Why Giving Matters," *BYU Magazine*, Summer 2009, 25–28
[10] Deut. 16:17
[11] Mosiah 2:17
[12] Jacob 2:17.
[13] Arthur C. Brooks, "Why Giving Matters," BYU Magazine, p. 25-28, Summer 2009.
[14] Mosiah 2:17.
[15] "Sacrifice: An Eternal Investment," *Ensign*, May 2001, 63.
[16] Mosiah 4:16-17.
[17] "Living Welfare Principles," *Ensign*, Nov. 1981, 92; emphasis in original.
[18] Mosiah 2:20-21.
[19] Robbins, Lynn G. "Tithing—a Commandment Even for the Destitute." *Ensign*, May 2005, 34
[20] Matt 25:20.
[21] 2 Nephi 32:5.
[22] 1 Corinthians 13:3
[23] *Lectures on Faith*, comp. N. B. Lundwall, Salt Lake City: Bookcraft, n.d., 58
[24] Mere Christianity [1952], 67.
[25] Mosiah 4:24, 27
[26] Luke 21:1–4
[27] Hales, Robert D. "Couple Missionaries: A Time to Serve." *Ensign*. May 2001, 27
[28] Mosiah 18:27–28
[29] In Conference Report, April 1974, p. 184.
[30] *Mere Christianity*, 1952, 67
[31] *Discourses of President Gordon B. Hinckley*, Vol. 2, Intellectual Reserve, 2005, 330
[32] D&C 64:23.
[33] Romney, Marion, G. Caring for the Poor—A Covenantal Obligation," *Ensign*, Nov. 1978, 87
[34] D&C 42:30.
[35] Alma 5:14.

21. Your Future 2: Decide to Decide So You Can Create with Confidence

Introduction

This has been a lengthy course on personal finance. If you have completed all of the previous chapters, you have spent over 40 hours getting your financial house in order, and you have dedicated even more time to working on your Financial Plan and each of the 16 sections. The purpose of this last chapter is to help you realize that your financial future begins now and that there are critical decisions you must make today that will impact your life throughout eternity. As you come to understand these important topics, you will be better prepared to achieve your personal and financial goals. This chapter also serves as a review of the topics we have discussed in this series. The main theme for this chapter is taken from a talk by Spencer W. Kimball in which he said the following:

> We hope we can help our young men and young women to realize, even sooner than they do now, that they need to make certain decisions only once. . . . We can push some things away from us once and have done with them! We can make a single decision about certain things that we will incorporate in our lives and then make them ours—without having to brood and re-decide a hundred times what it is we will do and what we will not do. . . . My young brothers [and sisters], if you have not done so yet, *decide to decide!*[1]

After all the work you have completed thus far, the challenge now is to decide to decide. What are the important decisions you must make now to help you achieve your personal and family goals?

Objectives

When you have completed this chapter, you should be able to do the following:

A. How do we bring Christ into our finances
B. Take a look back on the course and our learning framework
C. Understand some key decisions you must make to be truly successful in life
D. Learn about resources for additional readings on the subject of personal finance
E. Understand what wise financial stewards know.

You can make important decisions now, and will never have to question them. From the inspired words of Spencer W. Kimball, now is the time to decide to decide!

How do we bring Christ into our Finances

The first day of class we shared why we should want to bring Christ more into our finances. M. Russell Ballard stated: "In my judgment, we never will have balance in our lives unless our finances are securely under control."[2] Christ can help us bring balance into our lives and finances, and to bring our finances and lives more under control. We shared four different steps to bringing Christ in more.

Seek to learn and love the Savior and His atonement more. We study, pray, learn more about Him, and contemplate His amazing atonement and what it means in our lives. Christ knows us by name and loves us perfectly, and has designed a detailed, individual, and customized curriculum (called life) exactly tailored to our needs, mission and destiny. Managing our finances is one of the pieces of that curriculum and is simply part of the gospel of Jesus Christ.[3] Hopefully this class was a beneficial part of your curriculum.

Strive to change daily and become more like Him. God's grace, repentance and the atonement of Jesus Christ are perfect tools to help us change and to become more like our Savior. He has given us everything we need to become more like Him. He has taught through His servants that "a" pattern to change behavior is to understand doctrines and principles, and have them confirmed by the Spirit.[4] We have consistently shared in each class those doctrines and principles.

Learn to apply His words and create our lives more closely with Him. As we strive to develop and grow, application is an invitation to learn and create.[5] As we do, we become creators with God of ourselves, our families and our lives. We create each day in our prayers, families, the environment in our homes, budgets, goals and our lives. We are all creators, and learn best when we learn and follow the Master Creator, even Jesus Christ. You have created each and every day of class.

Always remember Him. We need Christ's inspiration and guidance daily if we are to return with our families to His presence. We already covenant to "always remember Him" each week in the Sacrament. We must strive to keep those and our other covenants. We must remember that our conduct on our journey is as important as our final destination.[6] We must, like the pioneers, make "a covenant and a promise to keep all the commandments and statues of the Lord" (D&C 136:2) as we daily remember the Savior and follow the covenant path.

Take a Look Back at the Course and Learning Framework

You have many challenges ahead of you. For students, some of these challenges may include going to graduate school or paying back student loans and credit card debt. For other individuals, challenges might include budgeting, spending, saving, investing, getting married, having children, serving in your communities, sending your children on missions, going on missions yourself, and retiring. With so many challenges ahead of you, it is critical that you remember that personal finance is simply part of the gospel of Jesus Christ and that you keep your priorities and your personal and financial goals in order.

A Look Back at our Learning Framework

As you look back on this course, I hope you feel it has helped you better understand the importance of having a correct perspective on personal financial issues. The first key part of the learning framework is personal finance is simply the temporal application of eternal principles.

Many of us, before we took this class, start in the wrong place, at application when we had a problem or challenge. Although this is understandable, it does not produce the spiritual power, protection and direction we need. David A. Bednar wrote:

> Somehow we seem to be drawn to application as the primary way to 'fix' things, to make life better. . . And far too often we emphasize application without the necessary understanding and divorced from the doctrinal content. . . Whatever the reasons, *emphasizing the application to the exclusion of fundamental doctrines and principles does not produce spiritual power, protection, and direction*. . . Appropriate applications are necessary but can never stand alone. What is needed is a balance among doctrines, principles and application. . . *The answers always are in the doctrines and principles. And the doctrines and principles need to be in us*.[7]

We helped you to think differently in this class. It was through a new learning framework. It asks three critical questions that lead to learning.

> 1. Why should we [learn and become better at personal finance] (this is "why" or a doctrine)?
> 2. What are the principles on which how we [learn and become better at personal finance are based] (this is "what" or a principle)?
> 3. How do we [learn and become better at personal finance] (this is "how" or an application)?

These three questions directed us to three areas: doctrines, principles and application. The second key of our learning framework was that doctrines and principles, confirmed by the Spirit, change behavior.

Doctrines

Boyd K. Packer taught, "True doctrine, understood, changes attitudes and behavior. The study of the doctrines of the gospel will improve behavior quicker than a study of behavior will improve behavior. . . That is why we stress so forcefully the study of the doctrines of the gospel."[8]

However, we learned that it is not enough to know the doctrines—we must understand them as well. David A. Bednar commented on the importance of understanding when he wrote,

> President Packer did not teach that simply knowing true doctrine changes us. Rather, doctrine must be understood. The word understanding in the scriptures frequently is

> linked to and associated with the heart and refers to a revealed result or conclusion. Thus, true doctrine confirmed in the heart as true by the witness of the Holy Ghost changes attitudes and behavior. Knowing true doctrine is necessary but is not sufficient. Understanding true doctrine both in our minds and in our hearts is essential to a righteous attitude and actions.[9]

Following are the five most important doctrines that we have learned in this class that can produce that spiritual power, protection and direction promised by Bednar that we so much need in our lives and our finances.

Identity. Identity is who we really are, children of God. Identity involves the way we see ourselves, as well as the way we perceive ourselves to be seen by others.

The scriptures teach we are "all the children of God by faith in Jesus Christ."[10] Paul reminds us, "And if children, then heirs; heirs of God, and joint-heirs with Christ."[11] Bruce R. McConkie said, "No doctrine is more basic, no doctrine embraces a greater incentive to personal righteousness . . . as does the wondrous concept that man can be as his Maker."[12]

The Proclamation on the Family reminds us, "All human beings—male and female—are created in the image of God. Each is a beloved spirit son or daughter of heavenly Parents, and, as such, has a divine nature and destiny."[13] As children of heavenly Parents, we are known by name and loved unconditionally. For God said, "This is my work and my glory—to bring to pass the immortality and eternal life of man."[14]

As children and heirs of all God has, we can accomplish anything that the Lord commands us, including obeying the commandments to live within our means, stay out of debt, and to save. "It is this doctrine of identity that defines our potential destiny of godhood. If one does not correctly understand his divine identity, then he will never correctly understand his divine destiny. They are, in truth, inseparable partners."[15] Russell M. Nelson said, "If the Lord were speaking to you tonight, He would urge you to understand your identity—to know who you really are."[16]

Obedience. Obedience is the source of divine guidance and power in our lives. As we choose to obey God's commandments and listen for the promptings of His Spirit, we will be guided in all we do, including our financial choices. Declared by Joseph F. Smith, "Obedience is the first law of heaven."[17] As such, it should be a critical component of our doctrine and understanding.

The scriptures state, "There is a law, irrevocably decreed in heaven before the foundations of this world, upon which all blessings are predicated—And when we obtain any blessing from God, it is by obedience to that law upon which it is predicated."[18] Blessings are predicated or built upon our obedience. When we fail to obey the commandments or sin, "this eventually, but invariably, leads to diminished happiness and forfeited blessings."[19]

Obedience is a misunderstood doctrine. Spencer W Kimball said, "The very first thing before beginning our world here, the Lord said, 'I'm going to give you your . . . agency. I want men and

women that are strong because it is right to be strong. I don't want weaklings who are righteous only because they have to be righteous.'"[20] Dale G. Renlund reaffirmed this when he said,

> Our Heavenly Father's goal in parenting is not to have His children do what is right; it is to have His children choose to do what is right and ultimately become like Him. If He simply wanted us to be obedient, He would use immediate rewards and punishments to influence our behaviors. But God is not interested in His children just becoming trained and obedient "pets" who will not chew on His slippers in the celestial living room. No, God wants His children to grow up spiritually and join Him in the family business.[21]

James E. Faust said, "Obedience leads to true freedom. The more we obey revealed truth, the more we become liberated."[22] Robert D. Hales said, "Obedience makes us progressively stronger, capable of faithfully enduring tests and trials in the future. Obedience in Gethsemane prepared the Savior to obey and endure to the end on Golgotha."[23] Finally, how do we know when we truly are becoming obedient? Ezra Taft Benson said, "When obedience ceases to be an irritant and becomes our quest, in that moment God will endow us with power."[24]

Stewardship. Stewardship is an amazing doctrine, and I divide it into three key areas, "whose" we are, that blessings are responsibilities, and that we are responsible to "make use of the means the lord has provided." [25]

The Psalmist wrote: "The earth is the Lord's, and the fullness thereof; the world, and they that dwell therein."[26] Scripture reminds us the Lord is the creator of the earth[27], the creator of worlds, men and of all things[28], the supplier of our breath, the giver of our knowledge[29], the giver of our life[30], and the giver of all we have and are.[31] Paul reminds us whose we are when he wrote, "For ye are bought with a price: therefore glorify God in your body, and in your spirit, which are God's."[32] All things belong to the Lord, including ourselves.

We are the Lord's hands here on earth, and are not to be "commanded in all things."[33] We are to "make use of the means the Lord has provided"[34] in accomplishing our finances and other challenges.

We are all the Lord's stewards over the things we have and are, especially ourselves. As His stewards, we need to be wise in how we spend the time and resources in our care. We are counseled to "not spend money for that which is of no worth, nor your labor for that which cannot satisfy."[35] We need to understand those things of eternal and true value and work toward them.

There are great blessings promised to wise stewards. "And whoso is found a faithful, a just, and a wise steward shall enter into the joy of his Lord, and shall inherit eternal life,"[36] and, "And he that is a faithful and wise steward shall inherit all things."[37] Surely this is a wonderful doctrine and a key to our understanding and being wise stewards over our family and financial blessings.

Agency. Agency is "the ability and privilege God gives people to choose and to act for themselves."[38] The Lord said, "Behold, I gave unto him [men and women] that he should be an agent unto himself."[39] The prophet Joshua wrote, "And if it seem evil unto you to serve the Lord, choose you this day whom ye will serve; . . . but as for me and my house, we will serve the Lord."[40] As we serve the Lord, we become more like Him.

Agency is critical to the Plan of Salvation. The Lord, in speaking to Moses said, "Wherefore, because that Satan rebelled against me, and sought to destroy the agency of man . . . I caused that he should be cast down."[41] The Lord through the prophet Joseph said, "That every man may act in doctrine and principle pertaining to futurity, according to the moral agency which I have given unto him, that every man may be accountable for his own sins in the day of judgment."[42]

When we were created spiritually, we were given knowledge, and in the Garden, we were given our agency. "The Lord said unto Enoch: Behold these thy brethren; they are the workmanship of mine own hands, and I gave unto them their knowledge, in the day I created them; and in the Garden of Eden, gave I unto man his agency."[43]

As we come to understand agency, we will learn that we must use it correctly or we will lose it. We can choose to take drugs and alcohol, but the coming addictions reduce our agency in the future, especially our agency to choose what we want to do and become. We can choose to disobey the law of chastity, but the coming guilt, disease, and broken relationships limit our choices later, including our chance for an eternal family. We can choose to not live on a budget, but the coming lack of savings for future needs such as missions, education and retirement cannot be avoided. There are consequences to our choices. Perhaps that is why the Lord reminds us to take an eternal perspective when He said: "Hearken ye to these words. . . *Treasure these things up in your hearts, and let the solemnities of eternity rest upon your minds*."[44]

Accountability. Accountability is how we are accountable to God for our choices. The second Article of Faith reminds us that, "We believe that men will be punished for their own sins, and not for Adam's transgression.[45] The Apostle John understood ultimate accountability and wrote, "And I saw the dead, small and great, stand before God; and the books were opened: and another book was opened, which is the book of life: and the dead were judged out of those things which were written in the books, according to their works."[46]

Alma expands our understanding about accountability when he taught, "For our words will condemn us, yea, all our works [including how we manage our finances] will condemn us; we shall not be found spotless; and our thoughts will also condemn us."[47]

The Lord said to the Prophet Joseph, "It is wisdom in me; therefore, a commandment I give unto you, that ye shall organize yourselves and appoint every man his stewardship; That every man may give an account unto me of the stewardship which is appointed unto him."[48]

David A. Bednar reminds us that "The gospel is so much more than a routine checklist of discrete tasks to be performed; rather, it is a magnificent tapestry of truth "fitly framed"[49] and

woven together, designed to help us become like our Heavenly Father and the Lord Jesus Christ, even partakers of the divine nature."[50]

Dallin H. Oaks affirms this and reminds us,

> From such teachings we conclude that the Final Judgment is not just an evaluation of a sum total of good and evil acts—what we have done. It is an acknowledgment of the final effect of our acts and thoughts—what we have become. It is not enough for anyone just to go through the motions. The commandments, ordinances, and covenants of the gospel are not a list of deposits required to be made in some heavenly account. The gospel of Jesus Christ is a plan that shows us how to become what our Heavenly Father desires us to become.[51]

Personal finance is a very complex process. When it comes to changing our behavior, we cannot do it on application alone. We need balance between doctrines, principles and application if we are to accomplish the things God would have us accomplish in our lives, including our finances. If we do application on its own, we can accomplish some things, but we miss the "spiritual power, protection and direction" promised. As we come to understand the key doctrines of the gospel, we gain the spiritual power, protection and direction to accomplish what we need. For us to accomplish all the things we need to in our lives and in our finances, we must understand the doctrines and principles. As Bednar said, "The answers always are in the doctrines and principles. And the doctrines and principles need to be in us."[52]

Principles

We have discussed many different principles in each of the 16 areas of your Personal Financial Plan. The key areas of your of your Personal Financial Plan included principles in each of these areas:

Your Plan for Life	Education Plan
Financial Statements	Mission Plan
Cash Management Plan	Auto/Toy Plan
Tax Plan	Retirement Plan
Credit Plan	Housing Plan
Insurance Plan	Giving Plan
Family Financial Plan	Investment Plan
Saving, Income and Expense Plans	Consumer Loans and Debt Plan

Most started with:

- Understand yourself, your vision, goals and budget.
- Seek, receive and act on the Spirit's guidance
- Understand the key areas of whatever topic we were discussing.

In addition, we discussed four general principles of personal finance on which the doctrines are

based, namely:

- Ownership. None of what we have is ours.
- Stewardship. We are stewards over all God has shared with us.
- Agency. The right to choose is one of God's greatest gifts to each of us.
- Accountability. We will be held accountable for every decision we make, including our financial decisions.

If our decisions recognize and apply these four key principles, then we are basing our decisions on the correct perspective.

Application

The third key to our framework was that application was an invitation to learn to apply His word and create our lives more closely with Him. We shared the creative process—the application of information in each of the 16 key areas. We are all creators, and we shared the process on how we apply these things to become better. God gave us life and He created a plan for us. This class and your PFP has been your chance of creating a Plan for this wonderful life He has given you?

We shared the most important parts of the creative process on how we change to become better. It is:

- Vision
    - What is your vision for yourself and your life? What would you like to accomplish in your lifetime? What do you hope to have accomplished when you have completed your life? How does Heavenly Father see you?
- Goals.
    - What goals will take you to your vision? What goals should you have? What goals are you willing to work toward?
- Plans and Strategies.
    - What are your plans for achieving your goals? What must you do to achieve your vision?
- Constraints.
    - What things will keep you from achieving your vision and goals? What are the things you should be careful of to make sure you can accomplish your goals?
- Accountability.
    - Who will you be accountable to for your vision and goals? Who will be your accountability partners to help you achieve them?

Finally, we shared that our conduct on our journey is as important as our destination. We must daily stay on the covenant path and do those things so we can have the guidance of the Spirit in our lives. Remember the revelation in D&C 136.) Many have underestimated the role it played in refocusing Brigham Young and the Church. "By helping the Saints remember that their

conduct on the journey was as important as their destination, the revelation helped transform the westward migration from an unfortunate necessity into an important shared spiritual experience."[53] As we remember the importance of our daily conduct, it helps us to keep focused on our ultimate long-term vision and goals, to returning to Father's presence; to keep our priorities in order and reminds us of the importance of being worthy of the guidance of the Holy Spirit; and it changes personal finance from being an unfortunate necessity into an important shared spiritual experience as we make the journey with our spouse and family.

Why is this learning framework important?

This learning framework is important for five reasons:

1. It can help us ask the right questions to help us understand and accomplish what we need.

2. It reminds us where the answers really are. Instead of jumping to application, the answers are in the doctrines and principles.

3. It helps us lift our perspective and vision. "With increased vision comes increased motivation."

4. Its helps us take a long-term perspective rather than a checklist approach to life. It is all part of the gospel.

5. This framework reminds us of the importance of Christ and of our daily conduct.

6. It changes our thinking from doing our "mundane acts of obedience" into "holy acts of consecration" to our Savior Jesus Christ.

Your Personal Financial Plan

We shared ideas and experiences on how you can apply the creative process to the things learned in this class, how you can create your vision of what you want to become, one step at a time. This process is applicable to all areas of your PFP.

Finally, you have followed the words of Ezra Taft Benson who said "Plan your financial future early, then live your plan."[54] You have done that with your PFP, the "spiritual creation" of your lives. Now is the hard work, to take your Plan and make your "physical creation" a reality. Your Personal Financial Plan includes 16 separate Plans, including your:

What is critical for you to become truly rich? This is an important question for you to answer early in your life, or you may get to the end of your life and not know what was truly important. Hopefully, we have helped in this process.

- You have your priorities in order and you strive to see things correctly, that is, to see

them as God sees them.

- You have the hope in Christ first, and then you seek riches–if you desire them.[55]
- You understand what is important in eternal life and you work accordingly[56]
- You think long-term[57] and follow the commandments of Jesus Christ.
- You know that commandments are protective—not restrictive.
- You live like millionaires, you practice discipline, charity, and frugality.

Life is Good

There is a three word summary for this class. It is simply that "Life is good." "Life is good" is an acronym to help you remember the things we wanted you to get out of this class. They relate to the key things you will have learned and are hopefully doing now. It includes the key parts of your Personal Financial Plan. It represents:

L Love the Lord, and always put and pay Him first.
I Invest your money wisely, consistent with your goals and risk tolerance.
F Find happiness where it is to be found, in your spouse, family and service.
E Enjoy the journey and give back, as its all God's anyway.

I Invest in yourself and family, and save for missions and education.
S Save 20% of everything you earn, and allocate 15% for retirement.

G Get and stay out of debt, and strive to be debt free except to God.
O Organize yourself, and know your vision, goals, plans and budgets.
O Operate on a budget, and get very good at planning
D Do good, be good, and get better, as we all strive to become more like our Savior.

As a missionary in England, Gordon B. Hinckley and his companies shook hands each morning and told each other "life is good."[58] We hope that we can all do the same and remember each day that same message.

Summary

In summary, the purpose of our learning framework was to help us to bring Christ into our finances. Following was the purpose and what our learning framework shared.

1. We seek to learn, understand and love the Savior and His atonement more. We shared that personal finance is simply part of Christ's gospel and part of Christ's customized curriculum for each of us.

2. We strive to change daily and become more like Christ. We shared that the best way to change behavior was to learn doctrines and principles and to have them confirmed by the Spirit.

3. We learn to apply His words and create our lives more closely with Him. We shared that application is an invitation to apply His words and create our lives more closely with him. Application is an invitation to learn and create

4. We always remember Him. We need Christ's inspiration and guidance daily if we are to accomplish our vision and goals; as such, we need to remember that our conduct on the journey is as important as our destination.

Understand Some of the Key Decisions You Must Make to Be Truly Successful in Life

Spencer W. Kimball said:

> We hope we can help our young men and young women to realize, even sooner than they do now, that they need to make certain decisions only once. … We can push some things away from us once and have done with them! We can make a single decision about certain things that we will incorporate in our lives and then make them ours—without having to brood and re-decide a hundred times what it is we will do and what we will not do… My young brothers [and sisters], if you have not done so yet, decide to decide![59]

In this course, we have discussed many critical decisions that I hope you will be well equipped to make as you "decide to decide."

It is not enough to know what to do. You must commit or bind yourself to do it! The Lord said "And thus ye shall become instructed in the law of my church, and be sanctified by that which ye have received, and ye shall bind yourselves to act in all holiness before me."[60]The sweet Psalmist of Israel wrote "Commit thy way unto the Lord; trust also in Him; and He shall bring it to pass."[61]

The following are nine key decisions we have taught in this course that I believe you must make to be truly successful in life and then to maintain these habits throughout your life. It is not enough to know what to do. You must do it!

1. Decide to Believe

Believe in God and yourself. Believe that God is interested in you as an individual, that He has a plan and a mission for you individually and believe that He is anxious for you to succeed. He has provided the sure pattern for ultimate success in the gospel of His son, Jesus Christ. When our lives are consistent with His gospel, we are given confidence through His Spirit that allows us to meet our daily challenges. We can say, along with Nephi, that "The Lord is able to do all things according to his will, for the children of men, if it so be that they exercise faith in him . . . Wherefore, let us be faithful to him."[62]

2. Decide to Listen

Take the Holy Ghost as your guide. Decide now that in all you do, you will live worthy of the Spirit and will listen to its guidance

> By following the rules, you will never make a serious mistake … without being warned. You will never take the wrong road, you will never go around the wrong bend, or make the wrong decision without your having been warned. That pattern is the pattern of the Latter-day Saint. You were confirmed a member of the Church, and you had conferred upon you the gift of the Holy Ghost to be a guide and a companion to you."[63]

3. Decide to Learn

Make learning a lifelong commitment. Gain both temporal and spiritual knowledge. Temporal knowledge makes it easier to avoid financial pitfalls and helps you recognize bad advice. Temporal knowledge also helps you handle the inevitable surprises that life will bring. Spiritual knowledge helps you discern what is truly important and helps you keep your priorities in order. Spiritual knowledge also helps you understand what God would have you do.

Plan for a lifetime of learning. Be sure to take the time to polish and upgrade your skills; the only true insurance you have is your ability to continue improving yourself and your job skills. To prepare for future job security, make sure your talents and skills are in demand. Continue to educate yourself and be the best employee you can possibly be.

4. Decide to Work

Work hard, smart, and with the Spirit. Hard work is necessary for you to reach your goals. Decide now to work hard and smart, to work as hard and as efficiently as you can, and to pray for Father's help as you work that you will do the right things and in the right way, and that you can work beyond your natural abilities. Rex D. Pinegar said: "If you and I are to reach the summit of our divine potential, we must work each step of the way. The path may be rugged, difficult, unheralded; but it can be successfully climbed if we are willing to work with all our strength and commitment."[64]

5. Decide to Create and Achieve

Create and achieve your vision and goals. Spencer W. Kimball said that it is appropriate for men and women "to quietly, and with determination, set some serious personal goals in which they will seek to improve by selecting certain things that they will accomplish within a specified period of time."[65]

Your vision and goals are the things that allow us to say "no" to the temptations of today in order to say "yes" to things in the future. Decide now to have a thoughtful good, timely, and well-thought-out vision and goals. Then work toward them. As you set your personal and family vision and goals, keep a long-term perspective on your goal-setting.

6. Decide to Budget and Stay Out of Debt

Always spend less than you earn and stay out of debt. Change your attitudes about spending and money. Eliminate the "I deserve this" mentality, and truly separate needs from wants. Learn to save for your wants. Spencer W. Kimball stated:

> Every family should have a budget. Why, we would not think of going one day without a budget in this Church or our businesses. We have to know approximately what we may receive, and we certainly must know what we are going to spend. And one of the successes of the Church would have to be that the Brethren watch these things very carefully, and we do not spend that which we do not have.[66]

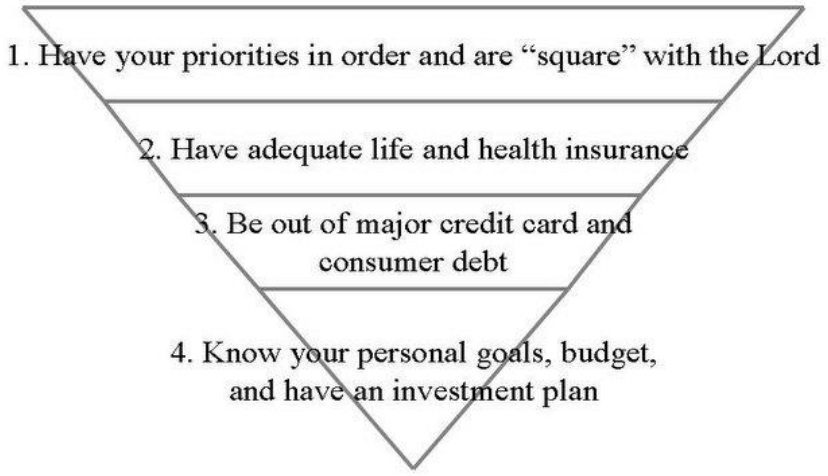
Decide now to budget; decide to stay out of debt; and decide to keep your priorities in order. Always pay the Lord first and pay yourself second. By doing this, you will learn to manage your finances instead of allowing your finances to manage you.

7. Decide to Protect Yourself

Realize that you are not indestructible. Get insurance for those you love. Having too little liability coverage can ruin your financial future. What types of insurance do you need? Life insurance? Sometimes—life insurance is a necessity if you are married with dependents. Disability insurance? Perhaps. Home and auto insurance are likewise necessary when you purchase a home and a car. Health insurance? Definitely.

However, your best and most important form of insurance is obeying the commandments and living the teachings of Jesus Christ. Decide now to protect yourself, your loved ones, and your belongings. Be sure you have sufficient insurance.

Chart 1. The Top of the Investment Hourglass



If you can answer these affirmatively, you are ready to invest

8. Decide to Save and Invest Wisely

Before you invest, review the top of the investment hourglass and answer the questions posed by the hourglass (see Chart 1). If you can agree with each of the statements, you are ready to invest. As you invest, consider not only the risks you are willing to take but the order in which you should make investments. Make sure your priorities are in order.

As you begin to save and invest, review the bottom of the investment hourglass (see Chart 2). Start with the basics: build your emergency fund and food storage, then work up the pyramid.

9. Decide to Give

Learn to give now. Many people say they will give more and serve more when they become rich. They want the miracle without having the faith, the fruit before the seed, the reaping before the sowing. But faith must precede the miracle.

Decide now to give. I recommend that you think about your giving in percentage terms. Learn to give a certain percentage of your income so you will never truly change the amount you give no matter what your income is or what you are blessed with.

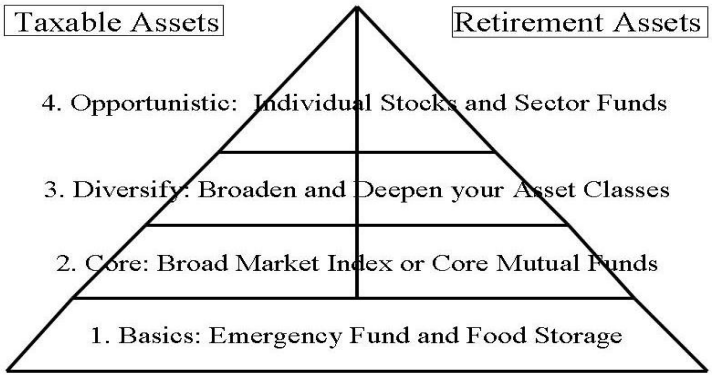
10. Decide to Decide

Live the gospel of Jesus Christ daily. It is the best cure for your finances and your life. With His help we can "commit thy way unto the Lord; trust also in Him; and He shall bring it to pass."[67] He will help us get our financial houses in order.

You have done much this semester. You have caught your vision and developed good goals and plans which will lead you to financial self-reliance. You have determined what will keep you from your vision and goals, and you will strive to overcome these things. Finally, you have developed accountability partners to help you in your quest. Decide now to keep these good habits for the rest of your life! Rex D. Pinegar said:

> You, our beloved young men and women, are in the most critical period of life. Youth is the time when habits are formed, when ideas are adopted. It is the time of decision. Decide today to heed these words of our prophet: "Decide to decide!"[68]

Chart 2. The Bottom of the Investment Hourglass



Following Christ is critical. He will make all the difference in your life. Remember He will give you success (Alma 26:27).

Pray, plan and work for your vision and goals. My father, who was 82 at the time, came and spoke to my class. He gave, what I consider, the best advice when he said: "The key to life is to live like our Savior and to obey the commandments of God. If you will do this, you will have the Spirit. And if you have the Spirit, you will be successful."[69]

Dallin H. Oaks counseled and said, "Some people live the gospel with "short, frenzied outbursts of emotion," followed by long periods of lapse or by performance that is intermittent or sputtering. What we need in living the gospel is "the tranquil and steady dedication of a lifetime."[70] He concluded:

> The "dedication of a lifetime" requires one to be tranquil and steady, steadfast and immovable. That is our standard and our goal. This steadfast standard requires us to avoid extremes. Our performance should be the steady 100 percent of a committed servant, not the frenzied and occasional 120 percent of the fanatic.[71]

My purpose and hope for this course on personal finance is that we can become the 100 percent committed servant of our Savior as we get our financial houses in order.

In summary, remember Nephi's counsel:

> And now, my sons [and all of us], remember, remember that it is upon the rock of our Redeemer, who is Christ, the Son of God, that ye must build your foundation; that when the devil shall send forth his mighty winds, yea, his shafts in the whirlwind, yea, when all his hail and his mighty storm shall beat upon you, it shall have no power over you to drag you down to the gulf of misery and endless wo, because of the rock upon which ye are built, which is a sure foundation, a foundation whereon if men build they cannot fall.[72]

Understand What Wise Financial Stewards Know

In the more than 19 years I have taught courses in personal finance, I have realized that certain principles are critical for developing good financial habits. Following are the 12 things I believe we should know about personal finance as we strive to follow Jesus Christ, become wiser financial stewards, to return with our families to His presence, and to accomplish our divine missions for which we were sent here to earth.

1. Wise Stewards Know Who they are and Why

They know they are a child of God and understand the doctrines that God wants them to:

- Spiritual: Bring them to Christ
- Temporal: Help them to become better stewards
- Family: Help them return with their families back to Heavenly Father's presence, and
- Individual: Help them to accomplish their divine missions, destiny and work.

They recognize that if they are living their lives and finances correctly, it will lead them to accomplish the above doctrines, and to help them become more like Jesus Christ.

2. Wise Stewards Recognize Their Stewardship

They understand the principles of:

- Ownership: everything they have is the Lord's
- Stewardship: they are stewards over all God has blessed them with
- Agency: the gift of choice is one of God's greatest gifts to us
- Accountability: they will be held accountable for all their choices, including their financial choices

They know that nothing they have is their own, it is all God's, and they listen to the Spirit and act accordingly.

3. Wise Stewards Create

They understand the creative process and know that creation is a spiritual gift. They have a vision of who they are, what they can accomplish, and what they should do (the spiritual creation).

They truly understand "they are children of God"[73] and "can do all things with His help." Then with that help, they create their vision, set appropriate goals, develop tactical plans, determine constraints, and then work with accountability partners to accomplish their vision.

They create themselves with confidence each new each day with their prayers, goals, budget and lives.

4. Wise Stewards Have Their Priorities in Order

They seek first the kingdom of God and His righteousness.[74] They know that the best things in life are free: families, relationships, and the teachings of Jesus Christ.

Wise stewards' first goal in life is not wealth, power, or gratification, things that the world seeks, but the gift of eternal life with their families. They seek the true riches first—the kingdom of God and the gift of eternal life. Then they seek the other riches, if they desire them, but it is with the intent to do good—to help and bless their families and others.[75]

5. Wise Stewards Plan Their Future Early and Live Their Plan

They follow Ezra Taft Benson's counsel when he said, "Plan your financial future early, then live your plan."[76] They prayerfully seek a vision for their lives, set their goals, plan their lives, live worthy of the companionship of the Spirit, and with God's help achieve their goals. They prayerfully develop a budget and follow it closely. They live on less than they make. They avoid debt. They build a reserve and save for their goals.

Wise stewards seek God's help in all aspects of their lives, including vision, goals, plans (budgets, debt reduction, savings, investing, giving, retirement planning, etc.), constraints and accountability.

6. Wise Stewards Know Money Cannot Buy Happiness

They know what money can do, which is to eliminate a lot of financial and other problems in life. They know that money can provide security for them and their families. But they know it cannot buy them happiness. They must find happiness on their own.

Wise stewards use money to reduce their financial difficulties, be secure in their families, and bless the lives of others. Then they find happiness in the gospel of Jesus Christ, their families, and serving others. They know money is only a tool, but an important one, in helping them to learn important lessons in life and become more like Jesus Christ.

7. Wise Stewards Understand Assets and Liabilities

Assets are things that have value. They are either income-generating (investments, savings, or rentals) or income-consuming (cars, toys, or houses). They know their choice of assets will largely determine how they will live their lives.

Liabilities are things they have borrowed to attain. Except for an education and a modest home, liabilities should be eliminated.

Wise stewards maximize income-generating assets, minimize income-consuming assets, and eliminate liabilities.

8. Wise Stewards Understand Income

Earned income is income they earn from their job or vocation. It is a good type of income. Passive income is income they earn from their investments, generally businesses or real estate. While they generally need to do work to earn and maintain this income, it is generally less work than they put into their earned income. Portfolio income is income they earn from their other investments. They do not need to do any work to earn income from these investments.

Wise stewards realize that the best income is not earned income but portfolio and passive income.

9. Wise Stewards Know They Are Responsible

In the book *Rich Dad Poor Dad,* Robert Kiyosaki and Sharon Lechter write:

> You were given two great gifts: your mind and your time. It is up to you to do what you please with both. With each dollar bill that enters your hand, you and only you have the power to determine your destiny. Spend it foolishly, you choose to be poor. Spend it on liabilities, you join the middle class. Invest it in your mind and learn how to acquire assets and you will be choosing wealth as your goal and your future. The choice is yours and only yours. Every day with every dollar, you decided to be rich, poor, or middle class.[77]

Wise stewards choose to be responsible in all their choices.

10. Wise Stewards Remember the Four Critical "Ifs"

Wise stewards remember four critical "ifs." These are not just the things they must know, but things they must *do* if they are to return with their families back to Heavenly Father's presence.

> **1. The scriptures make us wise, IF we learn to read and ponder them and obey the commandments.** It is not enough to read the scriptures—we must obey the commandments, "O remember, my son, and learn wisdom in thy youth; yea, learn in thy youth to keep the commandments of God."[78]
>
> **2. The Savior makes us holy, IF we repent.** It is not enough to have a Savior—we must repent and take advantage of His atonement, "For, behold, the Lord your Redeemer suffered death in the flesh; wherefore he suffered the pain of all men, that all men might repent and come unto him. And he hath risen again from the dead, that he might bring all men unto him, on conditions of repentance."[79]
>
> **3. The storms make us strong, IF we learn the lessons God wants us to learn.** It is not enough to have storms in our lives—we must learn from them. Nephi counseled "Nevertheless, . . . thou knowest the greatness of God; and he shall consecrate thine afflictions for thy gain."[80]

The prophet Ether counseled:

> And if men come unto me I will show unto them their weakness. I give unto men weakness that they may be humble; and my grace is sufficient for all men that humble themselves before me; for if they humble themselves before me, and have faith in me, then will I make weak things become strong unto them.[81]

The brother of Jared knew about storms. When he came to the ocean on his way to the promised land, he had three problems: air, light and navigation. The Lord helped the brother of Jared with each problems.

- The Lord instructed the brother of Jared to put holes in the top and in the bottom of the ships. We will instruct us in our lives as well.
- The Lord touched the stones, which gave light to the ships. The Lord will also touch our hearts and our lives, and give us light as well.
- The Lord sent the storms, to blow Jared and his family toward the promised land. Likewise the storms He sends today (whether economic, financial, health-related, spiritual, or otherwise) will take us where He wants us to be so we can return and live with Him.

The Lord is in our storms. He is trying to teach us those things that will take us to our promised land, to return to His presence.

If we will learn the lessons He is trying to teach us, we will become stronger, more valiant in the testimony of Jesus Christ, more willing and able to serve, and more ready for the next storm that will come. If we fail to learn the lessons from the storm, the Lord will need to teach us these lessons some other way. It may take even more severe storms for us learn what we need to know.

d. We can "be of good cheer" IF we will heed a living prophet's counsel

Thomas S. Monson said,

> I testify to you that our promised blessings are beyond measure. Though the storm clouds may gather, though the rains may pour down upon us, our knowledge of the gospel and our love of our Heavenly Father and of our Savior will comfort and sustain us and bring joy to our hearts as we walk uprightly and keep the commandments. There will be nothing in this world that can defeat us. My beloved brothers and sisters, fear not. Be of good cheer. The future is as bright as your faith.[82]

At the beginning of this course, I talked about how principles and doctrine was the key to lasting

change, whether it is in our families, our work, or our finances. I shared the following quote from Boyd K. Packer, "True doctrine, understood, changes attitudes and behavior. The study of the doctrines of the gospel will improve behavior quicker than a study of behavior will improve behavior."[83]

David A. Bednar said,

> President Packer did not teach that simply knowing true doctrine changes us. Rather, doctrine must be understood. The word understanding in the scriptures frequently is linked to and associated with the heart and refers to a revealed result or conclusion. Thus, true doctrine confirmed in the heart as true by the witness of the Holy Ghost changes attitudes and behavior. Knowing true doctrine is necessary but is not sufficient. Understanding true doctrine both in our minds and in our hearts is essential to a righteous attitude and actions.[84]

Now, at the end of this course, I add one final recommendation. The key to making permanent change for good in your family, your work, or your finances was given by Richard G. Scott when he said, "The best way to make a permanent change for good is to make Jesus Christ your model and His teachings your guide for life."[85] If you do this, you WILL be successful and you will find happiness in this life and the life to come. Finally, remember Nephi's counsel:

> And now, my sons [and daughters], remember, remember that it is upon the rock of our Redeemer, who is Christ, the Son of God, that ye must build your foundation; that when the devil shall send forth his mighty winds, yea, his shafts in the whirlwind, yea, when all his hail and his mighty storm shall beat upon you, it shall have no power over you to drag you down to the gulf of misery and endless wo, because of the rock upon which ye are built, which is a sure foundation, a foundation whereon if men build they cannot fall.[86]

Learn about Resources for Additional Readings on the Subject of Personal Finance

Thank you for your diligence in completing this work. I know it has been challenging and tough. I hope you feel it has been worth it. The following is a list of readings I recommend in addition to readings previously listed in this course. These readings may be helpful in your quest for greater financial understanding.

General Finance

- George S. Clayson, *Richest Man in Babylon,* USA: Signet Press, 1955.
- Napoleon Hill, *Think and Grow Rich,* New York: Random House Publishing, 1960.
- Richard Paul Evans, *The Five Lessons a Millionaire Taught Me,* Salt Lake City: Arcadia Press, 2004.
- Thomas Stanley and William Danko, *The Millionaire Next Door,* New York: Pocket Books, 1996.
- David Bach, *The Automatic Millionaire: A Powerful One-Step Plan to Live and Finish Rich,* USA: Broadway Books, 2004.

Investing

- William Bernstein, *Four Principles of Investing: Lessons for Building a Winning Portfolio*, New York: McGraw-Hill, 2002.
- Tim Sanders, *Love Is a Killer App: How to Win Business and Influence Friends*, New York: Three Rivers Press, 2002.

General Budgeting

- James Christensen and Clint Combs, *Rich on Any Income: The Easy Budgeting System That Fits in Your Checkbook*, USA: Shadow Mountain, 1985.
- Steven B. Smith, *Money for Life: Budgeting Success and Financial Fitness in Just 12 Weeks*, USA: Dearborn, 2004.

Marriage and Money

- Jeffrey R. Hill and Bryan Sudweeks, "*Fundamentals of Family Finance: Living Joyfully Within Your Means*," BYU Publishing, 2016.
- Bernard E. Poduska, *Love and Money: How to Share the Same Checkbook and Still Love Each Other*, USA: Deseret Book Company, 1995.

Summary

In the first chapter, we discussed the need to decide, educate, commit, believe and achieve. These are important parts of our work in personal finance.

Decide. You had to decide "why" you are doing this. Why did you want to learn personal finance? What was your vision for this class? What did you expect personal finance to bring into your life? What did you hope it will help you accomplish? I hope you have come to more fully understand the doctrines and principles, the "whys" and "whats" of personal finance and its place in helping us come to Christ, accomplish our divine missions, return with our families back to Heavenly Father's presence, and to be wiser stewards.

Educate. You needed to educate yourself to your available options. This is the "what" of personal finance. I hope you have learned a lot of important information and how that information can impact your life. Realize that much of this information changes every year, so you will need to stay abreast of developments including tax rates, tax tables, contribution limits for retirement, contribution limits for education savings, estate tax limits and percentages, etc. It may be a challenge, but it is doable.

Commit. Once you knew the "why" of your actions and the "what" that you need to do, it came down to choice. I hope you have determined your individual and family goals that will most likely take you to where you want to be. I also hope that you have realized the importance of those goals so you will really commit to accomplish them.

Believe. I have tried to help you to see who you really are, to believe that you can accomplish the things you set out to accomplish with God's help. You must develop the vision to know that you can accomplish these things if you are willing to put in the effort, work, and prayer. I believe that God will help us accomplish our goals if we seek His help in setting and committing to our personal and family goals, and then trusting in His promises to us as we willingly work toward them.

Achieve. Finally, you must work to achieve the goals that you have set. You must be willing to make the necessary sacrifices. But we must also be sure that we keep balance in our goals and it our lives, ensuring that we accomplish all our goals in a consistent manner.

Assignments

Financial Plan Assignments

You have come to the end of this course. We have discussed many important topics related to putting your financial house in order. What are the important ideas you will take away from this series of discussions? What are the ideas you have been impressed with regarding personal finance? What should you decide to decide? Write these decisions down in the goals section of your financial plan so that you do not need to remake those decisions.

Finally, put all the sections of your Personal Financial Plan together. Put each section under its respective tab. Make your plan something you are proud of. Put a picture of your family on the cover and put it in a place where you will be able to easily find it. Review your financial plan often.

The purpose of this course has been to help you plan for your financial future. Now it is up to you to follow your plan.

Review Materials

Review Questions

1. What is the main focus of this concluding chapter, taken from Spencer W. Kimball's quote?
2. In Jacob 2:18–19, Jacob tells us that we will obtain riches (if we seek them) only after we have done what?
3. According to Spencer W. Kimball, what should every family decide to maintain?
4. As a review, what are the four questions on the top half of the hourglass that you should ask yourself before you start investing?

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[3] For a discussion of this topic, see Sudweeks and Hill, "Personal Finance is Part of the Gospel of Jesus Christ," unpublished manuscript, 2019.
[4] For a discussion of this topic, see Sudweeks and Hill, "Doctrines and Principles, Confirmed by the Spirit, Change Behavior," unpublished manuscript, 2019.
[5] For a discussion of this topic, see Sudweeks and Hill, "Application is an Invitation to Learn and Create," unpublished manuscript, 2019.
[6] For a discussion of this topic, see Sudweeks and Hill, "Conduct on our Journey is as Important as our Destination," unpublished manuscript, August 2019.
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[9] Bednar, p. 153.
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[11] Romans 8:17.
[12] Bruce R. McConkie, *The Promised Messiah: The First Coming of Christ* (Salt Lake City: Deseret Book, 1978), 133.
[13] Spencer W. Kimball, "The Family: A Proclamation to the World," 1995.
[14] Moses 1:39.
[15] Tad R. Callister, "Our Identity and Our Destiny," BYU Speeches, Aug. 14, 2012.
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[17] Joseph F. Smith, "Discourse," *Deseret News*, Nov. 12, 1873, 644.
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[21] "Choose you this Day," Ensign, Nov. 2018.
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[23] Robert D. Hales, "If Ye Love Me, Keep My Commandments," Ensign, May 2014.
[24] Quoted in Donald L. Staheli, "Obedience—Life's Great Challenge," Ensign, May 1998, 82.
[25] Alma 60:21.
[26] Psalms 24:1, see also Deuteronomy 10:14; Psalms 89:11, D&C 104:14-15; and numerous others.
[27] John 1:3.
[28] D&C 93:10.
[29] Moses 7:32.
[30] Mosiah 2:26.
[31] Mosiah 2:21.
[32] 1 Cor. 6:20.
[33] D&C 58:26
[34] Alma 60:21.
[35] 2 Nephi 9:51.
[36] D&C 51:19.
[37] D&C 78:22.
[38] Guide to the Scriptures, "Agency."
[39] D&C 29:35.
[40] Josh. 24:15.
[41] Moses 4:3.
[42] D&C 101:78.
[43] Moses 7:32.
[44] Italics added, D&C 43:34.
[45] A of F 1:2.
[46] Rev. 20:12.
[47] Alma 12:14.
[48] D&C 104:11-12.
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[66] Marvin J. Ashton, One for the Money, 1992.
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[70] "The Dedication of a Lifetime," CES Fireside, Oakland, California, May 1, 2005.
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[73] Psalms 82:6.
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77 Robert Kiyosaki and Sharon Lechter, Rich Dad Poor Dad, Time Warner Book Group, USA, 1998, p. 197.
[78] Alma 37:35.
[79] D&C 18:11-12.
[80] 2 Nephi 2:2.
[81] Ether 12:27
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[84] Bednar, p. 153.

[86] Helaman 5:12.

Personal Finance Glossary

% Rank in Category. This is the number the fund ranks in its category or versus the benchmark. It is the top percentile, i.e., the lower the number the better.

12-b1 fees. These are fees paid by the shareholders to market the fund to other possible shareholders. These are just marketing fees. Avoid them.

401k Plans or Roth 401k Plans. These are defined contribution plans where employees contribute a percent of salary up to a specified amount. Employers may contribute a matching amount (free money) to encourage participation.

403b Plans or Roth 403(b) Plans (also called Tax Sheltered Annuities). These are defined contribution plans, and are the same as 401k but for non-profit tax-exempt companies and institutions (i.e., schools).

457 Plans. These are defined contribution plans, the same as 401k plans but for state and municipal workers and tax-exempt organizations.

529 Prepaid Tuition Plan. This is an education plan where you can prepay tuition for a child and you know tuition will be covered, regardless of raises in costs of tuition. May be useful if you think your children will not be eligible for financial aid.

529 Savings Plan. This is an education plan where you can put money aside after tax and it grows tax free if principle and earnings are used for qualified educational expenses. Control of the funds resides with the contributor, who chooses the assets within options provided.

60% Solution budgeting method. A process of budgeting where you determine your gross salary each month, take 60% of that amount and only spend that amount each month. Do not spend beyond that amount. This leaves 20% of your salary for long-term goals and 20% of your salary for taxes at year-end.

Account maintenance fees. These are fees for maintaining your account.

Account Transfer Fees. These are charges for moving assets either into our out of an existing account.

Account Transfer Fees. These are charges for moving assets either into our out of an account.

Accountability. This is a principle is that states we are accountable for every choice we make. We do not make choices with no consequences or accountable; rather, we will be held accountability for the decisions and choices we make.

Accumulation Stage (of retirement). This first stage of retirement begins when you first begin to work and is the time where you accumulate assets which you will later use for retirement needs.

Accumulation strategies. These are possible strategies to use while you are in the accumulation stage of retirement. They could include to save 20% of every dollar you earn after school, with 10% into the company 401k (or Roth 401k), 5% into the taxable account for retirement , and 5% into children's mission and education funds; save 20% of every dollar, with the priority of maxing out the Roth IRA for both yourself and your spouse, 3% into education IRAs for kids, etc.; or convert funds from traditional 401k and IRA accounts into Roth accounts with a minimum tax impact if financially viable.

Action Plan. This is your plan to accomplish our individual and family goals.

Active management. Active management is the process of trying to beat market returns by the active buying and selling of mutual funds and stocks.

Active portfolio management. It is the process of using publicly available data to actively manage a portfolio in an effort to beat the benchmark after all transactions costs, taxes, management, and other fees. However, to do this successfully you must do this consistently year-after-year, and not just from luck.

Actively managed funds. These are funds where the portfolio managers try to beat the performance of a benchmark through the active purchase and sell of securities in their asset class. Actively managed funds generally have higher management fees which must be overcome through higher returns

Adjustments. Adjustments are deductions from total

income allowed by the IRS to get your Adjusted Gross Income (AGI). These include (among others):qualified medical savings contributions (flexible spending accounts), contributions to individual retirement accounts (IRA), contributions to Health Savings Accounts (HSAs), student loan interest and tuition and fees deduction (IRS 970) (within limits), one-half self-employment tax, etc. Losses include net capital losses (up to $3,000), sole proprietorship losses, and active participation real estate losses

Advanced Health Care Directive. This document, also known as a living will or personal or advance directive, is a legal document where a person specifies what actions should be taken for their heath care if they are no longer able to make decisions for themselves due to illness or other reasons.

After-tax return. This is your return after you pay taxes. It is calculated as: after-tax return = before-tax * (1 – marginal tax rate) and your marginal rate includes both your federal, state and local (if any) taxes.

Agency bonds. Bonds issued by government agencies which were authorized by Congress including the Federal National Mortgage Association (FNMA), Federal Home Loan Banks (FHLB), and Government National Mortgage Association (GNMA).

Agency. This principle is that we have choice in our lives. We are agents of will, who can make choices consistent with our beliefs and values. Moreover, the gift of "choice" is man's most precious inheritance, and we should protect it carefully.

Annual Percentage Rate (APR). The APR is a rate that is generated from a precise calculation specified in Regulation Z. It only takes into account the fees going into the loan and does not take into account the time value of money.

Annuities. These are financial products developed and sold by insurance companies designed to accept and grow funds, and then, upon annuitization, pay out a stream of payments for a specified length of time. Annuities can be structured many different ways, such as payments for life for annuitant or spouse (i.e., for life of both), duration of payments (i.e., 20 years certain or life, whichever is longer), the type of payments (i.e., fixed or variable), etc. The different ways in which annuities can be structured (they are insurance products) provide the flexibility to construct an annuity contract to be meet your needs. However, it also increases expenses.

Annuitization. The process of determining what percent of retirement assets should be annuitized to ensure sufficient funds for the recipient's life.

Annuity types. These are the different types of annuities.

Application. Application is the "how' of how we do things. It is how we apply the doctrines and principles in our lives.

Appreciating assets. These are assets which may or which have historically appreciated in value.

Asset allocation funds. These are mutual funds which rotate asset classes among stocks, bonds, and cash for the best return. Asset allocation funds invest the fund's assets in the asset classes expected to perform the best over the coming period of time.

Asset allocation. This is the process of managing risk in your investment portfolio. Asset allocation is the process of allocating assets between various asset classes. It determines the risk of the portfolio and is the percentage allocated to each of the different asset classes.

Asset backed bonds. Bonds backed by specific holdings of the issuing company, such as equipment or real estate.

Asset classes. Asset classes are broad categories of investments with specific (and similar) risk and return characteristics. Asset classes are distinguished by characteristics specific to particular groups of securities, such as type of financial instrument, market capitalization, maturity, geographic location, etc. The major asset classes are cash and cash equivalents, fixed income, and equities.

Assets under management. This is another way an investment advisor is paid. It is calculated as a percentage of your assets under management, i.e., if you have $500,000 with an advisor and their fee is 1.0% per year, you will pay them $5,000 per year.

Assets. These are things that you own that have value.

Auto Loans. Auto loans are consumer loans that are secured with an automobile. Because they are secured, they have a lower interest rate than an unsecured loan or credit card. They normally have a maturity length of 2 to 6 years. The risk is that you

will often be left with a vehicle that is worth less than what you owe on it.

Automobiles and Other Vehicles. These are depreciating assets, such as cars, trucks, and RVs that normally must be inspected and licensed.

Average Amount Borrowed. This is the average amount borrowed over the life of the loan. In leasing, it is the (Net capitalized cost + residual)/2.

Average compensation. The average of the years of salary considered in making the defined benefit calculation.

Average Daily Balance (ADB): A common way of calculating interest to charge. Computed by adding each day's balance for a billing cycle and then dividing by the number of days in the cycle.

Average Indexed Monthly Earnings (AIME). The average lifetime earnings indexed for inflation is your top 35 highest earning years up to age 60. It entails adjusting each year's earnings total to reflect its value in the year in which eligibility is requested.

Average Monthly Interest Rates. This is the Annual Percentage Rate (APR) divided by 12.

Average tax rate. This is the average amount of every dollar you earned that was paid for federal income taxes. It is generally calculated at income taxes paid divided by AGI or Total income.

Baby bonds. A bond with a par value of less than $1,000.

Balance sheet (personal). This is a financial snapshot of your financial position on a given date.

Balanced funds. These are mutual funds which purchases both stocks and bonds generally in a specific percentage or relationship, i.e. 60% stocks and 40% bonds. Their benefit is that they perform the asset allocation, stock selection, and rebalancing decision for the investor.

Balloon loans. These are loans which payments including interest and principle are not sufficient to pay off the loan at the end of the loan period, but require a large "balloon" payment at some point in the future to fully pay off. This type of loan is not recommended.

Balloon Mortgages. These are mortgage loans whose interest and principal payment won't result in the loan being paid in full at the end of the term. The final payment, or balloon, can be significantly large. These loans are often used when the debtor expects to refinance the loan closer to maturity.

Bankruptcy Chapter 13. This process prepares a repayment plan in which the court binds both the debtor and the creditors to terms of repayment. The debtor retains property and makes regular payments to a trustee out of future income to pay creditors over the life of the bankruptcy plan.

Bankruptcy Chapter 7. This process liquidates assets and uses them to pay creditors according to precedence in the Bankruptcy Code. It is the quickest, simplest and the most frequently selected (75%) kind of bankruptcy filing. Certain debts cannot be waived by Chapter 7 bankruptcy such as child support, student loans, drunk driving fines, etc.

Basic Health Insurance. This is basic health coverage which covers hospital, surgical and physician expense insurance. It covers hospital insurance, which is hospitalization expenses including room, board, nursing, and drug fees; surgical insurance, which is the direct costs of surgery including the surgeon's and equipment fees; and physician expense insurance, which covers physicians' fees including office, lab, X-ray, and fees for other needed tests.

Bearer bonds. Bonds with coupons attach that pay interest only to the bearer upon surrender of the coupons.

Behavioral finance. Behavioral finance is an upcoming field of financial theory that attempts to further understand securities prices through understanding investor behavior. It came about because the assumptions which Finance makes, that people make rational decisions and people are unbiased about their predictions of the future are not always valid. Behavioral finance tries to incorporate "personal behavior" in an effort to extend finance beyond its narrow assumptions.

Benchmark. This is the relevant index for the specific category tracked by Morningstar or other fund monitoring company.

Bend Points. Calculating your PIA from AIME is divided into three calculations called "bend points" because the formula, when graphed, appears as a series of line segments joined at these amounts. These bend points change year to year.

Beneficiaries. The people who receive the property or assets.

Bidding and the Winner's Curse. Bidding may lead to a suboptimal result when you bid your fair value. Assuming everyone else has the correct value, if you won you overpaid.

Blend stocks. These are stock that are a part of both value and growth.

Bond interest and bond fund distributions. These are taxed at your Federal and state Marginal Tax Rate.

Bond mutual funds. Bond mutual funds are funds which invest a majority of their assets in bonds of specific types of companies or institutions. These funds generally have a specific objective, i.e. "corporate," "government", "municipals," "growth," etc. which relates to the types of bonds the mutual fund invests in. In addition, most have a specific maturity objective as well, which relates to the average maturity of the bonds in the mutual fund's portfolio.

Bond rating companies. A private sector company that evaluates the financial condition of the bond issuing company, its revenues, profits, debt, and other critical areas, and gives the company a rating which indicates the relative safety of the bond. They only rate corporate and municipal bonds. They include: Standard & Poor's, Moody's, and Fitch's.

Bond ratings. Bond ratings are measures of the riskiness of a company. Ratings run from "AAA" (Standard & Poor's) or "aaa" (Moody's) for the safest to "D" for the extremely risky. Ratings categorize bonds by default risk, the risk of the company being unable to repay the bond

Book-entry bonds. Bonds which are registered and stored electronically, similar to stock purchases.

Breakeven Analysis. This is a form of loan analysis that does not take into account the time value of money, but is simple to calculate. You calculate all new costs and fees for the new loan, and savings in principle and interest over the old loan. You then divide all new costs by monthly savings which will give you your breakeven point in months. If your breakeven point is less than 4 years, it may be a good idea, 5-7 years, it might be considered, or greater than 7 years, be careful. You may likely move before 7 years.

Budgeting Process. These are the steps you take to create your budget. It includes: 1. Know what you want to accomplish, 2. Track your spending (your expenses), 3. Develop your cash budget, 4. Implement your budget, 5. Compare it to actual expenses, then make changes where necessary to achieve your goals.

Budgeting the Better Way. This is a budgeting process where you pay the Lord first, and yourself second, then pay your bills. This makes paying yourself a higher priority.

Budgeting the Old Way. This is a budgeting process where whatever was left at the end of the month went into savings. The challenge is that there is never anything left at the end of the month.

Business risk. Risk that the bond's value will decline due to problems with the company's business.

Buyer's broker. This is a realtor that works specifically for the buyer and is paid by the buyer. The have a fiduciary responsibility to the buyer and not the seller which is different from the traditional buyer seller broker relationship.

Buying on margin. Buying on margin is borrowing money to invest. You borrow money from your broker and use it to purchase financial assets. If the stock goes up and you sell the stock, you make a profit due to leverage. Be careful as you can lose much more than your original investment.

Calendar Effects. The impact of tax and reporting is not consistent with theory. Behaviorists point out that returns are a function of cash flows, which tend to be concentrated around calendar turns. Institutions tend to "window dress," i.e., sell unwanted and buy desired stocks for period-end reports.

Call provision. A provision that allows the issuer to repurchase the bonds before the maturity date. Deferred calls provide more protection.

Callable bonds. Bonds which can be called, i.e. redeemed, before maturity at the option of the issuer.

Capital gains taxes. Capital gains are realized earnings from selling a financial asset at a profit. It is the sale price less the purchase price, and are divided into short-term and long-term. Short-term capital gains are gains from the sale of an asset where the asset was held for less than 366 days and is taxed at your marginal tax rate. Long-term capital gains are gains on the sale of an asset where the asset was held for more than 366 days and is taxed at a preferential federal rate. These are taxes you pay on assets held a specific period of time.

Capital gains. Capital gains are the best type of earnings as capital gains at the share level are not taxed until you sell your mutual fund shares. You decide when to be taxed. This is the difference between what you paid for the bond and what you sold it for, or the par value if you held the bond to maturity.

Capitalized cost reduction: Any reductions in capitalized cost, such as rebates, down payment, dealer incentives, trade-in, etc.

Capitalized cost: The cost to which you agree or negotiate when purchasing a vehicle.

Captive brokers. These are brokers whose company is part of a group which owns a mutual fund company. These brokers may be encouraged to sell company mutual funds which may not be the best fit for the investor but are in the interest of the company.

Carelessness. A reason for debt. We understand its costs, but we become lazy.

Cash accounts. This is money with the broker which you use to pay for purchases or receive any cash. There is a specific time between notification of purchases and when the purchases must be paid.

Cash Advance: Using a credit card to obtain cash, such as through an ATM or over the counter at a bank. This is an extremely expensive way to borrow, and carries several pricy fees.

Cash and Cash Equivalents. Cash and cash equivalents is an asset class whose major goal is liquidity and to preserve capital. Cash includes CDs, money market funds, T-bills, and commercial paper, etc. It also includes short-term interest-bearing investments such as treasury bills and savings bonds, loans to the U.S. government, commercial paper, and loans to corporations. It is a good investment asset class for money you plan to use in less than 3-5 years and don't want to take risks. It is less attractive as medium-to-long-term investments (> 5 years) as returns on cash and cash equivalents are unlikely to keep up with inflation.

Cash Dividends. Theory has shown that dividends are irrelevant in the absence of taxes and transactions costs. Behaviorists suppose that dividends can be justified by "mental accounts" which increase current income at the expense of "higher self-control" equity accounts. Older high-net worth investors value dividends more highly and concentrate in high income securities (preferred habitat) theory.

Cash-Balance Plans. A type of DBP in which provides specific annual employer contribution (generally 4-7%) each year, plus a low but guaranteed rate of investment earnings. Accounts grow at a predetermined rate, regardless of how much is in the account. Employees do not make any investment decisions.

Category. These are all funds in the same category as established by Morningstar.

CD Laddering: the process of getting a higher interest rate by buying longer term CDs and purchasing them more often. For example, 1 month CD rates are too low, but you like 6 month rates. Take the amount of money you want to invest, divide it by 6 (or any number), then invest 1/6 of your money every month in a 6 month rate. You are creating a ladder of CDs, and every month you have money coming in. You would then reinvest that in another 6 month CD.

Child's Benefit. Any child who is under 18 (19 if still in high school), is eligible for a benefit of 50% of the retired workers PIA, subject to a family maximum. Child's benefits terminate at age 18, marriage, or death. The dependent child of a fully or currently insured worker will receive a benefit of 75% of the worker's PIA (subject to family maximum) if the child is under age 18 (or age 19 is a full-time high school student), or is over age 18 and has been disabled since before age 22, and is not married.

Children's Trustee. The person who manages the assets for the children.

Children's Trusts. Trusts specifically for underage children.

Class A Shares: These shares commonly have a front-end or back-end load to compensate for the sales person's commissions. Because of the front-end loads, they usually have lower management fees.

Class B Shares: These shares commonly only have a back-end load that is paid only when the shares are sold. This load traditionally declines over time. Class B shares generally have higher expense ratios when compared to Class A shares.

Class C Shares: These shares generally have a lower front- and back-end load fees, but higher management fees.

Class R Shares: These shares are generally for

retirement purposes. Check the loads and management fees which may be substantial.

Class Y Shares: These are shares with very high minimum investments, i.e., $500,000, but which have lower management fees and waived or limited load charges. These are generally for institutional investors.

Class Z Shares: These are shares only available for employees of the fund management company.

Closed-end mutual funds. These are mutual funds with a specific number of shares outstanding. Individuals must purchase shares from existing shareholders, and shares may trade at a premium to (more than) or discount (less than) the underlying Net Asset Value (NAV). These premiums or discounts may be based more on investor demand than the underlying share value.

CLUE Report. A report, prepared by insurance companies that keep a record of all payments by insurance companies to individuals and institutions. Under the FACT Act (Fair and Accurate Credit Transactions Act of 2003) you can obtain the following Comprehensive Liability Underwriting Exchange (CLUE) reports each year: CLUE Auto: A 5-year loss history report of your automobile claims (if a loss was filed against your automobile insurance policy and if the insurance company reported the information to CLUE); and CLUE Personal Property: A 5-year loss history report of your homeowners claims.

Codicil. A document which institutes minor changes in the original will. Must be signed, witnessed, and attached to the original will.

Collateralized mortgage obligations (CMOS). More complex and specialized versions of mortgage backed bonds.

Commission costs. These are the cost associated with trading of bonds. While all bond trades incur commission costs, some newly issued bonds are sold without commission cost as the issuer absorbs the costs. Most trades however, incur commission costs, which are paid to the broker who arranged the trade.

Commissions. Commissions are the way a broker or investment advisor is paid. It is either a percentage of every buy or sell order (e.g., 20 bps per trade), or a specific charge for a trade (e.g., $9.99).

Community Property. A form of ownership is equal and only between partners. Lifetime control is shared by both spouses, consent from both is required to sell, income is shared between owners, and testamentary control in the one-half interest is unlimited unless property has right of survivorship feature (applicable in some states).

Compulsiveness. A reason for going into debt. We lack the self-control to discipline our purchases.

Computer Software budgeting method. This process uses commercially available budgeting software such as such as Mint.com (free), Quicken, Mvelopes, or others. Determine your gross salary and take home each month after taxes and other deductions, determine spending by category, and budget each category. Work to within your budget for each spending category. You will obtain receipts and credit card information directly via internet from financial institutions.

Conventional loans. These are loans that are neither insured nor guaranteed. They are below the maximum amount set by Fannie Mae and Freddy Mac of $424,000 in 2018 (single family). They require Private Mortgage Insurance (PMI) if the down payment is less than 20%.

Convertible bond. Bond which gives the holder the right to convert the bond to company stock instead of getting the cash repayment.

Convertible loans. These loans begin as a variable-rate loan and can be locked into a fixed-rate loan at the then current interest rate at some predetermined time in the future (for a specific cost).

Cooperation and Altruism. The process where we work with others and are concerned about them, not just ourselves and what we want. Cooperation may be a viable investment strategy. People's motives may lead to actions different than conventional rationality, i.e. individual selfishness, would suggest.

Corporate Bonds. (1)Bonds secured corporate debts by collateral or real property liens. (2) Debt instruments issued by corporations to fund the requirements of the companies.

Cost. These are the fees and expenses you pay to own a mutual fund or asset. Invest low cost. In a world where investment returns are limited, investment costs of any kind reduce your returns. We recommend you invest in no-load mutual funds to reduce costs.

Counseling: non-profit credit counseling agencies. These are agencies set up specifically to help people reduce the credit-card debt load in their lives. The non-profit companies have arrangements with many of the credit companies. Working with them, they can reduce or even eliminate your interest payments with specific creditors.

Counseling: For-profit credit counseling agencies. These are companies whose goal is to make money through helping people get out of debt. They often consolidate debt into a single loan with a lower rate, or get homeowners into an interest-only home loan and use the excess cash to pay down debt.

Coupon interest rate (or interest rate). The percentage of the par or face value that will be paid annually to the holder in the form of interest.

Covenants, Conditions and Restrictions (CCRs). These are legal documents that can affect what you can do with any potential homes. These can be quite restrictive as to what you can and cannot do with your home including exterior, landscaping, and other requirements. If you cannot live with the CCRs, don't buy there.

Credit Bureau: Private organizations which maintain credit information on individuals, which it allows subscribers to access for a fee. The three major credit bureaus to know are: Equifax, Experian, and Trans Union.

Credit Card: A financial instrument that allows the holder to make purchases through an open line of credit.

Credit Counseling Agencies (CCAs). These may be either non-profit or for-profit agencies to help you get out of debt. You should use these with caution.

Credit Limit: The maximum amount that one can borrow on a single credit card. This amount is often influenced by one's credit score.

Credit Report: Information collected by credit bureaus from subscribers, creditors, public court records, and the consumer.

Credit Score: A numerical evaluation of your credit based on specific criteria determined by the credit scoring company.

Credits. Credits are dollar for dollar reductions in your taxable liability. Credits are worth significantly more than deductions.

Current ratio. This is your monetary assets divided by your current liabilities. This ratio tells you how many times you could pay off your current liabilities with your liquid cash on hand.

Current Yield. It is the ratio of annual interest payments to the bond's market price.

Currently Insured Status. To be "currently insured", you must have at least 6 quarters of coverage in the previous 13 quarter period. Currently insured is adequate for eligibility for survivor benefits paid to children and for a surviving spouse caring for a qualifying child. Eligibility for other benefits generally requires fully insured status or 40 quarters of coverage

Custodial Accounts (UGMA/UTMA). These are investment vehicles that are managed for the child until the child turns a certain age. They can be invested in all types of financial assets, stocks, bonds, mutual funds, etc. UTMA (Uniform Gift to Minors Account) has fewer restrictions and may include real estate. These can be used for any educational or other expenses, including missions. The risks are there are no tax advantages and it is considered the child's money as soon as the child is of age—it cannot be taken back by the issuer. I prefer a tax-efficiently invested account.

Custody (or annual) fees. These are fees the brokerage house charges to hold the mutual funds or ETFs in your account. May be a minimum amount for small accounts ($15 per year), a specific charge per holding (8 basis points per security), or a percentage of assets for large accounts (25 basis points on assets under management).

DALBAR. DALBAR is a private company that does research on investor returns. It puts out an annual survey in a book titles "Quantitative Analysis of Investor Behavior." It discusses how average equity fund investors have done versus benchmarks over the past 20 years in the equity, fixed income, and balanced categories.

Day orders. These are orders to buy and sell securities which are good only until the end of the trading day.

Day trading. It is the process of an individual giving up all his spare time in an area in which he has little or limited competence, in an attempt to consistently beat the market and other professionals after taxes, costs and fees.

Debenture. A long-term unsecured bond. It can have a hierarchy of payment, with unsubordinated and subordinated debentures. These are bonds backed by the credit of the issuing company.

Debit Card: Unlike credit cards, debit cards act like a personal check. When used, money is taken straight from the connected account to pay for the purchased item.

Debt Cycle. It is the process of why and how we go into debt.

Debt Elimination: Expensive Debt First. This is one of the personal strategies. The logic is to pay off your most expensive debts first.

Debt Elimination: Smallest Debt First. This is one of the personal strategies. The logic is to pay of the smallest debts first. Then take the money saved to pay off all your other debts. You have success early on as you pay off the smallest debts first.

Debt Obligations or Back-end Ratio. This housing affordability ratio calculates what percent of your income is used for housing expenses plus debt obligations. It should not exceed 36% of your monthly gross income. The formula is: Monthly PITI and other debt obligations/ monthly gross income < 36%. Debt obligations include mortgage payments, credit card, student loan, car, and other loan payments. PITI = Principal, interest, property taxes, and property insurance

Debt ratio. This is your total liabilities divided by your total assets. This ratio tells you whether you could pay off all your liabilities if you liquidated all your assets. This represents the percentage of your assets financed with borrowing.

Debt Reduction Strategies. These are strategies for reducing debt. It is a six-step process: 1. Remember perspective, the "why's" and "what's." Accept that you have a debt problem; 2. Write down your goals so you know where you want to be. Stop incurring new debt; 3. See where you are by making a list of all your bills and debts. Admit the need to change your habits and lifestyle if being debt free is important; 4. Look for one-shot ways of reducing debt; 5. Organize a debt repayment Plan; and 6. Follow through on the Plan until total debt elimination.

Debt. It is the process of borrowing something with the expectation to pay it back in the future with interest.

Deductions. Deductions are IRS allowed reduction amounts (standard deduction) or taxpayer determined amounts (itemized deductions) to get taxable income from your Adjusted Gross Income.

Deep-discount and on-line brokers. These are brokers who are even cheaper than discount brokers. They do only trading, but at a 90% discount to full-service brokers. On-line can even be cheaper with other services.

Deferred. Payments are deferred until the specified time the investor elects to begin receiving the payments.

Defined Benefit Pension Plans. A Defined Benefit Pension Plan is a DBP where payments are based on a benefit payout formula. The formula is based on your salary, years worked and a company determined factor to calculate how much you will get each year. Employees do not contribute and bear no risk.

Defined Contribution Plan (DCP). A retirement plan where the employer contributes a specific amount to the employee's retirement funds while the employee is working and then has no responsibilities once the employee retires. Employer contributes to a fund, and then has no additional obligation when the employee retires. Employee may also contribute to the fund. Pension is determined by how much is invested by both the employer and employee, and how fast it grows.

Delayed Retirement Credit. Delaying payment beyond full retirement age results in a benefit increase for each year of delay. With a delay the worker's PIA is not increased and the benefits to family members is not increased.

Dental and Eye Insurance. This is insurance which covers only dental work and expenses relating to the eyes and teeth. Generally, it is only partial costs of eye exams, glasses, contact lenses, dental work, and dentures. Know your coverage, as the amount covered varies by plan provider. These plans are generally expensive, unless they are provided as part of an employer plan.

Depreciating assets. These are assets which depreciate. Often, the minute you take ownership of these assets, i.e. drive these assets off the car lot, they drop in value.

Direct PLUS Loan. These are loans available for parents of undergraduate, dependent students to help with school-related expenses, and the parent is

responsible for interest during school. Repayment begins six months after student graduates, discontinues, or drops below half time, and the parent is the borrower.

Direct Subsidized Loans. These are loans direct from the Federal government. The government pays interest while student is enrolled in school at least half-time, and repayment begins 6 months after student graduates or drops below half-time enrollment.

Disability Benefits. Workers who qualify for disability benefits are entitled to 100% of PIA until the earliest of the following: disability ends: benefits are terminated in the second month after the end of disability, or the workers dies: benefits are terminated in the month prior to the month the worker dies. If the worker attains full retirement age: disability benefits convert to retirement benefits.

Disabled Child. The disable child of a retired or disable worked is entitled to benefits past age 22 if the disability began before age 22.

Discount bonds. A bond that is sold at a discount to its par value. Generally, upon maturity the accrued interest and original investment add to the bond's par value.

Discount Points: These are payments made by the lender to reduce the interest rate on the loan. They are somewhat similar to prepaid interest. You pay more upfront in points but you will pay less on interest costs in the future. Your challenge is to minimize your overall interest costs, i.e., your effective interest rate.

Discount-service brokers. These are brokers who only perform trading, but usually at a 50% to 70% discount to full-service costs.

Discretionary accounts. These are accounts where you authorize a broker or investment advisor to make trades for you and your account. Exercise caution with this as the broker can buy and sell securities at will and you are responsible for all taxes and commission costs.

Discretionary contribution plans. Retirement plans where contributions are at the employer's discretion. These include profit sharing plans, stock bonus or ESOP plans, and money purchase plans.

Distribution Options. This is the decision as to how a distribution or payout is to be received. Make sure you understand the tax consequences of any payout or distribution option chosen.

Distribution/disposition/decumulation Stage (of retirement). This stage begins after you have retired. This is your plan as to how best take distributions from your remaining retirement and taxable accounts to minimize taxes and maximize the availability of your assets.

Distribution/disposition/decumulation strategies. These strategies help you set up a framework where you will not outlive your assets. Recommendations include taking out maximum distribution of 3.6% of total assets each year; only taking out maximum earnings from investments of previous year; or during your later years which income is less, i.e., during missions, transfer money from your tax-deferred to tax-eliminated accounts.

Distribution/Payout Options. These are options as to how you will take the benefits over your retirement.

Distributions. These are distributions of interest, capital gains, and dividends by a mutual or index fund while you own the underlying shares. Even though you have not sold the shares, you are responsible to pay taxes on this distributions because the mutual fund is a pass-through vehicle and the taxes on these distributions are paid at the shareholder level.

Diversification. Diversification is the process of allocating your assets so they are not concentrated in a single asset class. It is "not putting all your eggs in one basket". Having a diversified portfolio in many different asset classes is your key defense against risk

DNAH-ial Budgeting Method. This is a method many people use. It stands for DNAH ial - Do nothing and hope. It is not recommended.

Doctrines. Doctrines are the reasons behind why we do things. They answer the "why" questions of our lives, which are generally the most difficult questions to answer.

Down payment. This is the amount that you pay on the house to reduce the cost of the loan. Generally, lenders like a significant down payment as that indicates that the borrower is not likely to walk away from the loan. Different loans require different down payment amounts, i.e Conventional loans – 20 % recommended (but you can get in with 5%), FHA loans – 3.5%, and VA loans – 0% down payment

required.

Downgrade. A situation where a bond rating company reduces the bond rating of a bond generally due to a deterioration in the company's financial condition.

Dread Disease and Accident Insurance. This is a special insurance to cover a specific type of disease or accident. Generally it provides only for 'specific' illnesses or accidents on the "covered" list, and it provides a set maximum dollar amount of reimbursement. This insurance is generally expensive, unless included in your company's total health plan. Generally, concentrate on making your health coverage as comprehensive as possible.

Durable power of attorney. This provides for someone to act on your behalf in the event you should become mentally or physically incapacitated. This document is separate from the will and goes into effect before death. This document should be very specific as to which legal powers it transfers.

Earnings multiple approach. This is one approach for determining the amount of life insurance required. The goal is earnings replacement. The earnings multiple approach seeks to replace the annual salary stream of a bread winner for X years, normally 10 – 15 times gross salary.

Education investment vehicles. These are investment vehicles with the purpose to help you save for your children's education, i.e., Education IRA, 529 plans.

Education IRA. An Education IRA, also called a Coverdell ESA, is an investment vehicle for planning for the future cost of a child's education. The plan allows after-tax contributions each year for each child until age 18. Contributions and their subsequent earnings are tax-free when withdrawn to pay for qualified secondary and post-secondary education expenses.

Education Savings Account (Coverdell or Education IRA). The investment vehicle is similar to a Roth IRA where you invest in this account with after tax dollars, and if you use the proceeds for qualified educational expenses, distributions are tax-free. You choose your investments and the proceeds can be used for eligible elementary, secondary and post-secondary education expenses.

EE Bonds: US government savings bonds where the interest rate is set every 6 months and tied to current market interest rates.

Effective Interest Rate. This is the precise interest rate you are paying, after all costs and fees (regardless whether they are paid in the loan or out of the loan). The goal of a good loan is to have the lowest effective interest rate, which takes into account the time value of money.

Effective marginal tax rate. This is the average amount of every dollar you earned that paid for all local, state, and federal income taxes.

Emerging Market stocks and emerging market mutual funds. These are stocks or mutual funds of companies that trade in the countries not considered develop by the IMF. These are often smaller companies in smaller markets. International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets.

Employee Contribution (or Salary Reduction Plans). These are defined contribution plans where employees contribute before tax dollars reducing their taxable income and earnings accumulate tax deferred. The major plans are Roth or Traditional 401k and 403b plans and 457 plans. Employees direct the funds into different financial asset options provided by the company including mutual funds, index funds, fixed income, equities, money market funds, and GICs (guaranteed investment contracts). Companies have their list of approved investment assets. Employees choose where to invest their assets subject to the company list, and employees are not allowed to invest outside of approved investment assets.

Employer Qualified Retirement Plans. These are retirement plans, established by a company, that have specific tax and other benefits to both the company and the employee. Benefits include competition, tax shelters, personal retirement for the owners, and personal retirement for the employees. They can be either defined benefit or defined contribution plans.

Employment. This is working during college to help offset the cost of educational expenses.

Endowment Effect. Sometimes we perceive that an asset's value increases by virtue of our ownership. Once you own something, its value hasn't increased or changed.

Envelope budgeting method. A process of budgeting where you prepare divide spending each month into categories, create envelopes for each category of spending, and once a bill comes, take the money from the corresponding envelope and pay the bill.

Equities (or Stocks). Equities are an asset class that provides growth and earns returns in excess of inflation. Over longer periods of time, the stock market historically has been the only major asset class to consistently outpace inflation. Equity ownership is ownership in a businesses' earnings and assets. Equity asset classes are delineated by market capitalization (which is shares outstanding multiplied by the stock's current market price), type of company (growth versus value), and geographic area. The benchmarks for equity asset classes can be generally defined as capitalization: Large, mid, and small; type: Growth, blend, and value; or geographic area: US, international, global and emerging markets. Equities have offered the highest return of the major asset classes historically and have been a good investment for long-term investing—they have consistently beat inflation over the long-term. However, they offer less stability of principal than other asset classes, and subject to short-term price fluctuations (so very risky for short-term investments).

Equivalent Taxable Yield: This is the yield you would need to earn on a fully taxable security to give the same after-tax return that you receive on a tax advantaged security, i.e., a security that has specific tax advantages (i.e., tax free for Federal or State or both).

Estate planning. The process of anticipating and arranging for the disposal of your resources to accomplish your personal and family goals after you pass away.

Estate Taxes. These are taxes, paid to the government, due on passing of an individual. Estate taxes are equal to the gift-adjusted taxable estate multiplied by the appropriate tax rate. To determine the net tax owed, calculate the total tax owed and subtract the unified gift and estate tax credit.

Estate transfer. This is the process that property interests are legally transferred from one to another, either during the person's lifetime or at death

Euro Bonds. Bonds issued by U.S. companies and sold outside of the U.S. in U.S. dollars.

Exchange rate risk. Risk that changes in exchange rates will impact profitability for firms working internationally.

Exchange traded funds (ETFs). These are portfolios of stocks similar to mutual funds which trade on organized exchanges. ETF's trade like stocks, are purchased with all the transaction/custody costs, are priced throughout the day (rather than at day's end like mutual funds), and can be sold short and purchased on margin. ETFs can be either in a unit investment trust (UIT) format or an open-end mutual fund structure. The UIT structure does not allow for reinvestment of dividends.

Excise "sin taxes" and state sales taxes. These are taxes imposed when goods are purchased.

Exclusion Amount. This is the amount of estate value that is excluded from the estate tax.

Exclusive Provider Organization (EPO). These are similar to an HMO, but operates through an insurance company. It is funded through an insurance company, with health care provided by contracted providers. Only care received from contracted providers is covered (unless in an emergency situation).

Executor or personal representative. This is the person who is responsible for carrying out the provisions of the will.

Exemptions. An exemption is an amount of money set by the government that you can deduct for each qualifying person in your household.

Expenses. This is where your money goes. There are two types of expenses: fixed expenses, which are expenses you don't directly control; and variable expenses, which are expenses you can control.

Family Giving Plan. A family plan which states how the family will give, to whom it will give to, as well was what the family will or will not do or give to.

Family Money. This refers to the use of personal savings and help from parents or other family.

Fee for-service (or traditional indemnity plans). These are health care plans where the doctor bills the patient directly, and the patient is reimbursed, to a specific percentage, by the insurance company. They provide the greatest flexibility for choosing doctors and hospitals, they define the percent of each claim the policy will cover, and they define the amount the insured must pay before a claim is eligible for reimbursement. Generally these plans are more

expensive and require more paperwork.

FHA Loans. These are Federal Housing Administration (FHA) Insured Loans. The FHA does not originate any loans, but insures the loans issued by others based on income and other qualifications. There is lower PMI insurance, but it is required for the entire life of the loan (1.5% of the loan). While the required down payment is very low, the maximum amount that can be borrowed is also low.

FICO Score: This is the most commonly used credit score. It ranges from 300 to 850.

Fill or kill orders. These are orders which must be either filled or canceled immediately. Most often these are market orders.

Financial assets/instruments. These are different types of securities that are sold in financial markets.

Financial Goals. Financial goals are personal goals with a cost attached.

Financial markets. Markets in which financial securities or assets are bought and sold.

Financial Planning. This is the process of helping yourself and others to use their resources more wisely to achieve their personal and family goals. It should help determine where you are, where you want to be, and how you will get there.

Financial Ratios. These are ratios that can help you to analyze your spending.

Financial risk. How the firm raises money could affect the financial performance of the firm and the value of the bonds.

Fixed contribution plans. These are defined contribution plans where contributions are fixed by the employer. Examples are thrift and savings plans and target benefit plans.

Fixed Income. Fixed income is an asset class that attempts to provide income and to earn returns in excess of inflation. There are two different types of fixed income assets: Taxable bonds. Taxable bonds include U.S. Treasuries, corporate bonds and agency issues (bonds issued by U.S. government agencies, like Ginnie Mae). Tax-free bonds include revenue or general obligation bonds issued by local or state governments and agencies. Such bonds are generally free from federal and state taxes. Fixed income includes short-term bonds/bond funds, intermediate-term bonds/bond funds, and long-term bonds/junk bonds/bond funds issued by governments or corporations. Fixed income offers greater returns than cash, but with greater risk. It offers good diversification tool when holding a long-term stock portfolio, as bonds move differently than stocks. However, returns have been historically lower than stocks, they are very susceptible to interest rate and other risks, and generally, fixed income assets alone are not good long-term investments because they don't provide enough growth to beat inflation over long periods of time.

Fixed rate mortgages (FRMs). These are mortgage loans with a fixed rate of interest for the life of the loan. These are the least risky from the borrower's point of view, as the lender assumes the major interest rate risk above the loan rate. These are the most-recommended option for new home buyers.

Fixed. Payments are a fixed amount, and are made to the investor until the end of the contract, usually till the investor dies.

Fixed-rate loans. Have the same interest rate for the duration of the loan. Normally have a higher initial interest rate as the lender could lose money if overall interest rates increase. The lender assumes the interest rate risk, so they generally add an interest premium to a variable rate loan

Floating rate bond. Bond whose interest payments fluctuate according to a specific benchmark interest rate.

Free Application for Federal Student Aid (FAFSA). This is the application form for obtaining government student aid.

Free money. This is money that is made available by a company, generally on a matching basis, to encourage greater participation in company sponsored retirement plans, i.e., 401k, Roth 403b, Keogh, etc. It is also money made available through education tax benefits, i.e. 529 plan contributions deductible from state taxes.

Free Money. This is money you do not physically work for and is not paid back. It includes scholarships and grants.

Full Retirement Age (FRA). This is the age at which a retiree will receive 100% of their entitled benefits. Receiving benefits prior to FRA will result in a reduction in benefits. Receiving benefits after FRA will result in an increase of benefits.

Full-service brokers. These are brokers who will give you all the tools, research and other advice to help you trade and invest.

Fun. Sometimes we trade for fun and entertainment instead of financial performance. This is OK, but make sure your fun money is no more than 5% of the value of your portfolio—that way you don't lose too much.

General Obligation bonds. Bonds backed by the taxing power of the issuer.

Generation-Skipping Tax. This is a tax on revenue lost when wealth is not transferred to the next generation, but to a succeeding generation. It is a flat tax, in addition to the regular estate tax, imposed on any wealth or property transfers to a person two or more generations younger than the donor.

Gift and estate taxes. These are taxes imposed when assets are transferred from one owner to another.

Gift Tax Exclusions. A gift tax must be paid on all transfers to others (other than a spouse) that are in excess of the maximums specified. The maximum specified is your exclusion.

Gift-Adjusted Taxable Estate. This is equal to your taxable estate plus any taxable lifetime gifts, which is the cumulative total of all gifts over the annual limit.

Giving Plan. A plan on your thoughts on your personal and family giving. It discusses how you will handle both your institutional (through Church and other institutional contributions) and personal (personal and family contributions and service) giving.

Global stocks and global stock mutual funds. These are stocks or mutual funds of companies that contain a mixture of U.S. and foreign or international holdings. International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets.

Goals. These are things we would like to accomplish. They are often divided by time, i.e., short-term, in the next 12 months; medium-term, from 2-10 years; and long-term, beyond 10 years. They may also be divided by type, i.e., identity, integrity, and temporal goals. They will take effort and resources, but are things that are important to us and are what we want to accomplish.

Good Faith Estimates (GFE). This is an estimate from each lender (not just a Summary) of the likely costs you will likely pay as you complete the loan process. I recommend you get GFEs from each potential lender and compare them.

Government-Sponsored Health Care Plans. Government-sponsored health care plans are insurance plans which are sponsored either by the state or the federal government. These plans fall under three headings: Workers' Compensation, Medicare, and Medicaid.

Grace Period: The amount of time given by a credit card company to pay a due balance before interest starts to accrue. Normally 20 to 25 days, excluding cash advances. It does not apply if the card already carries a balance.

Grad PLUS Loan. These are loans available for graduate students to help with school-related expenses. The student is responsible for interest during school, repayment begins six months after student graduates, discontinues or drops below half time, and the graduate student is the borrower.

Grants. Money given to individuals for education on the general basis of need.

Gross Estate. This is the value of all your assets, including life insurance, pensions, investments, and any real or personal property.

Gross Income. Gross income for tax purposes is all income, unless specifically excluded or deferred.

Gross Savings Ratio. This is your income for savings divided by your gross income. This ratio tells you what proportion of your total income is being saved.

Growth stocks. These are fast-track companies whose earnings are expected to grow very rapidly. Frequently these are companies developing new technologies or new ways of doing things.

Guardian. The person who cares for minor children and manages their property.

Health Care Coverage. Health Care Coverage is divided into four areas: basic health insurance, major medical expense insurance, dental and eye insurance, and dread disease and accident insurance.

Health Care Providers. These are the major providers of health care. They fall into three types: Private health care plans, which are either fee-for-

service (or traditional indemnity plans) or managed health care (HMO, PPO); Non-group (individual) health care plans, or Government-sponsored health care plans.

Health care proxy. A health care proxy designates someone to make health care decisions should you be unable to do so for yourself.

Health Maintenance Organizations (HMOs). HMOs are prepaid insurance plans which entitle members to the services of specific doctors, hospitals and clinics. They are the most popular form of managed health care, due to their costs, which are roughly 60% of fee-for-service plans. They provide a system of doctors and hospitals for a flat fee, and emphasize preventive medicine and efficiency, and subscribers pay a relatively small co-pay for services rendered. They provide little choice of doctors and hospitals. As such, service may be less than at other facilities and referrals sometimes difficult to get.

Hedge funds. Hedge funds are less-regulated mutual funds which take much more risk than normal with the expectation of much higher returns. Generally they can take both long positions (where they buy assets) and short positions (where they short-sell assets, i.e., borrow assets and sell them). They hope to later buy back the assets at a lower price before they must return them to the borrower.

Holographic Will. A will and testament that is entirely handwritten and signed by the testator. Traditional wills require signatures of witnesses as well as the testator's signature and intent. Holographic wills are treated equally with witnessed will and need only to meet minimal requirements in order to be probated

Home Equity Lines of Credit (HELOC). Home equity lines of credit are basically second mortgages which use the equity in your home to secure your loan. These are generally adjustable rate notes that have an interest only payment, at least in the first few years of the note. Interest rates are variable and are generally interest only in the first few years. They have lower rates of interest than other consumer loans.

Home Equity Loans. This is a personal debt strategy. You take out a home equity loan, which is a loan against the equity in your home (the difference between what the home is worth and how much you owe on it) to pay off your debts. Home equity loans are basically second mortgages which use the equity in your home to secure your loan. Normally can borrow up to 80% of your equity in your home.

Home Inspection. This is a service, usually paid for by the buyer, to alert them to potential problems with the home. Many of these problems should be fixed by the seller prior to purchase and so these problems need to be discovered and disclosed. Don't buy someone's problems.

Housing Expenses or Front-end Ratio. This is a housing affordability ratio that calculates what percent of your income is used to make mortgage payments. Housing expenses should be less than 28% of your monthly gross income. The formula is: monthly PITI*/monthly gross income <28%. PITI = mortgage principle, mortgage interest, property taxes, and property insurance.

Housing. These are appreciating tangible assets, such as land, dwellings, vacation home, or rental property used for personal goals or capital income.

Housing Ratios. As Christians, we have other important obligations that we also pay, i.e., tithing and paying ourselves, i.e., savings. As such, should have smaller houses (at least less expensive), because we pay the Lord first and ourselves second. For a spreadsheet that takes into account the fact that we pay the Lord first and ourselves second within this front-end and back-end ratio framework, see: Maximum Monthly Mortgage Payments for Christian Savers Spreadsheet (from the website).

I Bonds: Inflation linked US government savings bonds, where the rates on the bonds are tied to inflation.

Identity goals. These are goals that relate to our long-term view of who we are and how we see ourselves. These goals help us be better in our long-term view of who we are and what we want to become.

Ignorance. A reasons for going into debt. We don't understand interest and its costs.

Immediate Annuity Distribution. You can use your defined contribution plan to purchase an immediate annuity, either from your retirement Plan provider or from others outside the Plan.

Impound/escrow/reserve accounts. These accounts are that portion of a monthly payments held by the lender or servicer to pay for: Taxes, Hazard insurance, Mortgage insurance, Lease payments, and

Other items as they become due. These are for payments for items above which are over and above your monthly mortgage payments of principle and interest. These may or may not be required by your lender.

Inactivity/Minimum balance fees. These are fees because you did not have account activity during the period or because you failed to keep a minimum balance in your account.

Inactivity/Minimum balance fees. These are fees imposed because you did not trade or have account activity during the period or because you failed to keep a minimum balance in your account.

Income Statement (personal). This is a financial record your inflows and outflows of cash. It is on a cash basis. The statement is based entirely on actual cash flows, not accruals.

Income Taxes. Income taxes are a progressive tax meaning that the more you earn the more you pay.

Income-consuming assets. These are assets which require a constant infusion of cash to keep operative.

Income-generating assets. These are the best type of assets. These assets generate income or capital gains which may eventually allow you to have income without your having to work.

Indenture. A document that outlines the terms of the loan agreement.

Independent brokers. These are brokers whose company is not part of a major chain or who own a captive mutual fund company. They may be inclined to give unbiased advice as they do not sell specific mutual funds.

Independent brokers. These are brokers whose company is not part of a major chain or who own a captive mutual fund company. They may be inclined to give unbiased advice as they do not sell specific mutual funds.

Index funds. Index funds are mutual funds designed to match the returns of a specific index or benchmark. Different Index funds may track many different benchmarks, including the S&P500 (Large-cap stocks), Russell 5000 (small-cap stocks), MSCI EAFE (international stocks), Barclay Aggregate (corporate bonds), DJ REIT (Real estate investment trusts), etc. Index funds are tax efficient since they do little in buying and selling of securities, and their goal is to match the return of their relative benchmarks.

Index funds. These are mutual funds or ETFs which hold specific shares in proportion to those held by a specific index, i.e., the S&P 500 or Russell 2000. Their goal is to match the benchmark performance. Index funds have become the standard against which other mutual funds are judged.

Individual Biases. The brain does not work like a computer. Instead, it processes information through shortcuts and emotional filters to shorten the analysis time. These filters and shortcuts lead to predictable errors in investing. We must be wise to these prediction errors so we can be better investors and better stewards over our resources.

Individual Development Accounts (IDA). These are matching resources from local and other sources to encourage saving for specific goals including education. They must be used for education, or home purchase, or to start a business, you must be in the program for 12 to 36 months maximum, and must attend a basic money management class (Fin418 counts), reside in Utah, be 18 or older, have income to save and meet needs criteria.

Individual Retirement Accounts. These are retirement account created with the Taxpayer Relief act of 1997. While there are over a dozen different individual retirement accounts, the three major types of Individual Retirement Accounts are Traditional IRA, Roth IRA, and Education IRA, which is also called a Coverdell Education Savings Account (ESA).

Individual Retirement Annuity: An IRA set up with a life insurance company through purchase of annuity contract.

Inflation risk. Risk that a rise (decline) in inflation will result in a decrease (increase) in the bond's value.

Inherited IRA: An IRA acquired by the non-spousal beneficiary of a deceased IRA owner.

Initial public offerings (IPOs). These are the very first shares ever issued by a company. Investment bankers serve as underwriters or intermediaries for these IPOs

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Initial target portfolio. This your first goal for a target dollar amount as you begin building your portfolio. It is calculated by taking your emergency fund goal and dividing it by your percentage in bonds and cash.

Installment Loans. Installment loans are loans which are repaid at regular intervals and where payment includes both principal and interest. These are normally used to finance houses, cars, appliances, and other expensive items. These loans are amortized, which is the process of the payment going more toward principal and less toward interest each subsequent month. These may be secured or unsecured loans, variable-rate or fixed-rate loans.

Insurance. Insurance is a tool help you achieve your personal and family goals. It is a product that transfers the risk of certain types of losses or events from an individual to another institution. By transferring risk, it can help the individuals achieve specific goals if they die, get sick or become unable to work. But it is a tool that needs to be understood and used wisely.

Insured Worker. A worker is only entitled to receive benefits if that worker is fully insured. Workers are considered fully insured if they have worked forty quarters of work (a quarter is three months) and earned a specific amount of money per quarter.

Integrity goals. Integrity goals relate to the characteristics and standards you want to achieve in the work and service you provide. These goals relate to how we will work and live, what we will and will not do, and characteristics and skills we wish to attain.

Interest only Option loans. These are FRMs or ARMs with an option that allows interest only payments for a certain number of years, and then payments are reset to amortize the entire loan over the remaining years. Some will take out an interest only loan to free up principal to pay down other more expensive debt. Once the interest-only period has passed, the payment amount resets, and the increase in payment can be substantial. These are generally not recommended.

Interest or finance costs. This is the average amount borrowed times the monthly interest rate. In calculation form, it is the (Net capitalized cost + residual value) / 2 times your average interest rates which is the APR/12.

Interest rate risk. Risk that a rise (fall) in interest rates will result in a decline (rise) in the bond's value.

Interest. The cost of using borrowed money. Interest must always be paid.

Interest/coupon payments. These are payments received as part of the contractual agreement to receive interest payments from a bond. Bonds which have preferential interest tax treatment, i.e., muni's and Treasuries, must still pay capital gains taxes.

Intermediate-term bonds. Bonds with a maturity of 2 to 10 years.

Internal Rate of Return (IRR). This is a form of loan analysis to determine whether you should refinance or not. The process is to calculate all costs and fees for the loan, calculate the monthly savings, determine the number of months of savings, and set the number of months on the new loan equal to the number of months remaining on the old loan so you are not extending the loan! If your IRR is greater than your risk-free rate, then refinance.

International Bonds. Bonds issued by international companies and sold internationally in various currencies.

International stocks and international mutual funds. These are stocks or mutual funds of companies based entirely outside the U.S. These can be of any size (small-cap, large-cap), any type (value, growth) and from any part of the world outside the US. International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, political instability, foreign taxes and regulations, and the potential for illiquid markets.

Intestate. The process whereby the state essentially writes the will for a person because they did not prepare a will during their lifetime.

Investment advisor. A person or an organization that helps makes the day-to-day decisions regarding a portfolio's investments for investors.

Investment Assets. These assets include stocks, bonds, mutual funds that are invested for the future. These are also income-producing assets used to accumulate wealth to satisfy specific goals.

Investment Benchmarks. An investment benchmark is the standard by which to judge your asset performance. You never choose an asset without choosing an investment benchmark. Use your

investment benchmark to determine how well you are doing.

Investment Constraints. These are specific needs you have which will constrain how you will invest your portfolio.

Investment Guidelines. Your investment guidelines are the general road map on how you will be investing your assets over your life cycle. It integrates your personal goals and your financial goals into a complete financial perspective.

Investment Horizon. This is when will you sell the investment.

Investment Plan (also called and Investment Policy Statement). Your Investment Plan is the most important document you will prepare in regards to your investing activities. It sets the plan and framework on every investing activity. It states what you will do: what you will and will not invest in, how you will invest, why you will invest, what percentages you will invest, etc. In short, it is the key document that will impact your investment returns most for the rest of your future.

Investment risk. This is the risk of who takes responsibility for the investment outcome, the insurance company or the insured.

Investment vehicles. The investment vehicle is the tax-law defined framework that has specific tax advantages, i.e., 401k, 403b, Individual Retirement Account (IRA), SEP IRA, Roth IRA, Roth 401k, etc. Investment vehicles have different benefits, i.e., due to matching (free money), tax elimination, tax deferral, or just tax-efficient and wise investing. Investment vehicles are like shopping carts in the grocery store, they are the things you put your groceries, or financial assets, into.

Investment/financial assets. Investment or financial assets are the securities that are invested in by the investment vehicles, i.e., stocks, bonds, mutual funds, REITs, MMMFs, CDs, etc. They are like the groceries you put in your shopping cart, which is your investment vehicle.

IRA Rollover distribution (Be careful and don't touch the funds). You can roll over your distribution into an IRA. The benefits are you can defer taxes until you withdraw the funds, you can direct investment to different assets and asset classes, and you can continue to enjoy tax-deferred growth. The risks are that there is no guarantee that funds will last a lifetime and you must begin withdrawals at 70½ or 50% penalty is incurred.

Irrevocable Living Trust. A trust that cannot be changed by the owner once established, because the trust becomes another legal entity which owns all the assets contained in the trust and pays taxes on the assets and gains they produce. The assets are not subject to estate taxes since they are not part of your estate and assets in the trust do not pass through probate.

Issue. These are children.

Issuer. The corporation or government agency that issues the bond.

Itemized Deductions. These are allowable deductions (if you itemize) and include: charitable contributions (cash, in kind, and/or mileage), home mortgage interest, medical expenses (>10% AGI), un-reimbursed qualified job expenses (> 2% AGI), casualty and theft expenses (> 10% AGI), etc.

Jensen's Alpha. This is a risk-adjusted performance measure. This is the ratio of your portfolio return less CAPM determined portfolio return, or alpha = rp - [rf + ßp (rm – rf)] where ap = alpha for the portfolio, rp = average return on the portfolio, ßp = Weighted average Beta, rf = average risk free rate, and rm = average return on market index port. It is portfolio performance less expected portfolio performance from CAPM model.

Joint and Survivor Annuities (percent relates to the amount the spouse receives). You receive payment for as long as you live or for a certain guaranteed period, whichever is longer, and your spouse, after you die, receives that percent of your payment for as long as they live.

Joint Tenancy with Right of Survivorship (JTWROS). Ownership is shared equally and lifetime control is shared, income is shared between owners, testamentary control is absent, and then right of survivorship is key.

Jumbo loans. These are loans in excess of the conventional loan limits and the maximum eligible for purchase by the two Federal Agencies, Fannie Mae and Freddy Mac, of $424,000 in 2018 (some areas have higher amounts). Some lenders also use the term to refer to programs for even larger loans, e.g., loans in excess of $500,000.

Junk Bonds. Bonds with very low bond ratings, a

higher interest rate and default rate, and are almost always callable.

Keogh Plan. This is a small business retirement plan set up by a sole proprietor or partnership (not incorporated) which allows employers to make tax-deductible payments to retirement plans, similar to pension or profit-sharing plans. Plans can be either a defined benefit or defined contribution, but most commonly are DC profit sharing or money purchase plans. Contributions are tax deductible, earnings grow tax-deferred, and employers may borrow from the Plan

Large-cap (capitalization) stocks. Large caps are stocks with a market capitalization greater than roughly $10 billion in the US, and smaller capitalizations for international companies. These are the generally the largest, most well established companies in the US, with a history of sales and earnings as well as notable market share. These are generally mature corporations with a long track record of steady growth and dividends.

Lease cost: The total cost of a vehicle's lease.

Lease term: The number of months the vehicle is leased.

Lease: A contractual arrangement calling for the lessee (user) to pay the lessor (owner) for the use of an asset.

Leverage. The decision of using debt to invest. It is not recommended.

Liabilities. This is what you owe to others. Liabilities come in two major forms: current liabilities, liabilities that must be paid-off within the next year, and long-term liabilities, liabilities that extend beyond one year.

Liability Coverage. Liability is the financial responsibility one person has to another in a specific situation. Liability results from the failure of one person to exercise the necessary care to protect others from harm. Personal liability coverage protects the policyholder from the financial costs of legal liability or negligence. There are two major forms of liability insurance: the liability portions of homeowners and auto insurance and an umbrella liability coverage.

Life Annuities (guaranteed for the "certain" period). You receive benefits for as long as you live or for a certain guaranteed period, whichever is longer.

Life insurance. This is insurance that provides compensation to your beneficiaries should you die prematurely. It transfers the economic loss of death from an individual to an insurance company by way of a life insurance contract. It can help us take care of our own and extended families should we die.

Life-cycle funds. These are funds which change their allocation between stocks and bonds depending on investor age. As an investor ages, life cycle funds reduce their allocation to stocks and increase their allocation to bonds, more consistent with the goals and objectives of an older investor.

Lifetime transfers. Methods of transferring property including the sale or gifting of one asset to another.

Limit orders. These are orders to sell or buy a specific number of shares at a specific price or better. This is generally the best method in working with brokers.

Limited Partnership Basis. A process of teaching children about finance based on their age and consistent with their ability to learn.

Liquidity risk. Risk that investors will be unable to find a buyer or seller for a bond when they need to sell or buy.

Liquidity. This is the speed and ease with which an asset can be converted into cash.

Living Trust. A trust where assets are placed in the trust while you are still living. You can take them out and move them according to what you want to do before you die.

Living will. It is a legal document that details your end-of-life wishes for health care. It is used when you are still alive but unable to make health care decisions for yourself. A living will states your wishes regarding medical treatment in the event of a terminal illness or injury

Loads. Loads are sales charges to compensate the sales force for selling the fund. Loads directly reduce the amount of money invested by the amount of the load. Loads can either be front-end or back-end, depending on when the mutual fund company takes out the load or sales charge. Generally, research has found that the performance of load funds and no-load funds is identical. When the sales charges are included, no-load funds significantly outperform load funds. (Matthew R. Morley, "Should You Carry a Load? A Comprehensive Analysis of Load and No-Load Mutual Fund Out-of-Sample Performance,"

Journal of Banking and Finance, vol. 27, nu. 7 (2003), pp. 1245-71.)

Loan term. This is the duration of the loan. It can be 10, 15, 20 or 30 years depending on your goals and your cash flow situation.

Local income taxes. These are uncommon; but some larger cities, for example, New York City, impose such a tax.

Long-term bonds. Bonds with a maturity of greater than 10 years.

Long-term capital gains. These are capital gains where the Fund has owned the assets for more than a year (366 days). These are taxed at a rate dependent on your taxable income.

Long-term Debt Coverage ratio. This is your income available for living expenses divided by long-term debt payments. This ratio tells how long you could make monthly payments on your debt based on the amount of money you have available for living expenses (which is wages less taxes). The inverse of this ratio is the Debt Service ratio.

Loss Aversion. Often losses are given more weight in our minds than potential gains in any position. These weights are more than utility theory would suggest. We should give gains and losses equal weight in your analysis. It is the gains and losses of the overall portfolio that are important, not individual securities.

Low Income Filer. This is a single filer with provisional income below $25,000 or married filing jointly (MFJ) with income below $34,000. None of the benefits are taxable.

Lump Sum Benefit. A lump sum of $255 is available to the surviving spouse, nonresident spouse, or to children eligible for the monthly benefits (for 2018).

Lump Sum Distribution. This is taking the entire retirement account at retirement. You are responsible to ensure this amount lasts your entire life. The benefits are you can take the money out as you need it, and can invest/gift/use it elsewhere. The risks are that plans only allow distributions every 3 months, taxes are incurred immediately, and if you do not plan well, may not have sufficient money for retirement.

Lump-sum. You receive a single payment of all principal and interest at retirement that you are responsible to manage.

Maintenance margin. This is money you put up to buy on margin. If your maintenance margin falls below a specific level, you will be required to put up more money. If not, your position will be closed out.

Major Medical Insurance. This is major coverage of medical costs over and above the basic health insurance coverage. It covers medical costs beyond the basic plan. These normally require a co-payment and/or a deductible. There is a stop-loss provision, which limits the total out-of-pocket expenses incurred by the insured to a specific dollar amount and a life-time cap for the insurance company, which limits the total amount the insurance company will pay over the life of a policy.

Managed health care providers. These are insurance companies which provide pre-paid health care plans to employers and individuals. There are four main types of managed care: i. Health maintenance organizations (HMOs), Preferred provider organizations (PPOs), POS Plans (POS), and Exclusive Provider organization (EPOs). They pay for and provide health care services to policy holders and they provide the most efficient payment of bills. However, they limit choices to the doctors and hospitals that participate and they require policy holders to pay a monthly premium and share the cost of care.

Management fees. These are fee charged by the advisor to a fund generally on the basis of a percentage of average assets under management, i.e. 75 basis points or .75% a year.

Manager Style Drift. This is a check on the management style. Make sure the manager's investment style remains constant. Investment fund managers have no authority to change the asset class. If you purchase a small cap fund, the manager should purchase small cap shares. The fund's prospectus should clearly define the market size, company, and portfolio style tilt.

Margin accounts. These are accounts where you borrow from the brokerage firm to purchase financial assets. This is debt, and can amplify both gains and losses.

Margin call. This is a call by the broker to put up more money when your margin declines below a certain level. I recommend you do not buy on margin. It is using debt to invest and you can lose more than

your original investment doing this.

Marginal tax rate. This is your taxes on each additional dollar of earnings. If you made $1 more this year, at what rate would it be taxed.

Market capitalization. It is one measure of the size of a company. It is calculated by multiplying the market price of the stock by the number of shares (i.e. ownership pieces) outstanding. The greater the capitalization, the larger the company. Market capitalization is used to weight companies in various benchmarks and to determine certain classes of companies, i.e. large-cap, mid-cap, small-cap, etc.

Market orders. These are orders to sell or buy a specific number of shares at the currently available or market price. Be careful as the market can move quickly and dramatically between when you place the order and order execution time.

Markup. This is the difference between the buying price and the calculated selling price.

Maturity date. The date when the bond expires and the loan must be paid back.

Maximum Family Benefit. When benefits are payable to more than one family member, a family maximum applies. This includes all benefits paid to the family. For disability, the family maximum is the lesser of 150% of the workers disability benefit or 85% of the AIME used to calculate the benefit, but is not less than the benefit paid to the worker. When the worker is living, and benefits exceed the family maximum, the worker's benefit is not adjusted; rather, the reduction is made in other beneficiaries' payments.

Mean Reversion. Prices tend to correct themselves as investors correct for overreaction. Long-term prices tend to revert to the mean.

Medicaid. Medicaid is a medical assistance program, operated jointly by the states and federal government, to provide health care coverage to low income, blind, or aged persons. Medicaid payments may be used to offset the premiums, deductibles, and co-payments incurred with Medicare. There is no guarantee that this plan will be around in its present form.

Medicare Benefits. Medicate hospital insurance (HI) portion of Medicare, also known as Part A, is largely funded by the 2.9% HI tax on earnings. Part A is compulsory. Individuals at least age 65 and eligible for Social Security retirement benefits on their own behalf are entitled to coverage under Medicare Part A. If the individual has applied for Social Security (SS) retirement benefits, no separate application is required.

- Medicare Part A is compulsory and covers all hospital related expenses, such as bed and board, operating room costs, and lab tests. Patient pays a deductible and coinsurance payment.
- Medicare Part B is voluntary, with a monthly charge. It covers doctors' fees and other outpatient treatment. Patient pays a premium, deductible, and 20% of approved charges.
- Medicare Part C (Medicare Advantage) provides three program alternatives: coordinated care plans, private fee-for-service Medicare, and health savings accounts (HSAs).

Medicare. This is a health care insurance program for elderly and disabled. Medicare insurance provides medical benefits to the disabled and to those 65 and older who are covered by Social Security. Its cost is covered through Social Security taxes. Individuals can get insurance through Medicare that would be prohibitively expensive through other channels, however, it doesn't cover all the costs and expenses and individuals must pay certain amounts. In addition, there are limitations to the coverage, such as out-of-hospital prescription drugs and limitations to the number of days in skilled nursing facilities. Medicare is divided into three parts: A, B, C.

Mental Accounts. Often investors keep mental accounts rather than viewing individual assets as part of a total portfolio. We do this to try to save ourselves from ourselves.

Mid-cap or mid-capitalization stocks. These are stocks with capitalization between roughly $2 billion and $10 billion. These stocks tend to grow faster than big cap companies, and are generally less volatile than small cap companies. Mid-caps generally perform similar to the small-cap asset class. For asset-allocation purposes, mid-caps are generally not considered a major asset class.

Middle Income Filer. This is a single with income from $25,000 to $34,000 and MFJ with income from $32,000 to $44,000. Up to 50% of social security benefits are taxable.

Minimum purchase amount. This is the minimum

amount the mutual fund company will allow you to purchase in their funds to begin investing.

Mission Statement. This can be your individual and family purpose and passion. It can also include other things such as family mottos, family mission statements, what you stand for, etc.

Modified Adjusted Gross Income. This is your adjusted gross income adding back certain items such as foreign income, foreign-housing deductions, student-loan deductions, IRA-contribution deductions and deductions for higher-education costs.

Monetary (or Current) Assets. This is cash or other assets that can be easily converted into cash. These may be also income-producing assets. They provide necessary liquidity in case of an emergency.

Money factor: A way of expressing interest rates, calculated by taking the APR and dividing it by 24.

Money Market Account or Money Market Deposit Account: A non-financial account that pays interest based on current interest rates in the money markets. They typically require a higher minimum balance to avoid monthly fees and typically have a higher rate of interest.

Money market mutual funds. Money market mutual funds are funds which invest the majority of their assets in short-term liquid financial instruments such as commercial paper and government treasury bills. Their goal is to obtain a higher return, after fees and expenses, than traditional bank savings or checking accounts.

Money Purchase Plans. These are defined contribution plans where the employer contributes a percentage of employee salary each year, not dependent on company profits. Employees do not contribute.

Monitor performance. The process of understanding and reviewing the performance of a portfolio. Unless you monitor performance, you will not know how you are doing in working toward accomplishing your objectives. You need to know how every asset you own is performing, and performing versus its benchmark, so you can determine how well you are moving toward your goals.

Month's Living Expenses Covered ratio. This is your monetary assets divided by your monthly living expenses. This ratio tells you how many months you could survive in the event of the loss of all current income. Your living expenses do not include charitable contributions, taxes or savings.

Mortality risk. This is the risk that the insured dies outside the contract period and is therefore not covered by insurance.

Mortgage-backed bonds. Bonds backed up by a pool of mortgages.

Mother's or Father's Benefit. The surviving spouse of a fully or currently insured worker is eligible to receive a benefit of 75% of the worker's PIA if they are caring for a child who is under age 16 or who was disabled before age 22 (subject to family maximum).

MSRP: The price the manufacturer hopes to get for the sale of a product.

Mutual fund returns. Mutual fund returns include distributions of dividends, capital gains, and interest, and any NAV appreciation. Your total return: (ending NAV–beginning NAV)+ distributions / beginning NAV. Mutual Fund after-tax returns is your return after all taxes are taken out. Mutual fund before-tax returns is your return before taxes.

Mutual fund share classes. These classes of shares vary depending on the loads and management fees paid. While there are differences in classes of shares among investment management companies which charge loads, they generally are:

Mutual fund supermarkets. Mutual fund supermarkets i.e., Fidelity Funds Network, Charles Schwab, or Jack White, allows you the benefits of the mutual fund company while you get access to a whole range of mutual fund companies (but not all of them). Mutual fund companies rebate part of their management fees back each month to the "mutual fund supermarkets" to have them included in their list of funds.

Mutual fund. It is a way of holding financial and real investments. It is an Investment company that pools money from investors to buy stocks, bonds, and other financial investments. Investors own a share of the fund proportionate to the amount of their investment divided by the total value of the fund.

Necessity. One of the reasons for going into debt. It is we truly cannot feed our families.

Needs Approach. This is an approach for determining the amount of life insurance that is required. It determines the total needs of the

beneficiaries which includes immediate, debt elimination, transitional, dependency, spousal life income, education, and retirement needs. It is the most detailed of the approaches.

Negative Amortization Mortgages (NegAm). These are mortgage loans in which scheduled monthly payments are insufficient to amortize, or pay off the loan. Interest expense that has been incurred, but not paid is added to the principal amount, which increases the amount of the debt. Some NegAm loans have a maximum negative amortization that is allowed. Once that limit is hit, rates adjust to make sure interest is sufficient to not exceed the maximum limit.

Net capitalized cost (also called **adjusted capitalized cost**): The final amount paid. Found by taking the capitalized cost and subtracting capitalized cost reduction.

Net worth or equity. This is the difference between your assets, the things you own of value, and your liabilities, what you owe to others.

New investor bias. New investors dilute the value of existing investor's shares. Since new money comes into the fund at Net Asset Value, and since this money must be invested (at roughly 0.5% on average in the U.S.), existing investors are subsidizing new investors coming into the fund

NMD (New Money / Donations) Addendum. This is a way to rebalance using either of the rebalancing methods. Rebalance as determined previously, but pay your charitable donations using appreciated assets, and use the money you would have spent on charity to purchase the "underweight" assets, so you do not have to sell and incur transactions costs or taxable events.

No-load mutual funds. Mutual funds that are sold without a sales charge and are redeemed without a charge as well.

No-Load Shares: These are shares sold without a commission or sales charge. Generally, these shares are distributed directly by the investment management company, instead of going through a sales channel. They may have higher management fees to compensate for the lack of a front- or back-end load.

Non-deductible IRA. Individuals may contribute to a non-deductible IRA. The benefits are that money is contributed after-tax, and investment earnings grow tax-deferred. No taxes are paid on the investment earnings until the earning are withdrawn at retirement. Accurate record keeping is required to pro-rate the nondeductible portion of any subsequent distribution.

Non-group Coverage Plans. These are health insurance plans which cover individuals on a case-by-case basis and are traditionally the most expensive type of coverage. They provide a custom insurance policy to the purchaser. They are expensive, usually 15% - 60% more expensive than a group policy and may require subscribers to pass a medical exam.

Non-probate transfers. These are "will substitutes," and include state law, right of survivorship, beneficiary designations, and gifts causa mortis.

Non-refundable credits. Non-refundable credits include child tax, child and dependent care, elderly and disabled, adoption, hope learning, and lifetime learning and are only good up to the amount of taxes owed.

OASDI – HI (Old Age, Survivors, and Disability Insurance and Hospital Insurance). This is payment for Social Security and Medicare taxes. The employee and employer each pay (assuming your Adjusted Gross Income (AGI) is less than $250,000: Social security tax (OASDI) of 6.20%, Medicare tax (HI) of 1.45%, for a total of 7.65% each. Self-employed individuals pay the whole 15.30%. OASDI-HI taxes are on taxable wages including wages, salaries, bonuses, commissions, value of employer provided meals/lodging, sick pay during first 6 months, employer paid group life insurance premiums in excess of $50,000, salary reduction from 401k, 403b, 457 plans, non-qualified deferred compensation no longer at risk, non-qualified stock options, vacation pay, and severance pay.

Open orders (GTC: good till canceled, GTD: good till date specified). These are orders which are good until filled or canceled. Be very careful with open or GTC/GTD orders. If you fail to cancel specific orders, you might have orders filled that you forgot to close out.

Open-end mutual funds. These are mutual funds that can be purchased and sold each day at the fund's Net Asset Value, which is the fund's assets less liabilities, divided by the number of shares outstanding.

Option Adjustable Rate Mortgages (Option

ARMs). This is an ARM where interest rate adjusts monthly, and payments annually, with "options" on the payment amount, and a minimum payment which may be less than the interest-only payment. The minimum payment option often results in a growing loan balance, termed negative amortization, which has a specific maximum for the loan. Once this maximum is reached, payments are automatically increased and the loan becomes fully amortizing after 5 or 10 years, regardless of increase in payment and must be repaid within the 30 year limit. These are not recommended.

Ordinary dividends. These are stock dividends earned from holding a stock an insufficient number of days within a specific period to be reported as qualified dividends. Ordinary dividends are taxed at a federal marginal or ordinary tax rate.

Organized Exchanges. These are areas used to facilitate trading of financial instruments.

Origination fees: These are the costs and profits made by the mortgage broker for originating the loan.

Overreaction. Many investors assign a probability to asset returns based on past theory. Appropriate reaction to a negative event is to update a prior probability to the most recent event. Overreaction is when they assign too high a value.

Over-the-Counter (OTC) Market. This is an electronic network of dealers used to execute trades without specialists or middle-men.

Ownership. This is the principle that everything we have is the Lord's, and we do not own the things we have and are. It is based on scripture and helps us to see our blessings as gifts on loan from a loving Father in Heaven.

Par value. The face value or amount returned to the holder of the bond at maturity.

Passive management. Passive management is the process of accepting average returns through purchasing index funds rather than trying to beat the market. It is much cheaper and more tax efficient.

Passive portfolio management. It is the process of buying a diversified portfolio which represents a broad market index (or benchmark) without any attempt to outperform the market or pick stocks. Since most active managers fail to outperform their benchmarks, especially after costs and taxes, investors have realized that if you can't beat them, join them, so they buy low-cost passive funds which meet their benchmarks consistently and minimize taxes.

Payday Loans. These are short-term loans of 1-2 weeks secured with a post-dated check which is "held" by the lender and then cashed later. These have very high interest rates and fees, APR > 720%. Typical users are those with jobs and checking accounts but who have been unable to manage their finances effectively.

Pell Grant. A type of government grant to help students attend college.

Percentages. We sometimes move in and out of asset classes and stocks instead of keeping specific asset class percentages relatively constant (within our minimum and maximum amounts from our Investment Plan). We get lower returns from increased trading costs and may have more risk than we want.

Percent-range-based rebalancing. This is the process of rebalance the portfolio every time actual holdings are +/-5% (or +/-10%) from target ratios. Rebalance whenever you are outside this range. It is easy to implement and wider ranges will reduce transactions costs (at the expense of higher tracking error).

Performance evaluation. It is the process of evaluating a portfolio's performance with the goal of understanding the key sources of return.

Periodic Payments distribution. With this distribution, you can plan for regular payments at regular intervals, and can ensure that payments are available for a specific period of time. However, there is no assurance of lifetime income, and your tax rate may be high due to the amount of money withdrawn.

Periodic-based rebalancing. This is the process of rebalancing where you specify a time period, i.e. bi-annually, annually, etc. After each time period, rebalance the portfolio back to your original asset allocation targets. It is the most simple of the methods, and longer periods have lower transactions and tax costs (but higher tracking error costs).

Permanent insurance. Permanent insurance is an insurance contract that is purchased for the entire life of the policy holder with premiums divided between death protection and savings. Provides insurance that cannot be cancelled, may be used for estate

retirement, and savings. It is complex, expensive, and not transparent, and unless premiums are paid, it can expire worthless. Please note that certain permanent products are not permanent, i.e. they can lose money.

Personal Financial Plan. This is a document that contains all critical areas of your personal financial life. It is your individual and personal roadmap for achieving your personal and family goals. It entails 6 steps: 1: Decide What You Want, 2: Evaluate Your Financial Health, 3: Define your Personal and Financial Goals, 4: Develop a Plan of Action, 5: Implement Your Plan, and 6: Revise Your Plan as Necessary.

Personal Property. These are depreciating tangible assets, such as boats, furniture, clothing, etc.

Personal Representative (Executor). This is the person who fulfills the requirements of the trust or will.

Perspective. Perspective is how we look at things. It is important because it impacts choice. We can take many different perspectives in our view of different aspects of our lives, with the best perspective being the perspective that last the longest—an eternal perspective.

Piggyback loans. These are two separate loans, one for 80% of the value of the home and one for 20%. The second loan has a higher interest rate due to its higher risk. The second loan is used to eliminate the need for PM Insurance. With a piggyback loan, PMI is not needed, but these are much harder to get now.

Point of Service Plans (POS). These plans have attributes of HMOs, PPOs, and indemnity plans. The point at which benefits are received determines the amounts of benefits paid. POS may include HMO, PPO, and indemnity type programs, and the POS may also have a gatekeeper.

Points. Points are fees for a loan. 1 Point is one percent or one hundred basis points of the loan. This money is pre-paid interest, money paid to the mortgage broker (not the lender). It is deducted from the loan proceeds (you still must pay it back), and is essentially another fee for helping you arrange the loan (minimize points). Lenders charge points to recover costs associated with lending, to increase their profit, and provide for negotiating flexibility. You will like have to pay origination points, but buy-down points (to reduce the interest rate on the loan) are purely optional.

Political or regulatory risk. Unanticipated changes in the tax or legal environment will have an impact on a company's bonds.

Portfolio attribution. It is the process of separating out portfolio returns into their related components, generally attributable to asset allocation, securities selection, industry, and currency.

Portfolio evaluation. The process of monitoring financial asset performance, comparing asset performance to the relevant benchmarks, and determining how well the fund is meeting its objectives.

Portfolio management. It is the development, construction, and management of a portfolio of financial assets to attain an investor's specific goals.

Portfolio rebalancing. It is the process of bringing portfolios back into given target asset allocation ratios. Changes in allocation occur due to changes in asset class performance and investor objectives or risk, or introduction of new capital or new asset classes.

Portfolio reporting. The process of reviewing portfolio performance with the necessary participants, i.e. your spouse or your investment advisor.

Potential Cap Gains Exposure. This is an estimate of the percent of a funds asset's that represent capital gains. If this is high, the probability is high that these may come to the investor as capital gains.

Pre-approval. Pre-approval is the process whereby lenders have pull your credit score, looked at your tax records and approve you for a specific amount of a loan. Get pre-approved for your loan by a number of lenders (with mortgage loans, you can have multiple loans requested within a 90 period and it's counted as one loan request). You can borrow up to this pre-approved amount without a problem. Remember however that you do not need to borrow that amount. I recommend you borrow less than that amount.

Preferred Provider Organizations (PPOs). PPOs are insurance plans which are essentially a cross between the traditional fee-for-service and an HMO. PPOs are organizations where in-plan provider's fees are covered, and out-of-plan providers results in higher fees. Insurers negotiate with a group of doctors and hospitals to provide care at reduced rates, while giving insurers the ability to go to non-plan doctors. PPOs provides health care at a discount to

fee-for-service plans. They provide a group of doctors which work at reduced costs to the participants, while assessing an additional fee if the participant uses a non-member doctor or center. PPOs are more expensive than HMOs and use of non-PPO providers results in higher out-of-pocket costs.

Prepayment Penalties. These are penalties enforced by the lender for prepaying a loan too soon. Prepayment penalties have a stated period of time, i.e., 1, 2, or 3 years the prepayment penalty is in effect, a maximum pay down percentage (MPP), i.e., 6% of the principal per year, and a prepayment penalty if you sell it before, i.e., 6 months interest. With a soft prepayment you cannot within the stated period of time without penalty, refinance at all, sell the loan to family members, or pay down more than your MPP each year. The only way to get out of a soft prepayment penalty is to sell the property to an unrelated party. With a hard prepayment, you cannot within the stated period of time without penalty refinance at all, sell the loan to anyone, or pay down more than your MPP each year. There is no way to get out of a hard prepayment penalty before the defined period without paying the penalty.

Prepayment. Prepayment is the process where you repay the loan early, either through paying off the loan or selling the house and the new buying paying off the old loan.

Pre-qualified. Pre-qualified is a process where lenders estimate your credit based on information you tell them. I recommend you get pre-approved, not pre-qualified.

Price. The price that the bond sells for.

Pride. A reason for going into debt. How we look to others is more important than how we look to God.

Primary and Secondary markets. Primary markets are markets for trading newly issued securities. Secondary markets are for trading already issued shares of stocks, bonds, and other securities. Secondary markets consist of organized exchanges and over-the-counter or electronic markets where existing shares are traded.

Primary Insurance Amount (PIA). Your PIA is the basic unit used to express the amount of a worker's benefit if they received benefits at their full retirement age (FRA). The calculation of PIA is based on the workers AIME, which is split into three segments and multiplied by specific percentages for each segment and summing the parts.

Primary markets. These are markets for trading newly issued securities.

Principles. These are doctrinally based guidelines for how we should live our lives. Whereas doctrines answer the 'why" questions, the principles are the "what" questions, i.e., what are the things and guideline we should be following and doing.

Priority of money. This is an educational tool to help individuals determine the order of which they should utilize investment vehicles to achieve their personal and family goals.

Private Alternative Loans. These unsubsidized loans are much more expensive than federal unsubsidized loans, interest starts immediately and accrues, and you must begin paying the loan back immediately. The student is the borrower. These have higher up-front fees and may require a cosigner. Read the fine print VERY CAREFULLY.

Private Health Care Plans. These are health care plans sold by private insurance companies to individuals and employers as part of a benefits package.

Private Mortgage Insurance. Insurance paid for by the borrower to ensure that the lender is made whole should the borrower default. If equity in the home is greater than 20%, PMI is not required for conventional loans or VA loans (but is required by FHA loans for the life of the loan).

Probate. Probate is the process of distributing an estate's assets after death. Probate is a matter of state law. It is the matter of administering the portion of the person's estate that is disposed of in either by will provisions, for those with a valid will, or by intestate succession, for those who die without a will.

Profit Sharing Plans. These are defined contribution plans where employer contributions vary year-to-year depending on firm profitability (it may be zero if the firm is not profitable in that year).

Psychological biases. These are views on how the brain works and affect our investment decision making process. Poor investment decisions caused by psychological biases affect your wealth, so we need to learn to recognize and avoid poor investment decisions which come from those psychological biases.

Q-TIP (Qualified Terminable Interest Property) Trust. A Q-TIP Trust is a testamentary trust which provides a means of passing income to the surviving spouse without turning over control of the assets. These trusts ensure that assets will be passed to your children upon the death of the surviving spouse.

Qualified dividends. These are stock dividends earned from holding a stock a minimum number of days within a specific period. Qualified dividends are taxed at a federal preferential tax rate depending on your marginal tax rate.

Qualified stock dividends. These are payment of cash to the Fund by the companies owned where the company owned the shares for a specific length of time. These are taxed at a preferential rate depending on your taxable income.

Real estate and property taxes. These are taxes imposed annually or semi-annually on assets owned.

Real Goals. These are goals you really want to accomplish, and are willing to work hard and seek Heavenly Father's help in accomplishing them.

Realtor or Real Estate Broker. This is a person supposedly trained in the process of selling and buying real estate. You want a realtor that know the market in the area you are looking at. Remember that realtors are paid by the seller, so remember that in your associations. Sellers divide the sales commission (usually 6-8%) between the listing realtor and the buying realtor.

Redemption. The process of redeeming a callable bond before its maturity date.

Refinance. The process of getting another mortgage loan on your home and repaying the old loan with a goal to reducing your interest and other costs overall.

Refundable Credits. These are credits paid to the taxpayer even if the amount of the credits exceeds the tax liability.

Required minimum distributions. For tax deferred retirement plans, the government requires that a certain percentage of assets must begin by April 1st of the year following age 70½. The distribution is the account balance on Dec. 31 of the previous year (age 69) divided by the life expectancy from the table below. There is a 50% penalty on minimum distributions not taken.

Required Minimum Distributions. This is a legal requirement of many tax-deferred retirement vehicles which require savers to distribute a specific amount each year after age 69 of total plan assets. It is calculated by dividing the total amount in accounts by a specified number given.

Residual value: Expected value of a vehicle at term end. Often used as purchase price after a lease has ended.

Retirement Benefits. Retirement benefits can either be reduced or increased depending on your PIA, your FRA and the date when benefits begin. You can begin receiving benefits as early as age 62. Benefits that begin 3 years before FRA will be reduced by a maximum of 20% (or 5/9% of 1% per month for each month benefits begin before FRA or 6.67% per year). Additional reductions of 5% per year are effective when FRA exceeds age 65.

Retirement Payout Options. These are the types of annuity distribution payouts available at retirement. Investors and spouses jointly determine the types of payments at retirement.

Retirement plans. These are income-producing assets, such as pensions, IRAs, 401K, Roths, SEPs. etc. by you or employer used to accumulate wealth for retirement.

Retirement vehicles. These are a specific type of investment vehicles which are related to retirement. These include qualified retirement plans such as both traditional and Roth 401k, 403b, and 457 plans; Individual retirement plans such as Roth and traditional IRAs; and small business plans such as SEPs, Simple, and Keogh plans.

Retirement vehicles. These are investment vehicles to help you save for retirement. These include for private businesses: 401-k, Roth 401-k plans; non-profit tax-exempt businesses: 403-b/Roth 403-b plans; State and municipalities: 457 plans; Individual retirement accounts: IRA/Roth IRA; and small business plans: SEP IRA, SIMPLE IRA;

Retirement/Annuitization Stage (of retirement). This stage begins when you retire. It is your plan on how your assets will be distributed at retirement. Your goal should be to have sufficient assets for your lifetime to enable you and your spouse to live like you want in retirement.

Retirement/Annuitization strategies. These are strategies to use while you are in the retirement stage. They might include: calculate a minimum acceptable level of retirement income, and annuitize that

amount; take out on a specific percentage of assets each year in retirement, etc.

Revenue bonds. Bonds backed by the revenues of a specific project.

Reverse Mortgages. These are mortgage loans whose proceeds are made available against the homeowner's equity. Financial institutions in essence purchase the home and allow the seller the option to stay in the home until they die. Once they die, the home is sold and the loan repaid, generally with the proceeds. These are typically used by cash-poor but home-rich homeowners who need to access the equity in their homes to supplement their monthly income at retirement.

Revocable Living Trust. It is the most common type of living trust. It is a trust which allows for unlimited control by the trust's owner, because the owner retains title to all the assets in the trust. They do not pass through probate. They provide greater ease and privacy of distribution upon death.

Risk of Downgrading. Should a bond's rating be downgraded, the seller would need to reduce the price of the bond (resulting in a lower yield to the seller and a higher yield to the buyer) to make up for the increased risk.

Risk pooling. It is the process where individuals transfer or share their risks with others to reduce catastrophic losses from health problems, accidents, lawsuits, etc.

Risk. Risk is the possibility of having a return different from what was expected, whether it is losing all your money, losing principle, or not achieving a specific rate of return. There are many different types of risk including: inflation, business, interest rate, financial, market, political and regulatory, exchange rate, call, and liquidity risk.

Risk-adjusted Performance. It is the process of determining performance after adjusting for the risk of the portfolio.

Rollover IRA: A traditional IRA set up to receive a distribution from a qualified retirement plan.

Roth Conversion. This is the process of converting a traditional individual retirement account to a Roth account.

Roth IRA. This is an individual retirement account which provides no deduction for contributions but provides that all earnings and capital gains are tax free upon withdrawal after retirement. You are actually investing more with a Roth, since your investments are after-tax, and contributions can be withdrawn tax/penalty free. Earnings grow tax-free if the Roth IRA is in place for at least 5 years, and you are 59½ years old.

Savings Bonds: Bonds issued by the US government with tax advantages to encourage savings.

Savings Ratio. This is your income for savings divided by your income available for living expenses. This ratio tells you what proportion of your after-tax income is being saved.

Scholarships. Money given to promising students because of their shown abilities in specific areas. There are many scholarships available, but you have to find and apply for them individually.

Seasoned new issues. These are new shares being issued by a company that is already publicly traded.

Secondary markets. These are markets for trading already issued securities. Secondary markets trade previously owned shares of stocks, bonds, and other securities. Secondary markets consist of organized exchanges and over-the-counter or electronic markets where existing shares are traded.

Secured Credit Card: Similar to a standard credit card, but is tied to a checking or savings account. The card cannot be used once the money in the account is gone, until more funds are added. Useful for building credit.

Secured loans. Secured loans are guaranteed by a specific asset, i.e. a home or a car, and typically have lower interest rates.

Securities markets or organized exchanges. These are areas used to facilitate trading of financial instruments.

Securities markets. Securities markets are where securities, i.e., financial assets, are traded. The two different types of securities markets are primary and secondary markets.

Seeking Solace (abdicating responsibility). Sometimes we follow newspaper/newsletter advice which we know has been shown to under-perform. We prefer to take other's advice rather than doing our own homework. That way if the performance goes bad, we can blame others (we don't have to take responsibility).

SEP-IRA. The Simplified Employee Pension (SEP-IRA) is an Individual Retirement Account which allows a small business employer to contribute to the retirement of the employees. Employer contributes the same percentage to all employees, and no required annual contribution. Contributions are tax deductible, earnings grow tax-deferred, and employees own the plans.

Series EE and Series I Bonds. US savings bonds with the special tax advantage that earnings on the bonds are tax-free if used for paying tuition and fees

Sharpe Index. This is a risk-adjusted performance measure. It is the ratio of your "excess return" divided by your portfolio standard deviation, i.e., your (rp – rf)/sp where rp = Average return on the portfolio, rf = your riskfree rate, and sp = Standard deviation of portfolio return. The Sharpe Index is the portfolio risk premium divided by portfolio risk as measured by standard deviation.

Shortfall. This is the difference between what you have now saved for retirement and what you think you need for retirement.

Short-sell. A short-sell is where a lender allows a property to be sold for less than the amount owed on a mortgage and takes a loss. A short sell allows the borrower to avoid foreclosure, which involves hefty fees for the bank and poorer credit outcome for the borrower, and the lender to make "less" of a loss on the property and to not enter foreclosure. A short sell does not necessarily release the borrower from the obligation to pay the remaining balance of the loan.

Short-term bonds. Bonds with maturity usually a year or less.

Short-term capital gains. These are capital gains where the Fund has owned the assets for less than 366 days. These are taxed at your Federal and state "ordinary" or "Marginal Tax Rate (MTR)"

SIMPLE 401k. This is a small business qualified retirement plan that provides some matching funds by the employer. Employees can have no other qualified plan, and may contribute up to the specific amount each year. Contributions are tax deferred and grow tax-free, and there is a penalty for early withdrawal. The employer is "required" to either contribute at least 2% or to match employee contributions, usually 1-3%

SIMPLE IRA. This is one of the SIMPLE retirement plans where Employees can participate. Contributions are tax deductible, it is easy to set up and administer (compared with a traditional 401(k)). A small business qualified retirement plan that provides some matching funds by the employer.

SIMPLE Plans. These are Savings Incentive Match Plans (SIMPLE) that provides matching funds by the employer. It can be established as an IRA or as part of a 401k plan. Employees can have no other qualified plan, and can contribute up to 100% of compensation to a maximum limit each year. The employer is "required" to either contribute at least 2% or to match employee contributions, usually 1-3%.

Single payment (or balloon) loans. These are loans that are repaid in only one payment, including interest. These are generally short-term lending of one year or less, sometimes called bridge or interim loans, often used until permanent financing can be arranged. These may be secured or unsecured.

Sinking fund. Money set aside annually to pay off the bonds at maturity.

Small-cap or small capitalization stocks. Small-cap stocks are companies with a market capitalization less than $2 billion. These are smaller, sometimes newer, US and global companies that are still developing and may have a smaller market share than their large-cap counterparts.

Smart Card: Similar to a debit card, but rather than being connected to a certain bank account, they magnetically store a certain amount of money linked to the card itself.

SMARTER Goals. SMARTER is an acronym for helping you as you strive to set effective goals. It is: S = specific, M = measurable, A = assignable, R = realistic, T = time-bound, E = evaluated, and R = reassessed.

Social Security or FICA. Social security is a government provided retirement, survivor, and disability benefits. Franklin D Roosevelt signed the Social Security Act in 1935 to Aid the displaced and out of work. Social Security is a pass-through account, which means that FICA taxes being paid by current workers provided the money for benefit payments to current retirees.

Sole ownership. Ownership where ownership and control is absolute in one individual. Income belongs to sole owner and testamentary control is absolute.

Special Joint and Survivor Annuity (if there is a death in the marriage the benefit decreases). You receive payment for as long as you live or for a certain guaranteed period, whichever is longer, and your spouse, after you die, receives a percentage of that payment for as long as they live.

Spousal IRA. A Spousal IRA is an IRA contribution for a non-earning spouse. If one spouse is an active participant, the non-earning spouse can contribute to a Spousal IRA. Limits are the same as the traditional and Roth IRA.

Spouses benefit. A fully insured worker's spouse age 65 (FRA) is eligible to receive a retirement benefit of 50% of the worker's PIA subject to the family maximum. This benefit is reduced by 25/36% of 1% for each of the first 36 months that the spouse is under FRA (25% for 3 years). Once the FRA > 65, a reduction of 5/12 of 1% is imposed for each month beyond 36 months the spouse is under the FRA. The reduction of benefit from early retirement will not affect the amount of the spouses benefit. Disability benefits for spouses are 50% of the worker's PIA, reduced if the spouse is under FRA, subject to a family maximum amount.

Spreadsheet budgeting method. Using a computer and spreadsheets, determine your gross salary and take home each month after taxes and other deductions. Determine spending by categories (rows) and dates (columns), and budget for each category. As bills come in, input the spending on each date (column) and row (category).

Sprinkling Trust. A Sprinkling Trust is a testamentary trust that distributes assets on a needs basis rather than according to some preset plan to a designated group of beneficiaries.

Standard Family trust. This is a testamentary trusts which hold the assets of the first spouse to die until the second spouse dies. The spouse has access to income from the trust, or the trust principal, if necessary. They reduce the estate of the second spouse so that the estate taxes can be reduced.

State taxes. Most states impose an income tax; however, some, like Texas and Nevada do not. Alaska actually pays you to live in that state

Status Quo Bias. Sometimes individuals prefer the status quo over a new, more preferable position. There is an aversion to change, even if the change is for the better.

Stepped Up Basis. This is the process of the value of an asset being stepped up, or changed from the original value when purchased, to the current value when the person dies and it is transferred to heirs.

Stewardship. This is the principle that we are stewards over all that the Lord has, is, or will share with us. This view helps us realize the things we have are a gift and we should take care of them.

Stock Bonus Plan. These are defined contribution plans where employer contributions are made with employer shares of stock. Employee stock ownership plans (ESOPs) and leveraged ESOPs (LESOPs) are the most common.

Stock dividends. Stock dividends are dividends received from a company from the ownership of the company shares. Stock dividends are of two types, qualified or ordinary/not qualified. A qualified dividend is a dividend paid by a U.S. corporation where the investor held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (see Teaching Tool 32). An ordinary dividend is a dividend that is not qualified, i.e., you have not held the stock for a long enough time period to get the Federal preferential tax rate.

Stock Market Secrets. These are supposed short-cuts or secrets that only the professionals know, but they will share them with you for a price. Don't get taken.

Stock mutual funds. These are stock mutual funds are funds which invest a majority of their assets in common stocks of listed companies. These funds generally have a specific objective, i.e. "large-cap," "small-cap", "value," "growth," etc. which relates to the types of stocks the mutual fund invests in.

Stockbroker. A stockbroker is a person who is employed by and solicits business for a commission house or merchant.

Stop (or stop-loss) orders. These are orders to sell a specific number of shares if the stock price falls below a certain price or buy a specific number of shares if the stock price rises above a certain price. These are used to set prices to safeguard against major fluctuations.

Student Loans. These are loans with low, federally subsidized interest rates used for higher education. Examples include Federal Direct (S) and PLUS Direct (P) available through the school; Stafford (S)

and PLUS loans (P) available through lenders. Some are tax-advantaged and have lower than market rates. Payment on Federal Direct and Stafford loans deferred for 6 months after graduation.

Style analysis. It is another way of obtaining abnormal returns is by analyzing the investment style pf the portfolio. You can decompose returns by attributing allocation to style, and style tilts and rotation are important active portfolio strategies.

Subordinated bond. Bond that will be paid after the other loan obligations of the issuer are paid.

Subsidized Loans. Loans where another party pays the interest while the student is in school. Interest begins 6 months after the student graduates or drops below half-time enrollment.

Subsidized University Loans. These are loans offered by the university to students attending school.

Successor Trustee. This is the person to succeed the trustee should the trustee not be able to manage the trust.

Supplemental medical insurance. The SMI portion of the Medicare program (Part B) is financed by premiums paid by participants and by federal government funding. Participation in Part B is voluntary.

Survivor Benefits. Deceased worker must had had fully insured status; other survivor benefit (mother's or fathers' child's lump sum) will be paid to eligible survivors of a fully or currently insured worker

Target Benefit Plan. These are defined contribution plans that establish a required contribution level to meet a specific target level of benefits at retirement.

Tax Considerations. These are how taxes will impact your investment decisions, including your tax position, specifically your marginal and average tax rate; and how tax-free investments may fit into your plan, i.e. municipal versus corporate bonds.

Tax Cost Ratio. This is the percent of nominal Fund return attributable to taxes, assuming the fund is taxed at the highest rate. If a fund had an 8.0% return, and the tax cost ratio was 2.0%, the fund took home (1 + return) * (1 – tax cost ratio) -1 or (1.08*.98)-1 or 6.00%.

Tax Efficiency. Invest in taxable funds with an eye to obtaining high returns while keeping taxes low. Taxes reduce the amount of money you can use for your personal and family goals. Watch the historical impact of taxes, for it will likely continue. Remember it is not what you earn, but what you keep after taxes that makes you wealthy.

Tax Freedom Day. This is the day you stop working for the government and begin working for yourself.

Tax Tables. These are tables to help you calculate how much taxes you owe.

Taxable accounts. There are investment vehicles without tax advantages.

Taxable bonds. Taxable bonds include U.S. Treasuries, corporate bonds and agency issues (bonds issued by U.S. government agencies, like Ginnie Mae).

Taxable Estate. This is equal to the gross value of your estate, less estimated funeral and administrative expenses, debts, liabilities, taxes and any marital or charitable deductions.

Tax-adjusted Return. This is your return after taxes

Tax-advantaged money. This is the process of using investment vehicles that have specific advantages. There are two types: Tax deferred and tax-eliminated vehicles.

Tax-deferred money. This money has the ability to be invested before-tax, with principle and earnings taxed only at retirement (IRA, SEP IRA, etc.). This money converts long-term capital gains into short-term income for tax purposes.

Tax-efficient and wise investments. This is money that is invested tax-efficiently and wisely, consistent with the principles of successful investing discussed earlier.

Tax-eliminated money. This money can be used at retirement (or for education) without penalty and without taxes, i.e., a Roth IRA/410k/403b for retirement, and 529 Funds and Education IRA for education. You pay the taxes upfront, and then pay no taxes on earnings or capital gains when you take it out at retirement.

Taxes (automobile) (also called government costs). It is the tax on the usage and interest in a lease. It is calculated as (Usage + Interest) times your tax rate.

Taxes on Distributions. These are taxes on your distributions which must be taken into account to get the true return of your portfolio but which are not noted on your monthly reports.

Taxes on mutual funds. Mutual funds are pass through vehicles, which means that taxes are not paid at the Fund level but are passed through to the individual shareholders who must pay the taxes. Mutual fund taxes are mainly capital gains, stock dividends and interest/coupon payments. They are handled the exact same way as the taxes for stocks and bonds discussed earlier.

Taxes. These generally are your largest single annual expense. These may include personal, income, business, transportation and other taxes. Taxes can further be divided into Federal taxes, or taxes we pay the Federal government; State taxes, or taxes we pay the state government, and local taxes, which are taxes we pay the local government.

Tax-free bonds. Tax-free bonds include revenue or general obligation bonds issued by local or state governments and agencies. Such bonds are generally free from federal and state taxes.

Teaser Rates: Very low introductory interest rates used to attract new customers to a certain credit card. They increase soon after the card is in the user's hands.

Temporal goals. These are goals that relate to the temporal measures of success. It could be money, title, fame, positions at work or in industry, include influence, rank or power, or assets, investments, or possessions.

Tenancy by the entirety. Ownership is shared equally and limited to spouses, lifetime control is shared by both spouses, consent from both is required to sell, income is shared between owners, testamentary control is absent, and the right of survivorship is key.

Tenancy in Common. Ownership is shared, with each owning an undivided fractional interest that may be unequal, lifetime control is unlimited, income is shared between owners in relation to fractional interest, and testamentary control is unlimited.

Term Insurance. Term insurance is insurance protection for the insured over a specific term or time period. They may be renewable or non-renewable policies. It is the least expensive form of insurance and the death benefit coverage is only for a specific term.

Term or Bond Maturity. The maturity of the bond.

Testamentary transfers. Methods by which property is transferred at death.

Testamentary Trust. The process where assets are placed in trust after you die. The trust is created after probate according to your will.

Thrift /Savings Plans (TSP). These are defined contribution plans where the employer matches a percentage of employee contributions to a specific amount (i.e., free money). This program is for employees of federal civil service.

Total Costs Analysis. This is a form of loan analysis that does not take into account the time value of money, but is simple to calculate. To do this, calculate your total new costs and fees from the loan until it is paid off, your total current monthly principal and interest costs remaining without refinancing, your total refinance monthly principal and interest costs. If you will be paying less overall, think about it, if it is equal or less, it likely does not make finance sense.

Total expense ratio. This is the total percentage of assets that are spent each year to manage the fund including management fee, overhead costs, and 12b-1 fees.

Tracking Error. This is the return on the fund less the return on the benchmark. This tracking error should be small versus your benchmark. Tracking error is the historical difference between the return of a fund (i.e. a mutual fund) and its specific market/sector benchmark or index. The smaller the tracking error, the better the performance of the Index fund relative to the benchmark. However, you won't complain if the tracking error is positive (i.e., your fund had higher returns than the index or benchmark).

Traditional IRA. An individual retirement account in which an individual can contribute up to a specific amount annually which is tax-deferred. Eligibility and amounts depend on the contributor's income level and whether they have other retirement plans. The contribution is tax deductible and earnings grow tax-deferred.

Transaction costs. These are costs of the fund buying and selling securities, which are not included in other costs. Mutual funds which turn over the portfolio often, i.e. buy and sell a lot, will have higher transactions costs. A good proxy for this is the turnover ratio.

Treasury Bills. A short-term debt obligation issued

at a discount and redeemed at face value upon maturity in 3, 6, or 12 months.

Treasury Bonds. A long-term debt obligation issued at or near par and interest is paid semiannually.

Treasury Notes. An intermediate-term debt obligation issued at or near par and interest paid semiannually.

Treynor Measure. This is a risk-adjusted performance measure. This is similar to Sharpe but it uses the portfolio beta instead of the portfolio standard deviation, or (rp – rf)/ ßp where rp = average return on the portfolio, rf = average risk free rate, and ßp = weighted average b for portfolio. It is the portfolio risk premium divided by portfolio risk as measured by beta.

Trust Grantor. The person who created the trust.

Trustee. The person who will manage the trust.

Trusts. A trust is a legal contract. When you create a trust you are simply creating another legal entity. Trusts avoid probate and are more difficult to challenge than wills. They may reduce estate taxes, allow for professional management, provide for confidentiality, can be used to provide for children with special needs, can be used to hold money until a child reaches maturity, and can assure that children from a previous marriage will receive some inheritance in the future.

Turnover ratio. This is a measure of trading activity during the period divided by the fund's average net assets. A turnover ratio of 50% means half the fund was bought and sold during the period. Turnover costs money and incurs taxes.

Turnover. This is the amount of the portfolio that is bought and sold during a specific period. Keep turnover low, as turnover is a proxy for fund expenses and taxes. The costs associated with turnover are hard to quantify and may not be disclosed in the prospectus. These costs include commissions, bid-ask spreads, and market impact.

Types of Mutual funds. The types of mutual funds generally follow the major asset classes, i.e., money market, stock, and bond mutual funds.

Underwriting. Underwriting is the process whereby the borrower fulfills the requirement of the lender and the lender funds the loan. It also includes the lender selling the loan and the loan being syndicated and sold to investors.

Un-invested Cash. This is the amount of cash in the portfolio. High cash levels in the portfolio are drags on performance so keep un-invested cash low.

Unique Needs. Unique needs are special needs that may impact your investing decisions.

Unlimited Marital Deduction. There is no limit on the value of an estate that can be passed tax-free to a U.S. citizen spouse. This does not apply to non-U.S. citizen spouses. The tax-free maximum gift per year to non-citizen spouses is specified.

Unsecured corporate debts. Bonds not secured by collateral, and pay a higher return.

Unsecured loans. Unsecured loans require no collateral, are generally offered to only borrowers with excellent credit histories, and have higher rates of interest – 12% to 28% (and higher) annually.

Unsubsidized Federal Loans. These are loans for both grads and undergrads where the student responsible for interest during school, repayment begins six months after student graduates, discontinues, or drops below half-time enrollment for a continuous 6 months. The interest is not subsidized.

Upfront costs. These are cost due at the signing of the loan which include closing costs and points, down payment (3-20 percent of the loan amount), and other closing costs including points (3-7 percent).

Upgrade. A situation where a bond rating company improves the bond rating of a bond due generally to an improving financial condition.

Upper Income Filer. These are singles with income above $34,000 and MFJ with income above $44,000. 85% of Social Security benefits are taxable.

US Savings EE Bonds. Savings bonds issued by the US government that pay a fixed rate of interest with is reset every 6 months.

US Savings I bonds. Bonds issued by the U.S. government, and tax deferred until maturity. They are not marketable, but can be redeemed from local banks. Bonds sold at face value, with interest paid at maturity, with the interest rate set to inflation with a fixed component.

Usage (automobile) (also called depreciation). This is the amount of the value of the vehicle that is used over the lease life. It is calculated at the Net capitalized cost – residual value.

VA Loans. These are Veterans Administration (VA)

Guaranteed Loans. These loans are issued by others and guaranteed by the Veterans Administration. They are only for ex-servicemen and women as well as those on active duty. Loans may be for 100% of the home value.

Value stocks. These are inexpensive (in terms of low PE and low P/BV ratios), companies that have potential for good long-term return through both appreciation and dividends.

Values Statement. These are the values you will live by to help you accomplish your vision and mission.

Variable or Adjustable Rate Mortgages (ARMs). These are mortgage loans with a rate of interest that is pegged to a specific index that changes periodically, plus a margin that is set for the life of the loan. Generally the interest rate is lower compared to a fixed rate loan, as the borrower assumes more of the interest rate risk. The may have a fixed rate for a certain period of time, then afterwards adjust on a periodic basis.

Variable-rate loans. Have an interest rate that is tied to a specific index (e.g., prime rate, 6-month Treasury bill rate) plus some margin or spread, i.e. 5%). Can adjust on different intervals such as monthly, semi-annually, or annually, with a lifetime adjustment cap. Normally have a lower initial interest rate because the borrower assumes the interest rate risk and the lender won't lose money if overall interest rates increase

Vesting period. This is the period required before the promised benefits are considered yours.

Vision Statement. This is your vision of what it is you want to become. It is seeing or visualizing with your mind's eye what you will be in the future.

Widow(er)'s Benefits. A benefit of up to 100% of the deceased, fully insured PIA will be paid to the surviving spouse who is at least age 60 and who was married to the worker for 9 months. The surviving spouse is generally eligible if he or she is not remarried and is not entitled to retirement benefits (due to his or her covered employment) of at least the amount of the deceased workers PIA. A widowers benefits terminates at death or at eligibility for an equal or greater retirement benefit.

Will. A legal declaration by which a person provides for the disposition for their property and other assets at death.

Winning by Losing. Sometimes we actively trade stocks instead of buying index funds or ETFs which we know are lower cost and take a lot less time to invest. We know index funds generally outperform the actively managed funds, but we try to invest actively anyway.

Workers' Compensation. Workers compensation is state insurance program that insures against work-related accidents and illness. Workers' Compensation provides insurance to workers injured on the job, regardless of whether they have other health insurance or not. It only covers work-related accidents and illnesses, and coverage is determined by state law and varies state by state.

www.charitynavigator.org. a website on information about various charities which file Form 990 with the IRS. However, they do not include religious organizations listed as "church or convention or association of churches" which are exempt from filing Form 990.

Yankee Bonds. Bonds issued by international companies and sold in the U.S. in U.S. dollars.

Yield to Maturity. This is the true yield received if the bond is held to maturity, which assumes that all interest payments can be reinvested at the same rate as the bond itself.

Yield. The annual interest on a bond divided by its price.

Zero-coupon bonds. A discount bond which pays no interest until maturity.

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