

FUNDAMENTALS OF FAMILY FINANCE



Basic Principles You Can Use

SECOND EDITION

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BYU SCHOOL OF FAMILY LIFE



*Fundamentals of Family Finance:
Basic Principles You Can Use*

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To my wife

Tammy

And to our children:

Sarah, Jeffrey (and Jenny), Aaron (and Jenny), Abigail (and James), Jordan (and Pasha), Hannah (and Joshua), Heidi, Emily (and Ben), Amanda (and Nathaniel), Ryan (and Rebekah), Seth, Cam, and Maddy

And to our 29 (and counting) grandchildren!

May they all abide these principles and live joyfully within their means!

EJH

To my wife:

Anne

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Kimberly (and Lane, Logan and Ryan Adrich), Natalie (and Taylor, Halle and Dylan Barrett), Laura (and Devin Dearden), Clinton, Emilee, Ashley and Kaili

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Contents

Introduction

Fundamentals of Family Finance: 1

Chapter 1

Time Value of Money (TVM) 13

Chapter 2

Budgeting, Net Worth, and More . . . 23

Chapter 3

Cash Management and More 41

Chapter 4

Credit and Loans 49

Chapter 5

Tax Planning 69

Chapter 6

Risk Management and Insurance . . . 89

Chapter 7

Understanding and Financing Major Family Purchases: Buying a Car 105

Chapter 8

Understanding and Financing Major Family Purchases: Buying a Home . . . 113

Chapter 9

Investing for the Long Term 125

Chapter 10

Retirement Planning. 143

Chapter 11

Tips for Frugal Living 153

Chapter 12

Work and Family 163

Chapter 13

Marriage and Money 175

Chapter 14

Children and Money. 185

Glossary 197



Introduction

Fundamentals of Family Finance:

Basic Principles You Can Use

This is a book about the fundamentals of family finance. It covers basic principles of money management that can help you live within your means, achieve your long-term goals, and strengthen your family relationships. By following the principles in this book, you can also minimize the financial stresses of you and your loved ones.

The five professors who wrote this book are financial experts by occupation; however, they also have personal experiences that have shaped their perspectives on money. To introduce this book, here are some of their stories about managing money and reducing stress.



E. Jeffrey Hill, PhD

A long, long time ago, Juanita Ray and I met while attending Brigham Young University. We played racquetball together, courted for a time, and were married. As newlyweds, we had no money. We lived in a tiny two-room apartment with low ceilings, bought clothes from thrift stores, and ate her family's old food

storage. We even drank disgusting powdered milk for the first several months. Even though it was difficult for a time, we were happy because we still had each other and we had our love. We learned that money doesn't buy happiness.

I graduated and got a good job. (We started drinking whole milk—it was heavenly!) My parents had taught me to share 10 percent of my income with others, save 10 percent to invest, and live on the rest. Juanita and I have followed those principles as we created our family budgets over the years. After 25 years, we had a bunch of kids and had paid off our home. We had solid investments. We learned that if you consistently save a little money and invest it in a broad, diversified stock market fund, it grows through the miracle of compound interest.

Then came the hard part. Though Juanita and I were financially set for a long life together—we anticipated retirement, humanitarian service, lots of travel, and lots of grandkids—life didn't go as planned. Juanita got cancer. She fought valiantly, but cancer won. I learned that there are many things that matter more than money, and I learned that “you can't take it with you.”

After Juanita died, I was a lonely, single dad with eight kids. I couldn't sleep. I got angry easily. I didn't eat well. To compensate, I spent money—lots of it. Juanita had always constrained my spending, and with her gone I bought lots of things and traveled to lots of places. I learned through personal experience the H.A.L.T. principle: how foolish it is to spend money when you are **H**ungry, **A**ngry, **L**onely, or **T**ired.



Then, after a lot of grief, a miracle happened. I met a beautiful widow named Tammy. It was so fun to be dating again (and to have and be willing to spend money this time)! Tammy and I fell in love, were married, and got to work blending a large family. What a good woman! It takes a remarkable person to marry a stuffy professor with so many kids. I will be forever grateful for her!

Tammy and I have learned that money makes important things, such as caring for a family and paying for education, possible. It is never easy to join two families, but money helped us blend our large family of twelve children, eight in-laws, and twenty-nine grandchildren. It enabled us to go on fun vacations to get to know each other. It helped us be able to travel to where our grandchildren were born. It made it possible to adequately fund marriages. Money also made it possible for Tammy to go to graduate school. Because of her degree, she is now able to bless many lives as an excellent marriage and family therapist and as an adjunct professor at Brigham Young University. I am excited to share ideas and experiences in this book that will help you with your family finances.

To conclude, let me share three things I ask 600 BYU family finance students to remember each semester:

1. Life is hard . . . but you can do hard things. With the right knowledge, attitudes, and behaviors, you can do anything—even balance a budget or invest in a mutual fund.
2. When life doesn't go as planned, don't get frustrated; make the best of it. Most of the time things don't go as planned—especially in financial matters—and if we don't make the best of our lives, we'll spend a lot of our time feeling frustrated.
3. TTT: Things Take Time. The best things in life take time. In fact, the best financial plan is the “get rich slowly” plan, where you safely and systematically invest to acquire resources that can be used to bless your family and community.



Bryan L. Sudweeks, PhD

I would like to share a few personal things about our family and a few of the lessons we have learned about family finances and the joy of living within our means. I graduated from Brigham Young University and at age 28 met Anne in Palo Alto, California. We were married and immediately moved to Washington DC to pursue a PhD. While in graduate school, we lived very simply, making do with inexpensive apartments, used cars, particle-board shelves, and a desk made from a door on four chimney flues. We had our first child halfway through the program and a second child right after graduation. We watched our finances carefully and graduated debt-free with a little money in the bank.

Anne and I set financial goals together and worked hard to achieve them. We worked in two different startup asset management companies, paid cash for our cars, and saved more than 20 percent of our salary every month for retirement and children's education. We also learned the importance of giving. We learned to sacrifice what we wanted now for what we wanted most: family happiness. We tried hard to do these things and still make memories for our children. We created two family mottos: *no empty chairs*, to emphasize the importance of family, and *we can do hard things*, to emphasize the importance of choice.

We moved from Washington DC to California, and the children continued to come (our seventh child and sixth daughter was born in Walnut Creek, CA). We tried to have a balanced view of life—investing time in our family, occupation, and spirituality.

Anne and I had a goal that when I turned 45 we would retire, pay off our home, have a specific amount of money saved, and come back and teach at Brigham Young University, not because we had to, but because we wanted to. My 45th birthday was my last day of work, and we had achieved each of our goals.

Fortuitously, the professor teaching personal finance in the Marriott School of Management at BYU retired at the same time we came back to BYU, so I began teaching that class. It has been a great opportunity to share the things we have learned from our experiences and work, and in our family.

I worked with other BYU faculty to create a personal finance website (www.personalfinance.byu.edu) to help individuals and families become more financially self-reliant. Meeting Jeff was an amazing experience because he had this same goal. I am excited about what you can learn from this textbook. We hope you will use this book to help your own family become more financially self-reliant.



Bryce L. Jorgensen, PhD

I remember tracking my income and expenses when I was a young boy. My father was the personal management merit badge counselor for my older brother's Boy Scout troop. For this merit badge, Scouts have to track their income and expenses for three months. My father, however, had his children track these numbers every month as soon as we started making any money (which for me was at an early age). I learned from an early age that knowing where you were spending your money allowed you options and choices, made

life less stressful, and allowed you to accomplish your financial goals. My parents followed the mantra, “fix it up, wear it out, make it do, or do without.” We didn’t leave food on our plates because my father would say, “take what you’ll eat and eat what you take.” I follow these same ideas with my children and, to their chagrin, any who eat at my house. Being wasteful is not an option.

My junior year of college, just before my 24th birthday, I married my wonderful wife Melanie. We were both in school and had very little money, but we worked hard, were careful to limit our expenses, and enjoyed doing things together that were inexpensive or free. I worked helping families with debt management as well as home refinancing, and Melanie was a waitress.

After we both graduated, we moved to Pennsylvania to work for Walmart. I quickly learned that I disliked retail and had to decide what I really wanted to do with my life. After brainstorming what I was good at, what I enjoyed doing, what came naturally to me, and what I could do that would provide for my family, I came to two choices: 1) join the US Air Force and become a pilot (I already had my private license and loved to fly), or 2) go back to school to earn my PhD to become a professor.

We moved to Blacksburg, Virginia to attend Virginia Tech where I earned two master degrees and my PhD. Going back to school full time plunged us back into poverty (we now had two children with our third on the way). We were very poor those six years (where we had two additional children) but had fantastic friends and a great church congregation. We still look back with fondness on these times. We learned to differentiate between needs and wants, to be grateful for what we had, and that the best things in life are free.

It isn’t enough to sit back and let life happen to you; we need to be intentional in our values and goals and work hard towards those goals. Throughout my life I have taken responsibility for my own future and my own

finances and have decided to make wise financial decisions. I buy reliable used cars and pay cash. I pay at least 10 percent to church/charity in order to help others, at least 10 percent to myself for retirement, and live off the rest. I minimize my expenses because I understand that financial freedom is more about how much you spend than how much you earn. I also know that our expenses can expand to fill our income whether we make \$35,000 per year or \$250,000 per year, unless we make an effort to limit our spending. I track my expenses so I can tell my money where to go based on my values and goals, which frees me from worrying about money. I haven’t gone into debt other than for a modest home and my education. I use the power of compound interest by investing in diversified mutual funds and real estate. I protect my family through adequate insurance (medical, home/renters, auto, disability, and life) and by having a will. Finally, I understand that the purpose of wisely using my resources is to create happiness and well-being for my family. I therefore don’t need to compare or compete with neighbors, friends, family members, or others.

My goal of returning for my PhD was to help strengthen families. I believe that “No other success in life can compensate for failure in the home.”¹ My degree focused on how to strengthen families and part of that was living within your means and understanding basic financial principles. My hope for you is that you will strengthen your relationships by learning how to be wise financial managers of your money. Money can either bless your life or add stress, heartache, and conflict. Understanding basic financial principles will bless your life and the life of your family in many wonderful ways. I encourage you to put effort into understanding and applying this topic. You will get out of this textbook and your class what you put into it. As many of our students have attested, it can be one of the most important classes you will ever take.



Xiaohui Li, PhD

I grew up as a single child in a Chinese family. My parents surrounded me with unconditional love and support, and worked hard to pay for my education, which they viewed as a top priority. They wanted to give me the chance to have a promising career and a quality life. We lived frugally, rarely buying new clothes or luxury items and eating potatoes and cabbage in the winter when the fresh market was expensive. I always felt that we lived on a tight budget, yet my parents could always come up with the money to pay for my education and college expenses. My parents taught me to spend carefully and try to be resourceful to save more for important things.

I completed most of my education in Beijing, China (including a bachelors in economics and a masters in psychology) before coming to the United States for my doctoral training in family science. After completing my PhD at the University of Minnesota, I am blessed with the privilege of working as a professor in family studies at Northern Illinois University.

When I graduated from my doctoral program, I had a significant amount of money saved, which my husband and I used to make a down payment on our first house. As was the case with my parents, my husband and I share similar values in spending and saving. We set financial goals together and work hard to achieve them.

When my husband and I married, we decided to have an inexpensive but memorable wedding. We were able to stick to a \$5,000 budget and still have that perfect wedding we

wanted: a beautiful conservatory hosting 65 guests, a beautiful dress, professional photos, special music performed by my husband's aunt, and a reception hosted by the sorority house with which I had a special connection.

To help achieve our financial goals, we maximize our contributions to the retirement accounts offered by our employers. After that, we follow our budget, paying credit card debts first and then putting a certain amount away for savings and our children's college expenses. We are proud to be debt free except for our mortgage. Even for this, we pay a little bit extra every month so that we can pay off our mortgage early and reduce the total cost of interest.

We sometimes shop at rummage sales and we don't buy new clothes very often. But we were able to pay for a new water heater when it broke and could afford a needed bathroom renovation. We are happy with where we are now; we have the peace of mind that comes when you don't worry about debt or not being able to pay for necessities in life. Of course, to get to this point, we've worked hard in our jobs to keep our income and we spend wisely to preserve our family wealth. We still have a long way to go, but I am confident in our family's financial situation because we have been following the basic financial principles you will learn in this book!



Laura Ricaldi, PhD

Throughout my life I have always struggled with the tradeoff of working in a job that I really love and being able to afford my financial goals. My first job was as a lifeguard at the local pool. I loved the job because it was

fun, I got to help people, I got to work with my friends, and I got to meet very interesting people. Since the job was only during the summer time, I only earned money for part of the year and struggled to save for the rest of the year when I wasn't working. Money was not an issue when I was in high school, but it was very different in college. I realized how difficult it was to survive only working in the summer time and found that I could no longer freely spend my money. Throughout college, I became diligent with my spending and learned to live within my means.

During my last year of undergraduate school, I met Marco, who became my husband. After graduation we decided to move to New York City. It was a fun and exciting time, but I also knew our money situation was going to change significantly. We struggled to make ends meet and finally realized that no matter how hard we worked (in jobs we didn't love), we would always struggle. In order to improve our future opportunities, we decided to move back to Texas to pursue more education.

Going back to school was a financial shock, but we were up to the challenge. We were already used to living on less, but we had to make other sacrifices and adjustments. During the last semester of my MBA program, I took a personal financial planning course. It was a career changing course and motivated me to start working on a PhD in Personal Financial Planning. I knew I had to make a career shift from the corporate world of business to the more intimate field of personal financial planning. Financial planning combines my desire to help people, my need for organization, and my background in business and accounting. With a PhD, I get to help others with financial issues, teach much needed financial principles and skills to future financial planners, and have a flexible lifestyle that allows me to be present with my children. Working as a financial planning professor, I can honestly say that I love my job, and I am able to afford my financial goals. I'm excited about what you will learn from this book.

Introduction

Oddly enough, the purpose of this book is *not* to teach you how to get rich or accumulate wealth. Its purpose is to teach you to use prudent financial management so you can have sufficient resources for your needs and can more fully bless yourself, your family, and others. You will learn how to use financial resources to strengthen your family and be a productive member of society.

The topics you study in this book will be among the most practical you will ever learn. You will use almost everything in this book for the rest of your life. You will acquire skills that will guide you in preparing budgets, managing debt, filing taxes, making home and auto purchases, finding insurance, acquiring investments, and improving marriage and family relationships.

The best way to learn something is to teach it. We highly recommend that you find someone with whom you can share what you learn in this book. That person could be your spouse, a roommate, a friend, a parent, a sibling, or anyone else you choose. As you share your newfound knowledge and skills, you will etch into your mind and your heart what you need to know to be financially successful.

The How's

Let's begin by considering *how's* of family finance: "How can I practically apply family finance in my life?"



1. CREATE, USE, AND UPDATE A BUDGET

Every person of every age should create, use, and update a personal or family **budget**. If you don't have one already, this book will help you create one. A budget is simply a plan for how you are going to spend the money that is available to you. To create a budget, you determine your spendable income and allocate it to different categories of expenses. Then you track your actual spending against your budget. It is acceptable to go over in some categories if you are under by the same amount in others. A budget is a living document that is modified as conditions warrant.

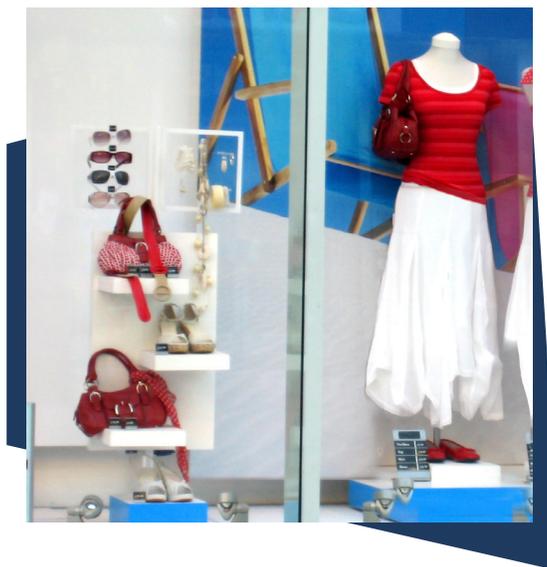
Robert D. Hales taught, "We help our children learn to be provident providers by establishing a family budget. We should regularly review our family income, savings, and spending plan in family council meetings. This will teach our children to recognize the difference between wants and needs and to plan ahead for meaningful use of family resources."²

Budgets can vary in complexity. Most budgets should also include at least a 10 percent allocation to long-term savings. You can find sample budgets on numerous Internet sites, such as the BYU Marriott School's excellent website personalfinance.byu.edu³ and on many apps, such as mint.com.⁴ Budgets generally include categories for food, housing, utilities, clothing, transportation, medical, recreation, debt reduction, and miscellaneous expenditures. It is often this last budget category, the miscellaneous category, which gets overlooked. Unexpected expenses always come up that don't fit neatly into your budget categories: a car repair or a root canal, perhaps an engagement ring or even a wedding.

In a marriage relationship, it is important that both the husband and the wife have a say in budget creation, and that they help each other live within their means and claim joy. In many marriages, one partner is a saver, and the other partner is a spender. Both play an important role. Early in a marriage, it is a great blessing when the saver can help the

spender stay within the budget. Robert D. Hales poignantly illustrated this point in the following story:

We were newly married and had very little money. I was in the air force, and we had missed Christmas together. I was on assignment overseas. When I got home, I saw a beautiful dress in a store window and suggested to my wife that if she liked it, we would buy it. Mary went into the dressing room of the store. After a moment the sales clerk came out, brushed by me, and returned the dress to its place in the store window. As we left the store, I asked, "What happened?" She replied, "It was a beautiful dress, but we can't afford it!" Those words went straight to my heart. I have learned that the three most loving words are "I love you," and the four most caring words for those we love are "We can't afford it."⁵



Budget

A plan for how you are going to spend the money that is available to you.

The spender can also play an important role in the marriage. If the family is financially stable for a period of time, the spender can help the saver see the wisdom in setting goals and planning for some special expenditures in the budget: maybe a nice second honeymoon, a boat, a camping trailer, or a sports court. All of these could strengthen family relationships through wholesome family recreation.

Learn to appreciate both the savers and

the spenders in your relationships. Whether you are married or single, we invite you to create, use, and update some form of budget for the rest of your life.

2. MINIMIZE AND EVENTUALLY ELIMINATE DEBT

Some college students make the mistake of borrowing more money than they needed, using student loans or credit cards. Most students don't know that you don't have to take the full loan amount offered. If you qualify for a \$10,000 subsidized or unsubsidized student loan, you don't have to take the full \$10,000! Instead, look at your budget and decide how much you need to borrow to live frugally for the semester or year. Take into account the money you earned and saved through summer jobs and/or a part-time job throughout the school year. Did you receive any scholarships or other monies (e.g., money from parents, grandparents or others)? Once you take into account the amount of money you receive (outside of loans) over the year and look at how much it costs to live frugally for the year, you will know how much you need to borrow, if any. Wise students will only borrow what they need rather than adding debt and interest that will limit their choices down the road. Unwise students borrow the full amount and then tend to waste most of their money on going out to eat, paying for activities or food for friends, and doing things they normally wouldn't do if they didn't have the "extra" money. Save yourself a lot of grief and money by borrowing only what you really need. Speaking of the consequences of debt, J. Reuben Clark said, "Once in debt, interest is your companion every minute of the day and night; you cannot shun it or slip away from it . . . and whenever you get in its way or cross its course or fail to meet its demands, it crushes you."⁶

Another financial mistake made by recent college graduates is buying a house that is beyond their means, then paying large monthly mortgage payments for decades. We also recommend that you avoid home-equity loans like the plague.



When property values go down, home equity loans can leave you upside-down in your home. This doesn't mean you are standing on your head in your living room; it means you cannot sell your home for what you owe on it. When that happens, you become a prisoner in your home because you can't sell it. Worse yet, many people in this situation have lost their homes because they couldn't afford the payments when financial challenges occurred. Be very careful when considering a home equity loan.

Many people do not realize that you can actually pay off a home mortgage. You can accomplish this by signing up for a fifteen-year mortgage instead of a thirty-year mortgage. The interest rate is lower, and you can save hundreds of thousands of dollars in interest.



Avoid home equity loans like the plague!

If you already have debts, adding a “debt repayment” category to your budget helps you pay them off. The money allocated to this category is applied each month as an extra payment to the debt with the lowest balance or highest interest rate until it is eliminated. Again, personalfinance.byu.edu has excellent advice on this topic.⁷

3. PREPARE FOR EMERGENCIES AND BUILD A RESERVE

Your family will have greater peace of mind and greater insulation from unexpected financial difficulties if you build a **financial reserve** to act as a cushion for rough times. Start with one month of living expenses set aside in a checking or savings account. Most financial planners recommend you build a three to six months’ reserve. These emergency funds should be held in reserve for major unexpected needs—lost job, hospital or medical bills, major home or car repairs, travel to a funeral, etc. In addition to preparing a cash reserve, it is also important to build up appropriate food storage and assemble 72-hour kits, first-aid kits, and other emergency essentials to prepare for times of need.



4. INVEST EARLY, CONSISTENTLY, AND WISELY

After a reserve is built, you should begin saving for short- and long-term goals. Some short-term goals may include purchasing a newer vehicle, upgrading a cell phone, getting a new outfit, taking a trip to Disneyland, or buying furniture. It is gratifying to save and sacrifice for these short-term goals.

Some long-term goals to save for include

paying cash for a car or making a down payment on a home. You may also be saving for education, weddings, large philanthropic contributions, funeral expenses, or retirement.

It is never too early to begin saving for retirement. After graduating, you and your spouse should decide to save at least 10 percent of your income for retirement and understand your available options. If your employer offers a matching contribution to a 401(k), you should always contribute enough to get the full match. There is no other investment that yields a 100 percent return the first year! If your employer does not offer a 401(k), then consider investing in a personal IRA (Individual Retirement Account). 401(k)’s and IRA’s are tax-advantaged retirement plans set up by the government to encourage retirement savings. We’ll explore the ins and outs of these plans in Chapter 9.

We would also like to caution you against a few investment options. First, avoid **speculation**. Speculation is any investment that promises a greater-than-market-rate return. Most of these are scams or extremely high-risk ventures.

Second, it is important to realize that the only way to get greater-than-market-rate returns is to take greater-than-market-rate risks. This means if you put money into investments that promise large returns, you likely stand to lose a lot of money. It is much better to take the “get rich slowly” approach and invest wisely for the long term.

5. PROTECT YOURSELF AND YOUR FAMILY THROUGH ADEQUATE INSURANCE

Without insurance, major financial setbacks could wipe out decades of savings. Adequate insurance that protects major investments provides a family peace of mind. Marvin J. Ashton counseled:

Appropriately involve yourself in an insurance program. It is most important to have sufficient medical, automobile, and homeowners insurance and an adequate

Financial Reserve

Cash or other liquid assets held to cover 3–6 months of emergency expenses.

Speculation

Any investment that promises a greater than market-rate return.

life insurance program. Costs associated with illness, accident, and death may be so large that uninsured families can be financially burdened for many years.⁸

Once you have someone who is dependent upon you for income, you have a moral responsibility to get life insurance. You should have enough insurance to replace your income for long enough to raise your children and for your spouse to be financially self-sufficient. Some financial planners recommend 10–15 times your gross salary. In general, term life insurance is preferable to whole life insurance to obtain this coverage. In addition, be sure to have adequate health, auto, disability, and homeowners/renters insurance.



Because of the Affordable Care Act, almost everyone in the United States is required to have health insurance. In general, if you have little need for health services, you are better off to have a high-deductible plan with lower monthly payments. However, if you interact with health services more than average, it is usually better to have a lower deductible and higher monthly payments.

6. SHARE FINANCES AS EQUAL PARTNERS IN YOUR MARRIAGE

If you are married, you and your spouse must stand as equal financial partners in your marriage. You must both be involved in creating, implementing, and modifying the family budget. You must be open and transparent in your financial communication with your

spouse. Both you and your spouse should have knowledge of family income, expenses, investments, and debt. You should not hide liabilities or assets from one another.

Regarding finances in marriage, Marvin J. Ashton wrote: “Management of family finances should be full and equal and mutual between a husband and a wife. Control of the money by one spouse as a source of power and authority causes inequality in a marriage and is inappropriate.”⁹

Unfortunately, many couples are not successful in managing their finances, and the resulting conflict compromises their marriages. Indeed, research shows that financial difficulties are often associated with marital stress¹⁰ and divorce.¹¹ Dr. Bernard Poduska reflected, “The saying ‘married for better or worse, until *debt* do us part’ seems to reflect today’s marital realities more accurately than does the traditional vow.”¹² A word of advice for those seeking marriage: an important criterion for a future spouse is the way they handle money.



7. TEACH YOUR CHILDREN AND FAMILY ABOUT FINANCES

You must teach your children to manage money well. Millennials are struggling with financial capability and independence.¹³ To remedy this for the next generation, we must teach our children about finances not just in schools but in the home. Children learn more about finances from their parents than from school and work combined.¹⁴ The way you instruct and model financial knowledge, attitudes, and behaviors for your children will

shape their financial capability and independence in adulthood.¹⁵

Instruction and example are both essential. Joseph B. Wirthlin taught,

Teach your children to set and achieve goals, and let them see you doing the same. Teach them the principles of financial management, and show them how you apply those principles in your life. Involve them in creating their own budgets and in creating the family budgets. Teach the principles of hard work, frugality, and saving, and stress the importance of obtaining as much education as possible. Teach by example.



Summary

Are you ready for an adventure? Within the pages of this book you will learn many things about finances that you can use the rest of your life. We hope you will take the time to seriously study this material, teach others about it, and apply it to your own life. If you do so, you will claim not only financial blessings but happiness and stronger relationships as well. Let's get started!



Notes

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1

Time Value of Money (TVM)

Strengthening Your Family with the Eighth Wonder of the World

In past centuries, articles of fine clothing such as silk scarves and dresses were very valuable. Wealthy Europeans would use them to store financial value, carefully packing away the clothing in cedar chests for future financial security. However, there was an enemy to this financial strategy: *Tineola bisselliella*, as scientists call it today. In those days, it was known as the clothes moth.¹ This moth can lay up to one thousand eggs, each of which can hatch into a larva with a voracious appetite, eating virtually anything organic. Imagine the disappointment of someone planning to retire who, upon opening his chest, is greeted by a cloud of moths and discovers that his retirement investments have been devoured by thousands of caterpillars!

Likewise, today there is an enemy to savers who do not understand the time value of money and do not invest their money wisely: inflation. I will demonstrate this with a very graphic illustration. Reader discretion is advised; this is not for the faint of heart!

Imagine that you want to ensure a comfortable retirement and carefully calculate that you will need \$500,000 when you turn seventy in fifty years. You work very hard, scrimp and save, and put one hundred crisp \$100 bills (\$10,000) away in a cedar chest every New Year's Day for fifty years. Imagine your disappointment when at age seventy you open the cedar chest and, because of inflation,² discover that your retirement fund of five thousand crisp \$100 bills (\$500,000) will only purchase the equivalent of \$70,356!³ Now you are going to have to work forever. You will never have a comfortable retirement!



LEARN

- That the value of your family's money is always changing due to inflation and interest
- About the power of the eighth wonder of the world—compound interest
- Basic family finance terminology associated with TVM
- To set family financial goals using TVM

Inflation can wreak as much havoc with your retirement savings as the larvae of the clothes moth did with fine clothing. You can prevent this havoc by understanding and applying the time value of money.

Of the many principles of family finance, the key mathematical principle you should master is the **time value of money (TVM)**. This principle basically states that the value of the dollar is not stagnant. As time passes, your dollars do one of two things: they either grow in value due to interest earned, or they decline due to the corrosive effect of inflation. The key to successful financial planning and investing is to create a situation where the interest you receive is significantly greater than the rate of inflation. The purpose of this chapter is to give you a conceptual overview of the time value of money.

Inflation and Interest

First, let's compare and contrast inflation and interest. **Inflation** represents an increase in the price your family will pay for goods and services over time. Because of inflation, your family's dollars will buy less in the future (future value) than they will today (present value). The overarching economic reason for inflation is an increase in the supply of available money in relation to the supply of available goods and services. The more money is printed and sent cycling through the economy, the more producers can ask for their goods and services. Although inflation is a healthy byproduct of economic growth, too much inflation is not healthy for your family's long-term financial situation.

Avoid letting your money be eaten away by inflation like the plague!

Inflation negatively impacts your family's investments. Although the amount of money you are saving now will have the same *nominal* value in the future (\$1000 will still be \$1000), your family will not be able to buy as much with that money because the purchasing power of the money has eroded. Inflation makes

it necessary to save more and invest money because your currency will be worth less in the future.

During the past fifty years, the annual inflation rate in the United States has ranged from a low of -0.4 percent in 2009 to a high of 13.5 percent in 1980.⁴ For family financial planning, various experts suggest assuming a long-term annual inflation rate between 2.5 percent and 4 percent. The United States inflation rate for 2017 was 2.1 percent. See www.usinflation.org for more information on the current and past inflation rates, as well as an inflation calculator to help you realistically determine investment goals for the future.

Although inflation decreases your purchasing power, **interest** helps your money grow. In this broad sense, interest pertains to any use of your money that results in a return on investment. The return is generally positive (your money grows), but with some risky investments, the return can be negative (your money diminishes or disappears altogether). Some examples of how you might invest your money to gain interest include checking and savings accounts, certificates of deposit, government and corporate bonds, stocks, commodities (such as gold), real estate, and even cryptocurrency.

Try thinking of it this way: Interest is similar to rent. Just as tenants pay rent to landlords in exchange for the use of an apartment or house, people and institutions will pay you interest in exchange for the temporary 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. We will explore the topic of investing in much greater detail in Chapter 8.

Here's another way to look at inflation and interest: A dollar in hand today is worth more than a dollar received in the future. Inflation is one of the main reasons you pay interest when you borrow money (for credit cards, mortgages, etc.). A dollar in hand today really is worth more than a dollar received in the future because you can invest that dollar today and begin earning interest on it. The sooner

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Value of
(TVM)

Value of
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**Avoid letting
your money be
eaten away by
inflation like the
plague!**

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your money can earn interest, the faster your interest can earn interest, and the more money you will have.

There are those with average incomes who saved up quite an amount for their kids' college funds, and there are those who receive large salaries who are still struggling from paycheck to paycheck. The difference between the two groups is the first group simply spends less than they receive. They save regularly and take advantage of the power of compound interest.

We will now introduce you to a real "marvelous work and a wonder" related to your family's financial future. Albert Einstein is thought to have said that "Compound interest is the eighth wonder of the world."⁵ **Compound interest** means that not only is your initial investment earning interest, your interest is earning interest! Compounding refers to the number of periods in which interest is calculated during the year. Interest can be compounded annually, quarterly, monthly, and even daily. The shorter the compounding period, the more money from interest you will earn, and the faster your money will grow. Using compound interest can bless your family greatly. The following example about compound interest demonstrates how understanding the time value of money is crucial to making wise investments for your family's financial future.

Imagine there are four twenty-year-old college students, each with \$10,000 to invest now in preparation for retirement in 2068. Let's compare different investment options, assuming similar returns to the past few decades.⁶

The first student does not trust the financial system, and he puts the money under

his bed in a strongbox. In fifty years, he still has \$10,000. And, alas, because of inflation (assuming a 4 percent long-term inflation rate) the \$10,000 will only have the purchasing power of \$1,407.

The second student puts her money in a savings account, which averages about 2.5 percent annual return. Because of compound interest, it doubles every twenty-five years. She has \$40,000 when she retires, but because of inflation, it will only be worth \$4,904.

The third puts his money in a safe government bond mutual fund, which averages about 4.5 percent annual return. It doubles every fifteen years. By 2068, the \$10,000 has become almost \$100,000, but because of inflation, it will only be worth \$13,294. At least it beat inflation!

The fourth puts her money in a broad, diversified stock market fund, which averages about 10 percent return. It doubles every seven and a half years. In fifty years, it doubles nearly seven times, and the \$10,000 has become more than \$1,000,000! And even when inflation is accounted for, the \$10,000 has grown in purchasing power to \$204,553!

That is the miracle of compound interest! When you consistently and wisely invest like the fourth student, you have the peace of mind that comes from knowing you will be able to conquer the moth of inflation that threatens your financial security. You will be able to have a financial reserve you can count on. You will be able to retire and do whatever you truly enjoy without a financial care in the world! Wow! Isn't time value of money amazing!?! Understanding this principle is essential to living joyfully within your means.

Financial Terms and Definitions

Let's take a look at some financial terms and definitions. An **investment** is a current commitment of your money in the expectation of reaping future financial returns. Examples of major financial investments include checking and savings accounts, certificates of deposit,



Time
Money
www.youtu
watch?v=ASPE

Compound interest

Interest earned on interest.

Investment

A current commitment of your money in the expectation of reaping future financial returns.

Present value (PV)

Current value of money.

Principal

The original amount of money borrowed or invested (generally synonymous with present value).

Interest rate (I)

The rate you will receive for investing at a specified compounding period for a specified period of time (generally expressed in percent per year).

Nominal return

The return on an investment before the impacts of inflation and taxes are taken into account.

After-tax return

The return on an investment after the impact of federal, state, and local taxes has been taken into account.

Real return

The rate of return on an investment after the impacts of taxes and inflation are taken into account.

Compounding periods (N)

The frequency with which interest is applied to an investment.

government and corporate bonds, stocks, commodities (such as gold), and real estate.

In this book, references will be made 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. You should have priorities when it comes to investments, and the most important investments you will make involve your personal and family's long-term goals.

Present value (PV) refers to the original amount of money borrowed or invested, i.e. the current value of a future sum of money. It is also the initial **principal** of a loan or investment. When paying off a mortgage, a certain amount of each payment goes toward paying off the principal and a certain amount goes toward paying interest.

The annual **interest rate (I)**, in investment terms, is the rate you will receive for investing at a specified compounding period for a specified period of time, expressed as a percentage per year. It can be a specific, fixed rate (as is the case with a bank account or a bond) or it can be a projected rate (like in a stock-based mutual fund). More specifically, this can refer to the nominal, after-tax, or real return. **Nominal return** is the return on an investment before the impact of inflation and taxes is taken into account. **After-tax return** is the rate of return on an investment (interest earned) after the impact of federal, state, and local taxes are taken into account. **Real return** is the return on an investment after accounting for the impacts of taxes and inflation.

Compounding periods (N) refer to the frequency with which interest is applied to an investment. As mentioned previously, interest may be compounded daily, monthly, quarterly,



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, quarterly, or annually.

Payment (PMT) is a periodic amount invested or received during the life of the investment. For example, in a car loan it would be the amount you pay per month as you bring the principal down from the initial loan value (Present Value or PV) to the final loan value of zero (Future Value or FV).

Future value (FV) is the monetary value of an investment at some point in the future after taking into account the present value (the principal), the annual interest rate (I), the number of compounding periods (N), and any



payments (PMT) along the way. For a loan, the FV is always zero.

A **lump sum** is a one-time payment or investment. The example of the four college students used earlier demonstrates a lump sum investment. Lump sum problems utilize present value (PV), future value (FV), number of compounding periods (N), and interest rate (I) functions on a financial calculator. These are lump sum events, meaning they occur only once.

Annuity is the disbursement of money on a periodic basis—a series of equal payments which are made at a specific time (for example, at the end of a month or year). The example earlier in the chapter of investing \$10,000 every year is an example of an annuity. Annuity problems also utilize the payment (PMT) function on a financial calculator in addition to PV, FV, N, and I. This disbursement (or payment) may either be money received by you (monthly allowance, bimonthly paycheck, annual stock dividend, etc.) or money leaving you (quarterly deposit into savings, monthly loan payment, etc.). When money is received by you, the sign of this amount in a financial calculator is positive. When money is leaving you, the sign of this amount in a financial calculator is negative.

Purchasing power is the value of monetary funds based on the amount of goods or services that one unit of money can buy. The purchasing power of a dollar changes over time because of inflation. For example, due to inflation, you would need to make a much higher wage than your grandfather did fifty years ago to have the same purchasing power that he did then.

Opportunity cost is the potential loss or gain that occurs when one financial option is chosen over another. For example, when you consider leaving your employment to go to college, you must consider the value of the wages that you will lose during the years you study to get your degree. In making the decision, this opportunity cost would be measured against the higher wages that you hope to earn after you receive your college degree. As another

example, the opportunity cost of buying a boat is not only the dollar amount of the purchase, but also everything you are giving up that you could have bought with that same money.

Opportunity cost applies to more than just finances. Choosing to invest time on your education or career that could have been spent with your family carries with it a certain cost. It is important to regularly evaluate how you are using your resources so that your opportunity cost can be in harmony with your personal and family's long-term goals. We will explore this more in Chapter 12.



Family Financial Goals

Once you have a healthy perspective on wealth and understand the importance of the time value of money, the next important step is to begin your Family Financial Plan (FFP) and set personal and family goals.

Financial planning is the process of planning how to wisely use your available resources to achieve your personal and family goals. It will help you determine where you are, where you want to be, and how you will get there. While financial planning may not help you make more money (although it likely will), it

Payment (PMT)

A periodic amount invested or received during the life of the investment (e.g., monthly payment, annual disbursement, dividend, etc.).

Future value (FV)

The monetary value of an investment at some point in the future.

Lump sum

One payment at a specific time.

Annuity

The disbursement of money on a periodic basis—a series of equal payments which are made at a specific time.

Purchasing power

The value of monetary funds based on the amount of goods or services that one unit of money can buy.

Opportunity cost

The potential loss or gain that occurs when one financial option is chosen over another.

"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."

—M. Russell Ballard⁷

will help you make better choices and become more responsible over the things you have prepared and established.

We encourage you and your family to write down your wishes, transform them into goals, and accomplish them. Setting goals is not simply writing a list of things you would “like” to accomplish. Rather, it is a process of understanding yourself and your family—your aspirations, desires, and values—and then trying to understand what kinds of things are important to you. Once you have determined these things, you must combine them to form a plan of action that will help you attain your potential as a unified family.

Financial planning is not easy. Motivation, diligence, and time are required to complete a successful family financial plan. However, like most things that take time, family financial planning is well worth the effort.



Creating Your Family Financial Plan

We recommend a six-step process for putting together your Family Financial Plan.

STEP 1:

Decide What You Are About

Deciding what you are about establishes what kinds of things are important to you. It expresses your family’s core values and beliefs. What is truly important to you? How would you like to be remembered after this life? What do you want to accomplish with your life? These are probably the most important questions you will ever ask and answer, and discussing these things as a family strengthens relational bonds.

STEP 2:

Evaluate Your Financial Health

Evaluating your financial health helps you determine where you are financially. If you don’t know where you are, how can you determine how to get to where you need to be? You will learn more specifically how to evaluate your financial health in the next chapter. 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? You will learn more about this in Chapter 2.

STEP 3:

Define Your Family Goals

Once you know what is important to you and where you are financially, it is critical to define your family goals. The first step is to write your goals down. Attach a cost to each goal. Remember, there are more costs than just financial costs. What are the true costs of your goals in terms of time, money, and effort? There is no difference between financial and personal or family goals. Financial goals are personal goals with a monetary cost attached.

It is also important to determine potential obstacles. By identifying the obstacles early in the analysis, you increase your ability to plan for, avoid, and overcome those obstacles. Set a date for when your goals are to be completed. In what time frame can the goal be reasonably accomplished? Make your goals SMART: specific, measurable, attainable, relevant, and time-bound. Then, share them with others so they can hold you accountable for your goals. Family goals are strong when you help each other remember and stick to them. We will learn more about how to define and apply your goals to a family budget in Chapter 2.

STEP 4:

Develop a Plan of Action

Think long term—consider your family’s future needs. Develop a budget, and use it wisely. Plan for big-ticket purchases, such as houses and cars. Plan for managing debt, and remember that debt is the enemy to growth. Plan for insurance, and protect yourself. Determine and write your investment plan, and follow that plan. Plan for the expenses of children, trips, and college. Plan for retirement. Most importantly, plan your financial future early and then live your plan. This book will help you know how to develop that plan.

STEP 5:

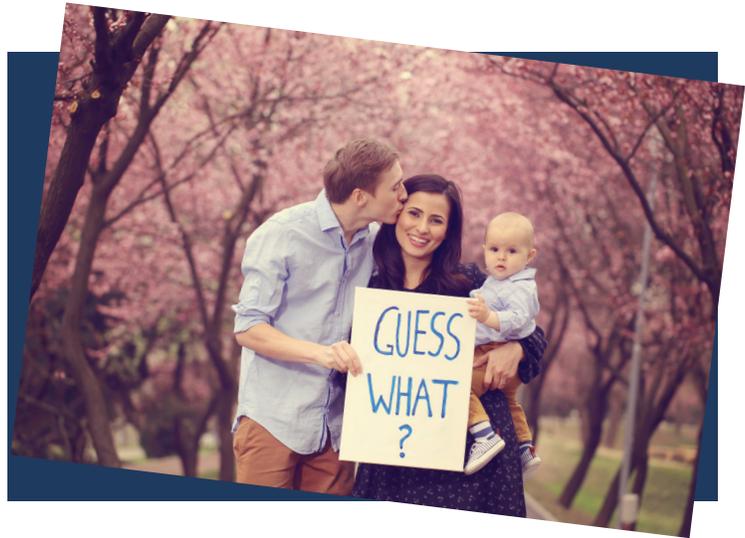
Implement Your Plan

Once you have your plan, implement it. Use common sense and moderation in the things you do. Set wise goals and work toward them each day. Stay positive. Remember that your family plan is a goal to set your sights on, not a stick to beat yourselves with. Realize that detours will come, but also realize that you can get back on track. We all encounter detours, but good things come to those who hang in there!

STEP 6:

Revise Your Plan as Necessary

Ongoing 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. In the weeks ahead, you will probably change your financial plan quite a bit as you identify critical areas and learn more about financial decisions.



A Good Perspective of Family Goals

Think about how the following poem by Jessie B. Rittenhouse relates to your family goals:

I bargained with Life for a Penny,
and Life would pay no more,
However I begged at evening,
when I counted my scanty store.
For Life is a just employer,
He will give you what you ask,
But once you have set the wages,
why, you must bear the task.
I worked for a menial’s hire,
only to learn, dismayed,
That any wage I had asked of Life,
Life would have willingly paid.⁸

Too many of us do not think about what we want to get out of life. Instead, we wander aimlessly through life just taking things as they come. We set our wages too low—settling for just a single penny. Unless we make some changes, we will be disappointed with the penny we receive from life.

A wise philosopher said, “We are not human beings having a spiritual experience. We are spiritual beings having a human experience” (Pierre Teilhard de Chardin). When we set goals, we need to consider more than just what might be termed “temporal” achievements—goals related to money, title, or fame; influence, rank, or power; and assets, invest-

SMART principle

Family goals should be

Specific
Measurable
Attainable
Relevant
Time-bound

ments, or possessions. We must also consider our values, our time, our family and other relationships, and any other factors that we feel would contribute to our joy and happiness.

Temporal goals are often means to a greater end—we want financial success not for its own sake, but for the opportunities and security it can provide. However, we must be vigilant; because temporal goals are more visible and easier to measure, we may focus only on them at the expense of the goals we hoped they would help us attain. Achieving temporal goals may also 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 we are not careful, life can easily become an “unending stream of extenuating circumstances.”⁹ Remember to balance your temporal goals with your other goals.

As you continue studying this book, create and revise your own family goals, both financially and in all aspects of life. The time value of money is a wonderful tool you can use to help your family accomplish your long-term financial goals.



Conclusion

Time value of money is the mathematical and conceptual basis for much of what we will learn about in subsequent chapters.

In this chapter, we learned that the value of money is always changing due to inflation and interest. We learned about the power of compound interest and how it is key to your family’s financial success. We learned basic family finance terminology that will act as a foundation as you continue to learn throughout this course. We also learned about the importance of family financial goals and how to set them. Through all of this, we stressed how essential your financial capability is to your family and how it reflects a responsible life.

Other Resources

- www.personalfinance.byu.edu/beginning
- www.usinflation.org
- www.youtube.com/watch?v=ASP6LGHFjow
- “Moth and Dust Doth Corrupt” Animation: <https://www.youtube.com/watch?v=lcf5G-0FxJfw>
- “Time Value of Money” Animation: <https://www.youtube.com/watch?v=ASP6LGHFjow>

Notes

1. <http://www.todayifoundout.com/index.php/2013/11/moths-really-eat-clothes/>.
2. <http://www.calculatorsoup.com/calculators/financial/investment-inflation-calculator.php>.
3. <http://usinflation.org/us-inflation-rate-calculator/>.
4. <http://usinflation.org/us-inflation-rate/>.
5. <http://www.telegraph.co.uk/sponsored/finance/premier-asset-management/11257819/compound-interest-investment.html>; <http://www.quotesonfinance.com/quote/79/Albert-Einstein-Compound-interest>.
6. <http://www.homesteadfunds.com/>.
7. M. Russell Ballard, *Preach My Gospel*, (Intellectual Reserve, Inc., 2004), 146, <https://www.lds.org/manual/preach-my-gospel-a-guide-to-missionary-service/how-do-i-use-time-wisely?lang=eng>.
8. Quoted in *Think and Grow Rich* by Napoleon Hill, (New York: Fawcett Books, 1960), 40.
9. Clayton M. Christensen, “How Will You Measure Your Life,” *Harvard Business Review* (July–Aug. 2010).



2

Budgeting, Net Worth, and More

Measuring Your Family's Financial Health and Planning for Future Success

As we learned in the previous chapter, understanding the time value of money is an essential tool in meeting family needs and satisfying appropriate wants of family members.

Another important part of planning for your family's financial future includes evaluating and monitoring your financial health. Family financial statements are very important in this process. In this chapter, we will examine several different kinds of family financial statements: an income and expense statement as a record of the past, a net worth statement as a snapshot of the present, and a budget as a plan for the future. A family income and expense statement shows categorized cash inflows and outflows over a specific period of time, generally a month or a year. A family net worth statement is calculated periodically (usually at the end of a month, quarter, or year) by subtracting a snapshot of your family's liabilities (what you owe) from a snapshot of your family's assets (what you own). A family budget forecasts planned spending within the constraints of your expected income on a monthly or annual basis. Each of these family financial statements is essential for financial health.

Just as company executives use financial statements to help manage their businesses to achieve specific financial goals, families can also use financial statements to understand their current financial health and help them meet their family goals. Financial



LEARN

- To record your family's important personal and financial information
- How to document your family's financial past with a family income and expense statement
- To calculate your family's present financial health with a family net worth statement
- How to plan your family's future finances by developing and implementing a successful family budget

familysearch.org

statements are important tools that help us provide the necessities of life for our families.² Learning how to track your income, expenses, assets, and liabilities, as well as learning how to budget effectively will help you and your family maintain good financial health and, consequently, better quality of life. Let's embark on this adventure!



Families used to keep paper copies of all their records, usually filling several filing cabinets in a den, office, closet, or garage. Inside these innumerable, carefully labeled folders were canceled checks, bank statements, pay stubs, bank deposit slips, credit card statements, loan coupons, household receipts, donation slips, tax returns, and on and on and on. Nearly everyone kept a paper copy of almost every financial transaction, holding on to them for years. What a mess!

Today, most record keeping can be done electronically and then safely saved in the Cloud. In many cases, keeping a physical paper trail is no longer possible unless you print your records yourself. For example, most employers require your salary to be deposited electronically, so there are no pay stubs to file away. Most banks no longer provide physical copies of canceled checks, so those are unnecessary as well. Often, the physical records you need to keep may be limited to just a few folders in one file drawer. We are fortunate to live in this day and age!

Family Financial Record Keeping

Keeping our personal records in order simplifies the process of documenting where we have been, where we are, and where we hope to be. Keeping our financial records in order does the same for our financial lives.

Habitually keeping your family's important personal and financial records organized will contribute to your family's financial success. Well-kept records help you track how your money is being spent, which will help you create and stick to a budget. Additionally, organized record keeping helps you easily find the information you need to file your taxes. Should an emergency arise, family members and legal representatives may need to access your financial information, and an organized set of records will help them easily find the necessary information.

The way we keep family financial records has changed dramatically in recent years.



Although most financial transactions are recorded electronically today, it is still important that they be well-organized so that pertinent information can be retrieved in a timely manner. Some documents must be kept as hard copies, including birth certificates, social security cards, marriage licenses, and passports. You should keep these items together in a safe place.

You should also know how long certain records should be kept. Let's review some family records.

Income and expense statement

A record of your family's past cash inflows and outflows over a specified period of time.

Cash inflow

Family income.

Cash outflow

Family expenditures.

Fixed expenses

Expenditures that your family has little direct control over and that do not often change from month to month.

Family Income and Expense Statement

A family **income and expense statement** is a record of your family's past cash inflows and outflows over a specified period of time—usually the previous month or year. It can give your family a tangible basis for building a realistic budget based on past financial experience.

Family Income: Cash Inflows

Cash inflows include income that is available to be used for the expenses of the family. This money is usually deposited in the family checking account. Sources of income usually include net wages and salaries from employment (after taxes, health care costs, retirement, etc. are deducted). Inflows can also include tips, interest, dividends, royalties, gifts, tax returns, scholarships, and refunds. In a dual-income family, cash inflows should include income from both husband and wife. In some cases, children may also contribute to the family income.



Family Expenses: Cash Outflows

Cash outflows include all the expenses of the family. If there are sufficient cash inflows, the expenses are generally paid out of the family checking account, either directly or indirectly by paying off credit cards each month. However, if cash outflows exceed cash inflows, the difference is made up by taking on debt, usually in the form of high-interest credit cards.

There are two kinds of expenses: fixed expenses and variable expenses. **Fixed expenses**

Family Records

Records to keep forever:

- Adoption papers
- Birth certificates
- Citizenship papers
- Death certificates
- Divorce decrees
- Education records (diplomas, transcripts, etc.)
- Marriage licenses
- Military discharge papers
- Passports (even expired passports)
- Safe deposit box key
- Social Security cards

Records to keep forever, updating as needed:

- Advance directives (living wills)
- Family and personal journals
- Family and personal photos, videos, and audio recordings
- Household inventory
- Life histories
- Password list
- Powers of attorney
- Safe deposit box inventory list
- Vaccination records
- Wills

Records to keep as long as they are in force or as long as you are the owner:

- Contracts
- Home purchase and improvement records
- Life insurance policies (often in the Cloud)
- Loan documents
- Real estate deeds
- Receipts for items under warranty
- Receipts for large purchases
- Service contracts and warranties
- Stock and bond certificates (often in the Cloud)
- Vehicle titles

Records to keep for at least seven years:

- Income tax returns
- Anything needed to document income tax returns
 - Access to bank statement documenting tax information
 - Access to credit card statements documenting tax information
 - Contribution receipts
 - ➔ Yearly contribution summary
 - ➔ Donation receipts
 - Medical receipts
 - W-2 forms
 - 1099 and other tax forms



are expenses over which you do not have any direct control. There is no wiggle room with fixed expenses because you are obligated to pay a certain amount every month or every year. Examples of fixed expenses include rent, home mortgage, car payment, insurance payments, college loan payments, tuition, and property taxes.

Variable expenses are those expenses over which you have a greater measure of control. For example, food is a variable expense. Though you need to eat, you can choose to eat dinner at a restaurant or make dinner at home. What you choose to eat greatly affects the level of expense. Other examples of variable expenses include clothing, entertainment, vacations, and home maintenance.

To create an income and expense statement, you first record net income received. This includes any deposits into the family checking account and could include income, refunds, gifts, etc. Then you track and categorize every expense—everything going out of the family checking account. Here is a sample of the categories an income and expense statement might include. (See Table 2.1.)

Expenses can be tracked manually or electronically. One way to accurately track your expenses is to make sure every expense is paid for with a check, credit card, or debit card. Then the transactions can be noted and categorized from the bank and credit card statements. An easy way to automate this is with an online app such as www.mint.com or www.creditkarma.com. These aggregate all transactions in real time, allowing you to have an up-to-the-minute view of your expenses. These

apps will be explained in greater detail in the budgeting portion of this chapter.

After you have categorized every income and expense transaction, you sum up the totals and complete the family income and expense statement.

Example

Joseph and Vanessa are a young married couple who graduated from Northern Illinois University last year. Joseph received his master's degree in marriage and family therapy and Vanessa received a bachelor's degree in English. Last year Joseph earned \$50,000 (net income after taxes and deductions) as a marriage and family therapist, and Vanessa earned \$75,000 net income editing family finance textbooks. Over the course of the year, this \$125,000 was deposited in their family checking account. They kept all 1,434 receipts for their expenses during the year and manually categorized and entered them into a spreadsheet. Amazingly, every expense category total was a precise multiple of one thousand! This is what their annual income and expense statement looked like.

(See Table 2.2.)

Family Net Worth Statement

While an income and expense statement is a record of your family's *past* financial history and a budget is your family's financial plan for the *future*, a **net worth statement** is a snapshot of your family's *present* financial situation. Commonly referred to as a balance sheet, a family net worth statement is calculated by subtracting the monetary value of your family's **liabilities** from the monetary value of your family's **assets**. This statement can be very helpful in determining your family's financial health and in making financial decisions. In addition, a net worth statement may be required when applying for credit, such as a home mortgage. Since these are important matters, net worth should be calculated care-

Variable expenses

Expenditures that your family controls and that may vary from month to month.

Net worth statement

A snapshot of your family's total assets minus your total liabilities on a particular day.

Liabilities

Synonymous with debt, calculated by adding up the outstanding balances on any current and long-term family debts.

Assets

The monetary value of what your family owns that could be turned into cash.



"I think I just solved my cash flow problem."

Table 2.1 Blank Income and Expense Statement

<i>Income (Cash Inflows)</i>		<i>Expenses (Cash Outflows)</i>	
After Tax Income		Charitable Donations	
Job 1		Savings	
Job 2		Debt Payments	
Job 3		Housing (rent/mortgage)	
Other Income		Utilities	
Interest		Food	
Dividends		Clothing	
Capital Gains		Transportation	
Refunds		Medical/Dental	
Gifts (receiving)		Recreation/Entertainment	
Other		Gifts (giving)	
		School Expenses	
		Miscellaneous	
		Mad Money	
Total Income		Total Expenses	

Total Income – Total Expenses = Cash Surplus <or Deficit>

Table 2.2 Example Income and Expense Statement

<i>Income (Cash Inflows)</i>		<i>Expenses (Cash Outflows)</i>	
After Tax Income		Charitable Donations	\$15,000
Therapist	\$50,000	Savings	\$15,000
Editor	\$75,000	Debt Payments	\$5,000
Job 3		Housing (rent/mortgage)	\$15,000
Other Income		Utilities	\$5,000
Interest		Food	\$5,000
Dividends		Clothing	\$4,000
Capital Gains		Transportation	\$6,000
Refunds		Medical/Dental Expenses	\$5,000
Gifts (receiving)		Recreation/Entertainment	\$4,000
Other		Gifts (giving)	\$1,000
		School Expenses	
		Miscellaneous	\$5,000
		Mad Money	\$5,000
Total Income	\$125,000	Total Expenses	\$90,000

\$125,000 (Total Income) – \$90,000 (Total Expenses) = \$35,000 (Cash Surplus)

fully and at regular intervals, such as at the end of every month, every quarter, or every year. Net worth can be calculated for the family as a whole or for each individual in the family.

Family Net Worth Equation

$$\text{Family Net Worth} = \text{Family Assets} - \text{Family Liabilities}$$

Family Assets

Put simply, family assets are the monetary value of what your family owns that could be turned into cash. These assets come in many forms, including the following:

- Monetary assets: cash, savings accounts, checking accounts, certificates of deposit (CDs), etc.
- Investment assets: stocks, bonds, mutual funds, etc.
- Retirement assets: company pensions, IRAs, 401(k) plans, etc.
- Real estate: land, homes, rental properties, etc.
- Vehicles and other personal property: cars, trucks, recreational vehicles, boats, furniture, clothing, electronic equipment, jewelry, etc.

To determine the total dollar value of your family's assets, find the sum of the **current market value** of all assets. The current market value is the price at which your asset could be sold in the present market environment. There are various ways to calculate the current market value. To calculate a vehicle's value, you can look up the low book listing for your make and model in the Kelley Blue Book on www.kbb.com. To calculate your home's current market value, you can refer to www.zillow.com or www.realtor.com for an estimate. When calculating investment assets, you can use the most current market price as listed in any of the following sources: *The Wall Street Journal* (www.wsj.com), *Barron's* (www.barrons.com),

USA Today (www.usatoday.com/money/), or other financial periodicals. When calculating the value of personal property, be sure to use the estimated price you could sell the item for, not what you paid for it when it was new. This often equates to a thrift store, garage sale, www.craigslist.org, or www.ksl.com price.

Family Liabilities

Family liabilities are synonymous with debt and can be categorized into current liabilities and long-term liabilities. Current liabilities are those debts which are due on the short-term, or within one year. Two examples of current liabilities are your current credit card balance (even if you pay off the balance every month) and unpaid utility bills. Long-term liabilities are debts that are repaid over a period longer than one year. Three common examples of long-term liabilities are student loans, auto loans, and home mortgages.



You can calculate your liabilities by adding up the outstanding balances on any current and long-term debts. Note that your outstanding balance is not your monthly payment but rather the total amount, or principal, you still owe as of the date on your net worth statement. If your debt has accrued interest, such as with credit card debt, this should be calculated as part of that liability. Note that rent or tuition is not considered a debt unless it is overdue.

Calculating Your Family Net Worth

Remember, your family net worth is a snapshot of your total assets minus your total liabilities on any particular day. For example, a net worth of \$1,350 indicates that you have \$1,350 more in assets than in liabilities. In other words, if you were to sell everything you own at its current market value, you would have \$1,350 left after paying off all of your debts.

Many liabilities have a counterbalancing asset. For example, a liability of \$200,000 for a home mortgage loan might be more or less “balanced” by the current market price of the home, an asset worth \$260,000.

Tables 2.3 and 2.4 are two examples of net worth statements. The first shows a college student’s possible net worth statement; the latter shows a statement for a couple who graduated from Northern Illinois University ten years ago and now has a family with two children.

Notice that the college student’s net worth is significantly less than the family’s. In fact, many students have a negative net worth, with more liabilities than assets. This is normal, particularly when student loans have been acquired. A student loan is a unique form of debt because although the counterbalancing asset—the knowledge and preparation you

gain in college—is of great value, it is not easily quantified and does not count in the net worth calculation. Therefore, a student loan of \$5,500 shows up as a liability on the balance sheet with no offsetting asset. In reality, the “asset” is your increased earning power in the future, but that cannot be shown on the balance sheet.



As people get older and start families, buy houses, build retirement investments, etc., it is common for both the total liabilities and the total assets to grow, but financially healthy couples continually build greater net worth by both increasing their family’s assets and decreasing their family’s liabilities.

Table 2.3 Net Worth of a College Student

Assets	Current Market Value	Liabilities	Total Dollar Amount
Cash	\$47.88	Credit card balance	\$847.45
Savings account	\$1,292.30	Student loans	\$5,500
Checking account	\$415.66	Loan from Dad	\$1,000
Mutual fund	\$500		
Car	\$3,500		
Clothing	\$400		
Electronic equipment	\$300		
Jewelry	\$50		
Total Current Value of Assets	\$6,505.84	Total Amount of Liabilities	\$7,347.45

Total Assets – Total Liabilities = <\$841.61> (Net Worth)

Table 2.4 Net Worth of a Couple with Two Children

Assets	Current Market Value	Liabilities	Total Dollar Amount
Cash	\$255	Credit card balance	\$458
Savings account	\$10,432	Student loans	\$23,000
Checking account	\$4,918	Mortgage loan	\$152,000
Bonds	\$9,500	Car loans	\$6,400
Stocks	\$167,461		
401(k) plan	\$129,993		
Home	\$380,000		
Cars	\$23,500		
Clothing	\$700		
Furniture	\$3,000		
Electronic equipment	\$2,000		
Jewelry	\$3,000		
Total Assets	\$734,759	Total Amount of Liabilities	\$181,858

$$\$734,759 \text{ (Total Assets)} - \$181,858 \text{ (Total Liabilities)} = \$552,901 \text{ (Family Net Worth)}$$

Budgeting

Now that you have documented your past spending (family income and expense statement) and evaluated your current financial situation (family net worth statement), the next thing to do is plan for your financial future by creating a family **budget**. Simply stated, a family budget is a spending plan to meet future needs and wants in harmony with available family income. It is perhaps the most important thing families can do to keep their financial houses in order and minimize financial difficulties.

Effective budgeting is an ongoing and interactive process that involves five repeating steps:

1. Set goals to address family needs and wants, and determine financial resources needed to meet those goals.
2. Categorize your current income and spending (family income and expense statement).
3. Develop your family budget by allocating

income to budget categories that will meet your family's goals.

4. Implement your budget by tracking income and expenses against your budget.
5. On a regular basis (usually monthly), compare your budget to your actual expenses and make changes to your budget when necessary to achieve your goals.

Step 1

Set goals to address family needs and wants, and determine the financial resources needed to meet those goals.

The purpose of a budget is to make a plan to use your financial resources for those things of worth, your true needs and worthy wants. As we expend the fruits of our labor on these things, we feel a great sense of satisfaction. It is not enough just to want to save money—you should know what you are saving for. Basic needs, such as food, clothing, shelter, and transportation should take first priority. After

Budget

A spending plan in which family income is allocated to specific categories of expenditures.

needs are taken care of, the worthy wants of family members should be considered.

The acronym **SMART** is a good way to describe your family goals. They should be Specific, Measurable, Attainable, Relevant, and Time-bound. Your family goals should also be written down, because, “A goal not written down is merely a wish.”¹ It may also be useful to place these goals in a place where your family will see them often. This may help to remind you of your purpose and bring about more success.

Let’s look at the example of George and Tara. George and Tara got married as juniors, had a baby, and both graduated from Brigham Young University last year. George got a good job as an engineer earning \$80,000 per year. They expect to have several more children in the next decade or so. They set a goal to buy a used late-model minivan in three years without going into debt. They figure they’ll need it to fit all their children and their children’s car seats. They determine it will cost about \$18,000 to realize that goal. Knowing this, they create a budget in which they will save \$500 per month to put toward that goal. After saving \$500 per month for 36 months they will have the money they need to pay cash for a nice Toyota Sienna. It is much easier for George and Tara to save and sacrifice when they know what they are saving and sacrificing for.

Many families have not set goals together nor have they determined what their true needs and worthy wants are. They spend money on many different things in an attempt to find out what makes them happy. They engage in impulse buying. As a result, they find little satisfaction in their family financial management. Your family can be different!

Once you understand what is important to you, write down your goals, and begin working toward those goals, you will find that spending money on things that really matter becomes a lot easier. This kind of financial living allows you to control your money rather than letting your money control you. A bud-

get is not worth much if it does not help your family accomplish your family goals.

Step 2

Categorize your current income and spending in categories.

The next step is to categorize your current income and spending. Gather all of your financial transactions over some period of time (usually a month or year), put them in categories, and sum a total for each category. This is most easily done when all of your income goes into one account, usually the family checking account, and then all expenses are paid for from this account. Online apps such as www.mint.com and www.creditkarma.com can do most of this automatically. A family net worth statement can also be a great tool in assessing your current financial health and how you are using your money. Analyzing your past cash flow patterns can help you create a realistic budget.



Step 3

Develop your family budget by allocating income to budget categories that will meet your family’s goals.

Based on family goals to meet needs and wants, and the information in the family income and expense statement, the next step

SMART principle

Family goals should be

Specific
Measurable
Attainable
Relevant
Time-bound

is to intelligently allocate available income to budget categories. To be effective, family budgeting should be guided by the following principles:

- Spend less than you earn (income should exceed expenses)
- Keep good records for spending, taxes, and other purposes
- Use a budgeting method that meets your individual and family needs and circumstances

- Insurance (different types)
- Phone bill
- Car payment
- Education
- Food
- Fun
- Miscellaneous
- Mad money
- Clothing
- Pocket cash
- Car expenses
- Travel



Miscellaneous

One of your budgets most important, but often neglected, categories; a generous catch-all category for those unexpected expenses which find the holes in your budget.

Mad money

A certain amount of funds allocated to each spouse, for which they are not accountable to the other spouse.

BUDGET CATEGORIES

There are limitless budget categories that you can choose from to help keep track of your spending, because families spend money on an endless list of things. Some families who appreciate (and can handle) more flexibility use fewer, broader categories, while families who need more structure use many smaller categories. Again, it is up to you to decide which categories fit best in your family budget, but here are a few of the most popular categories.

Budget Categories

- Income 1, income 2, etc.
- Tax return
- Savings
- Mortgage/rent
- Charitable donations
- Utilities
- Groceries
- Fast food/eating out
- Credit card payments

The **miscellaneous** section is one of the most important sections in your budget. It's highly unlikely you will ever create a budget that will perfectly match all your expenses. There are many unforeseen expenses which tend to pop up that may not fit the categories within your budget. It is always a great idea to have a generous catch-all miscellaneous category for those unexpected expenses which find the holes in your budget.

Avoid not having a miscellaneous category in your budget like the plague!

“**Mad money**” is a certain amount of funds allocated to each spouse, for which they are not accountable to the other spouse. For example, you and your spouse might have \$50 per month each of “mad money” that you can spend however and whenever you wish (as long as it is legal). This can strengthen marriages and give each spouse some personal freedom, while still helping the couple stick to a budget.

Remember to budget for your family's short- and long-term goals. Purposefully spend your money on what you value. Invest your money in what matters most, such as budgeting for weekly date nights to strengthen your marriage. The easiest way to work toward goals and make them happen is to allocate money toward them each month.

If your family is struggling to spend less than you earn, it may be helpful to rethink your fixed expenses and your variable expenses



Always have a miscellaneous category in your budget.

previously discussed in this chapter (see family income and expense statement). Remember, expenditures that you may have thought of as fixed expenses are in fact variable, and can often be either reduced or eliminated as needed. For example, you might sell a car with a \$500 per month car payment, and then purchase a less expensive vehicle. You may also choose to eliminate your \$100 monthly cable bill for a time. Differentiating between needs and wants is a valuable skill, especially in times when money is tight.

Table 2.5 is an example budget of a young couple who have recently graduated from college and started working and do not have children yet.



BUDGETING THE BETTER WAY

Many families 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 debts and expenses, and then save what they do not spend during the rest of the month.

$$\text{Income} - \text{Debts} - \text{Expenses} = \text{Available for Savings and Family Goals}$$

This is an ineffective pattern for budgeting monthly income because families are paying themselves last. It also creates the feeling that your family budget is a ball and chain that is restricting you.

Avoid not budgeting the better way like the plague!

There is a better pattern. After you have paid off all or some debt, pay yourselves a pre-

Table 2.5 Example Budget

	Budget	Actual	Difference
Income			
Wages/salaries (after taxes)	\$2,500	\$2,400	<\$100>
Other income	\$200	\$250	\$50
Total income	\$2,700	\$2,650	<\$50>
Expenditures			
Tithing/Donations	\$325	\$318	<\$7>
Long-term savings	\$405	\$398	<\$7>
Short-term savings	\$70	\$70	\$0
Food	\$300	\$320	\$20
Mortgage or rent	\$600	\$600	\$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>
Miscellaneous	\$100	\$75	<\$25>
Mad money	\$30	\$30	\$0
Total expenditures	\$2,700	\$2,641	<\$59>
Income minus Expenditures	\$0	\$9	\$9

determined amount or percentage directly into savings, then budget and live on the remaining income.

$$\text{Income} - \text{Debts} - \text{Pay Yourselfs (savings and goals)} - \text{Expenses} = \text{Other Savings}$$

Using this pattern will help you keep your priorities in order and create more positive feelings about your family budget.

BUDGETING METHODS

Different families use different budgeting methods (or a combination of several methods) because each family has unique preferences for how to track their money. Whatever method your family chooses to use should accomplish the principles you learned earlier in this section.

Consider the timeline you want for your budget. How you create your budget may depend on whether it is for the short-term (weekly or monthly), intermediate-term (quarterly or yearly), or long-term (several years to a decade). It would be a good idea to have a set budget for each term, and you might decide to use different methods for each term. However, a monthly budget is the most common because so many payments are due on a monthly basis. Here are a few of the most common budgeting methods:

Online Internet Services

To use this method, you create an account on a financial tracking service such as www.mint.com or www.creditkarma.com. You provide this service access to all of your financial accounts (bank accounts, credit cards,

investment accounts, etc.) and set up a monthly budget allocating a set amount per month to different categories. Then, in real time, the service tracks credit card, debit card, and check activity.

As long as you deposit all of your income into one account and always use a credit card, debit card, or check for every expenditure, you will always have a perfect record of your income and expenses. Using this method, you can always check the status of your budget. You can also opt to receive automatic alerts if you start spending more than you have allocated. Another benefit to using online internet services is that they provide your credit score free of charge.

Some have worried about the security issues that can arise from giving all of your personal financial information to online service providers such as those mentioned above. It appears that these two service providers have equivalent security measures that are as secure as the financial institutions themselves. This type of service is free. The service providers make their money by offering you financial options (e.g., credit cards, loans, etc.) based on your financial data and credit score, but you do not have to purchase any of these offers to use the service for free.

INCOME



- DONATIONS

- EXPENSES



= SAVINGS & GOALS



VS.

INCOME



- DONATIONS

- SAVINGS & GOALS



- EXPENSES



= OTHER SAVINGS

Spreadsheets/Written

This method is mostly self-explanatory. If you are good with Excel or another spreadsheet software, then this may be the method for you. There are endless ways to set up your personal spreadsheet, but you might list take-home pay (money you earn after taxes and other deductions) at the top. 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 category (row). Be sure to allocate 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

This method can be a little more expensive than other methods, but there are many options available. Two of the most popular



Always budget the better way.

budgeting software currently available are Quicken and Mvelopes. Much like the spreadsheet method, most software programs assist you in determining spending categories, tracking your expenses in those categories, and setting up saving and spending goals. There are even budgeting apps that can be of great help. If set up correctly, this method can save significant time and effort while helping your family achieve your goals.

The Envelope Method

This method requires you to physically take the money your family plans to spend that month or week out of the bank and divide the cash into different envelopes that are marked as different expense categories (like rent, food, entertainment, etc.). Once a category's envelope is empty, you cannot spend any more money in that category until the time period is over, at which time you go to the bank and get cash for the next period. For those who find living within a budget difficult, this may be the most straightforward method.

Zero-Based Budgeting

This method is centered on the idea that every cent of money you earn already has a place for it to go even before you receive it. This means allocating all of your income into different categories, leaving very little wiggle room for going over budget in any category or having extravagant spending binges. This method can help you increase the amount of money in your savings account.

DNAH-ial Methods (Do Nothing and Hope) or "It's All in My Head" Budgeting

This is the method used by most individuals, and it is the cheapest and least time-consuming. It requires nothing. Individuals simply deny responsibility 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.



Avoid the "Do Nothing and Hope" budget like the plague!

Although you have to determine yourself which method is best for you, the best methods are those that have the following attributes:

1. Low cost and relatively easy to use
2. Allow downloading of bills from banks and credit card companies—makes data entry easier
3. Allow adequate categorization of spending for income, spending, reporting and tax purposes
4. Minimize the time spent on finances



Avoid the "Do Nothing and Hope" budget like the plague!

Step 4

Implement your budget by tracking income and expenses against your budget.

Now that you have set up an effective family budget, give it a try. 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.

Adjust your plan as necessary to make it work for you. Try to be financially prudent—

HALT principle

Avoid making purchases or financial decisions when you are

Hungry
Angry
Lonely
Tired



Avoid making purchases or financial decisions when you are Hungry, Angry, Lonely, or Tired like the plague!

HALT video

<http://bcove.me/davyf55y>



don't buy things you don't need or haven't budgeted for. Following the **HALT principle** can help with this. Strive to avoid buying things when you are feeling Hungry, Angry, Lonely, or Tired. It's easy to try to make ourselves feel better by spending money, but in the end it will hurt your family budget and increase your stress. Use each month as a learning experience to help you do better the next month.

Avoid making purchases or financial decisions when you are Hungry, Angry, Lonely, or Tired like the plague.

While you are in the implementation stage of your budgeting, take time to assess how well you are doing. Here are a few introspective questions that you can ask to see how well your budget is being implemented in your family:

- Do you know how much money you have in your accounts right now?
- Do you know how much you can spend when you go grocery shopping?
- How often do you check your budget?
- Do you adjust your budget every month?
- Are you prepared for unexpected financial setbacks by having a section of your budget devoted to savings?
- Is your budget realistic?
- Is your budget personalized to you and your spending?
- Do you have a miscellaneous section in your budget?
- Do you view your current budgeting practices as helpful?
- (If married) Do you and your spouse have “mad money” in your budget?
- (If married) Do you and your spouse have time set aside weekly to go over your budget together?
- (If married) Do you feel that you and your spouse are on the “same page” financially?

HUNGRY**ANGRY****LONELY****TIRED**

- (If married) Are there any unresolved financial issues between you and your spouse that could be solved by sitting down together and going over your family budget? (For example, have you or your spouse been angry with one another for spending too much money?)
- (If married, with children) Are you including your children in the family budgeting process?

Step 5

Compare your budget to your actual expenses and make changes where necessary to achieve your goals.

The fifth step in creating an effective budget is comparing your budget to your actual spending. 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 debts or to yourself.

Creating a budget is a learning experience. You will likely never create a perfect budget because life situations change. Every month may require different spending needs. Assessing and editing your budget each month for different expenses that come with different situations is a healthy habit to establish.

Budgeting Advice for Couples

Each husband and wife needs to reason together about the family budget on a regular basis. If downward adjustments need to be made in the family spending habits, it is far better to do what needs to be done now rather than build up to an impossible financial crisis later on—a crisis that too often leads to the divorce courts.²

Budgeting can be a big stress on a couple's relationship. Here are a few tips to help manage that stress and learn to budget together:

- Decide who would be the best, or the main person, in charge of budgeting
- Mutually agree to monthly budget amounts

- Discuss finances early and often (weekly) to resolve misunderstandings
- Be flexible and forgiving with each other—compromise
- Be willing to adapt

Overall, remember that if you don't control your money, it will control you.

Commit to healthy, successful budgeting for the rest of your life! It is an essential part of living joyfully within your means.

Financial Ratios

Financial ratios are another way to measure your family's financial health. Using ratios can help you better understand how you are managing financial resources by pointing out areas of strength and areas of weakness. Analyzing these ratios over time can help you identify trends and compare your financial standing to recommended target ratios.

Ratios to Remember

Table 2.6 shows some of the more common ratios.

Table 2.6 Common Ratios

Ratio	Calculation	Example	Interpretation	Recommended Guidelines
Debt Ratio	Liabilities divided by net worth	$\$25,000/\$50,000 = 0.5$	Shows relationship between debt and net worth	A low debt ratio is best
Current Ratio	Liquid assets divided by current liabilities	$\$4,000/\$2,000 = 2$	Indicates \$2.00 in liquid assets for every \$1.00 of current liabilities	A high current ratio is desirable to have cash available to pay bills
Liquidity Ratio	Liquid assets divided by monthly expenses	$\$10,000/\$4,000 = 2.5$	Indicates the number of months in which living expenses can be paid if an emergency arises	A high liquidity ratio is desirable
Debt-payments ratio	Monthly credit payments divided by take-home pay	$\$540/\$3,600 = .15$	Indicates how much of a person's earnings goes for debt payments (excluding a home mortgage)	Most financial advisers recommend a debt/payments ratio of less than 20 percent
Savings ratio	Amount saved each month divided by gross income	$\$648/\$5,400 = .12$	Shows relationship between amount saved and income earned	Financial experts recommend monthly savings of 5–10 percent

Conclusion

In this chapter we have explored several essential ways to measure your family's financial health and to plan for future financial success. We have taught about the importance of regularly and accurately recording your family's personal and financial information. You learned to document your family's financial past with a family income and expense statement. You documented all of your family's financial assets and liabilities in order to calculate a family net worth statement. And finally, you developed and implemented a family budget. We wish you well as you take your family's financial health into your own hands and move purposefully toward your family goals.



Other Resources

- www.barrons.com
- www.creditkarma.com
- www.daveramsey.com
- www.kbb.com
- www.ksl.com
- www.mint.com
- www.personalfinance.byu.edu
- www.realtor.com
- www.usatoday.com/money
- www.wsj.com
- www.zillow.com
- HALT Video: <http://bcove.me/davyf55y>

Notes

1. Sean Covey, *The 7 Habits of Highly Effective Teens* (New York, NY: Simon and Schuster, 1998), 59.
2. Robert L. Simpson, "A Lasting Marriage," *Conference Report* (Apr. 1982), <https://www.lds.org/general-conference/1982/04/a-lasting-marriage?lang=eng>.



3

Cash Management and More

Introducing Your Family to Banks and Other Financial Institutions

Cash management deals with how to effectively manage your family's monetary assets. **Monetary assets** are financial resources that are legal tender (cash) or can be converted to legal tender very quickly. They are very low risk. Some examples of monetary assets are the currency in your wallet, coins in a pickle jar, checking and savings accounts, certificates of deposit (CDs), and money market accounts. Things like houses, cars, washing machines, stamp collections, apartment buildings, gold, silver, bonds, art collections, baseball teams, stocks, and children are not considered monetary assets because they cannot be turned into cash very quickly (if at all) or they are not low-risk. The goals of effective cash management include convenience (easy-to-access services without travel or hassle), cost (you are not charged fees and/or penalties), consideration (you can get personal help when you need it), security (low risk of losing any money), and gain (you are paid some interest from those who use your cash).

Because everyone receives and spends money, cash manage-



LEARN

- The importance of saving money in an emergency fund
- About several cash management alternatives
- About different types of financial institutions
- To compare financial institutions based on their convenience, cost, consideration, security, and gain





Goals of effective cash management:

- convenience
- cost
- consideration
- security
- gain

Cash management

How to effectively manage your family's monetary assets.

Monetary assets

Financial resources that are legal tender (cash) or can be converted to legal tender very quickly.

Liquidity

The immediate accessibility of money.

Emergency Fund

Liquid financial resources to meet unexpected and immediate needs; this should total at least 3–6 months of living expenses.

ment is an essential part of your family's financial strategy. Cash and cash-like assets provide your family needed financial protection and flexibility because of their high liquidity. **Liquidity** refers to how quickly and easily you can access your money. Funds that are more liquid are immediately accessible for both ordinary and urgent family needs. Long-term assets are not considered very liquid because they are often impossible to access immediately, and may have substantial penalties for access on short notice. For example, suppose you own a piece of property that could be sold in 180 days for \$500,000. If you need the money in two weeks, you may be forced to have a "fire sale" and only receive \$400,000 for it. Having sufficient liquid funds on hand provides you and your family peace of mind and is an important component of financial health and security.

Although it is essential for your family to have enough cash reserves to meet immediate and emergency needs, it is also very important to have long-term investments. A couple who invests all of their retirement contributions into a savings account at a bank will find in 40 years that much of their financial wardrobe would have been mercilessly devoured by the clothes moth of inflation. Monetary assets generally have returns less than the rate of inflation, so the wise family will generously invest in tax-advantaged, diversified, primarily stock-based mutual funds as well. This is necessary to unleash the eighth wonder of the world: the miracle of compound interest.

Importance of an Emergency Fund

Perhaps the most important role of cash management is to save sufficient monetary assets to build an **emergency fund** for your family. Your family's emergency fund is a resource you can use to meet unexpected, immediate needs for money caused by job loss, car problems, an emergency surgery, or myriad other disasters. Even if you escape these calamities, just knowing that you have an emergency fund will give you and your family peace of mind and help you live joyfully within your means.

An emergency fund is for *emergencies* only! New tires, the semi-annual payment of your auto insurance, and Christmas are NOT emergencies. You can plan for these expenses in your budget (i.e., look at and plan for new tires, put aside part of the auto insurance payment, and save each month for Christmas) rather than being "surprised" by them each year.

The first step is to build a one-month emergency fund with enough cash reserves to survive one month in the event of a total loss of income. The general rule of thumb for an emergency fund is to have sufficient liquid assets to cover three to six months of family expenses. If you want to be even more prepared, you may want to substitute the term "expenses" with the term "income" 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.



Whether you need three months or six months of monthly income in your emergency fund depends on the security of your employment. If your job is secure, you may only need three to four months of income. If your job is less secure, you want to save the full six months of income. These funds should be liquid and secure (see Cash Management Options below) rather than invested in the stock market.

Some might ask, “Is it still necessary to have an emergency fund in this world of credit cards and home equity loans?” 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. Additionally, one of the main reasons to have an emergency fund is to break the cycle of debt. Instead of going back into debt or using a credit card when an emergency happens, you will have access to your emergency fund.



Cash Management Options

There are many options available to help you manage your family’s monetary assets, and each has its own costs and benefits. Some cash-management alternatives include cash on hand, checking accounts, savings accounts, certificates of deposit, and money market accounts. Gaining a basic understanding of each of these cash management options can be helpful as you decide where to put your money.

An important attribute to keep in mind

Emergency Fund Story

The story of Brett’s family illustrates the importance of having an emergency fund and an emergency food supply.

Brett married his sweetheart and received an engineering degree. He obtained a good-paying job in his field and distinguished himself as a top performer. He provided well for his family that now included three growing children (ages 11, 13, and 15).

Brett and his wife Mary were financially responsible. Not only did they contribute 10 percent to their church and set aside 10 percent for long-term savings, they also saved a six-month emergency fund and a 3-month food supply. They could easily afford the payments on their modest country home with its acre of land and a few fruit trees. They seemed set.

One day, Brett came home from work and calmly announced to the family, “Our company doesn’t exist anymore; I’m without a job and without an income.” Though this was a complete surprise for everyone, Brett told his family they did not need to worry. They had prepared for this emergency by accumulating a one-year supply of food and an emergency supply of money that could probably last about a year. They would have to be frugal, but they could make it until he found another job, a hunt he estimated would take about one year.

The family pulled together to deal with this financial trial. They reduced expenses to a minimum. Being a religious family, they specifically prayed that Dad might find a job. In the meantime, looking for a job became Brett’s new full-time job. He spent 30–40 hours per week job hunting, which was much less than the 50–60 hours per week he had been working. Brett used this newfound discretionary time to engage in more family activities. They chose inexpensive recreation such as camping and backpacking. Brett would later say, “Losing my job was the best thing that ever happened to my family. We really connected!”

After nine months of searching, Brett finally found another good job in a different state. This time, he chose a job that demanded fewer hours with slightly lower pay because he wanted more family time.

Since this family was prepared with an emergency supply of money and food, the trial of unemployment became a period of growth and unity.



when comparing cash-management options is liquidity. In general, the higher the liquidity of a cash management option is, the lower the interest rate will be for that option.

Cash On Hand

The most basic cash management option is to store real currency on your person or somewhere in your home (under your mattress, in a home safe, in the cookie jar, etc.).



means that on a \$7,500 average balance, over one year you would earn exactly \$1.50, just enough for a soda once a year! For this reason, you should limit your checking account balance to the liquidity you actually need for current expenses and deposit the rest where you can earn higher interest.

Unlike credit cards, purchases made with checks and debit cards cannot exceed the amount available in the consumer's checking account without incurring a substantial fee. When this happens, it is called overdrawn, or "bouncing" a check. Because a penalty occurs every time a payment exceeds the amount in the account, overdrawn can be very costly and should be avoided through careful budgeting practices. The average cost of the first bounced check is \$30.47.³ One way to avoid bouncing checks is to link your checking account to a mobile app like mint.com so that you always know what your checking balance is.

Another common way to avoid overdrawn your account is by enrolling in overdraft protection, which pulls money from your savings account or from a pre-approved line of credit. The line of credit does accrue interest you will have to pay but if you quickly pay the balance, the interest you will pay will be very minimal and much less than the penalty for overdrawn your account.

Avoid bouncing checks like the plague.

Knowingly writing a bad check, or writing the check even though you know there are insufficient funds in your account to cover the



FDIC

Federal Deposit Insurance Corporation. The government agency which insures deposits at most commercial banks for up to \$250,000 per depositor. Joint depositors are insured for up to \$500,000.

This option has the advantage of being totally accessible with a guarantee of no fees. However, it doesn't offer interest earned and carries the risk of theft and loss.

Checking Accounts

Checking accounts are perhaps the most common cash management option because most paychecks are deposited directly into a checking account. They are also among the most liquid of all cash management alternatives. Checking accounts provide you with immediate access to your funds anywhere that accepts checks or debit cards. Money held in a checking account can be conveniently withdrawn by writing checks, accessing automated teller machines, using debit cards, and authorizing automatic withdrawals.

The high liquidity of checking accounts also means they have very low interest rates and sometimes garner no interest at all. For example, in late 2018, the standard rate of interest on a checking account at Zions First National Bank was 0.02 percent per year.² That



Avoid bouncing checks like the plague!

check, is a crime. Bad checks are also known as NSF checks, rubber checks, or bounced checks. You can go to jail and receive stiff fines for writing bad checks. Depending on the state, this may be called fraud, forgery, and, in some cases, embezzlement. Don't take a chance. Always know that you have money in your account before writing a check or using a debit card.

Checking accounts are extremely safe and are generally insured by the **Federal Deposit Insurance Corporation (FDIC)**. The FDIC was a result of the Great Depression. During the 1930s, many depositors lost confidence in the banking system and withdrew their savings. This run on the banks caused many banks to fail and exasperated the financial crisis. By insuring deposits, the government hopes to avoid a repeat of the financial catastrophe of the Great Depression. The FDIC insures deposits at most commercial banks for up to \$250,000 per depositor. Joint depositors are insured for up to \$500,000. Simply put, if the bank fails, you get your money back.

In credit unions, checking accounts are called share draft accounts. They have slightly higher interest rates. The **National Credit Union Administration (NCUA)** insures deposits at credit unions for up to \$250,000 per depositor or \$500,000 for joint depositors, the same amount that the FDIC insures at banks.

Savings Accounts

Money in a savings account is deposited with a financial institution. To use it, you must either go to the bank and withdraw it, or transfer it to a checking account where it may be accessed by check, ATM, or debit card. One common way to transfer money between savings and checking accounts is through electronic funds transfer. This allows you to transfer funds electronically without having to physically go to the bank, making transferring funds between accounts very easy and convenient. Because money in a savings account is slightly less liquid than money in a check-



ing account, savings accounts have a slightly higher interest rate. As of the writing of this textbook, interest rates on savings accounts are extremely low. For the past 50 years, annual interest on savings accounts has generally been between 2 percent and 6 percent.⁴ In late 2018, the standard rate of interest on a statement savings account at Zions Bank was 0.06 percent per year.⁵ That means that on a \$3,000 average balance, over one year you would earn exactly \$1.80! Savings accounts are extremely safe and are generally insured by the Federal Deposit Insurance Corporation (FDIC).

Certificates of Deposit (CDs)

Certificates of deposit (CDs) pay you a fixed interest rate for keeping your funds in the account for a fixed period of time. Interest rates are fixed for the life of the deposit, and the longer the term of the deposit, the higher the interest rate. For example, in late 2018 the interest rates at Zions Bank ranged from 0.25 percent on a one-year CD to 1.00 percent on a five-year CD.⁶ CDs are less liquid than other cash-management alternatives because the money must be deposited for a certain amount of time before it can be withdrawn without penalty. Penalties vary across banks and credit unions but are typically between 3–6 months' interest.⁷ They are, however, FDIC or NCUA insured when deposited in banks or credit unions.

Money Market Accounts (MMAs)

A **money market account (MMA)** is similar to a savings account, but instead of having a fixed rate of interest, its interest rate varies

NCUA

National Credit Union Administration. Government agency which insures deposits at credit unions for up to \$250,000 per depositor or \$500,000 for joint depositors.

CD

Certificate of Deposit. Pay a fixed interest rate for keeping your funds in the account for a fixed period of time.

MMA

Money Market Account. This 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.

with the current level of market interest rates. MMAs generally have higher interest rates and a higher required minimum balance. For example, in late-2018 the interest rates at Zions Bank ranged from 0.10 percent on an MMA account with a minimum balance of \$1,000 to 0.18 percent on an MMA account with a minimum balance of \$1,000,000.⁸ MMAs are also insured by the FDIC or NCUA when deposited in banks or credit unions.

In today's market of historically low interest rates, the rate of return among all these and other alternatives varies little. As we will see in the next section, the determining selection criteria in these days lie with the convenience and fees charged by the different financial institutions.

Financial Institutions

As you explore different cash management alternatives, you must also consider the different types of financial institutions that offer those alternatives. Here we will consider three of the most common alternatives: commercial banks, online banks, and credit unions.

Commercial Banks

Also known as brick and mortar banks, commercial banks generally compete by offering the widest variety of support and services. They usually have employees who can help you face-to-face with financial situations: a bank president, loan officers, customer service representatives, tellers, etc. For some, it is comforting to have a banker who knows them by name and sends them a Christmas card. Commercial banks also offer on-site services such as

safe deposit boxes, fax service, cashier's checks, cookies, and coffee. Because they have to cover the cost of the building and of these services, they usually do not offer the highest interest rates on deposits or the lowest interest rates on loans. With today's very low interest rates, there are not many differences among different commercial banks, unless you are saving large amounts of money. Some common banks include Wells Fargo Bank, U.S. Bank, Chase, and Bank of America.

Another consideration is the size of the bank: Is the bank a small local bank or a large national bank? Whether you choose a national or local bank depends on your financial goals. If you and your parents have a shared account but your parents live in another state and you want a bank close to your campus, you probably want a larger, national bank. However, if you want to borrow money for a local business, you may want to work with a small, local bank that probably knows your community better.

Online Banks

Online or 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. However, they do not have anyone you can sit down with face-to-face. Everything is done electronically. Obviously, they do not offer the onsite services that commercial banks and credit unions offer. Some common online banks include Ally Bank, Nationwide Bank, Discover Bank, Capital One 360, and ING.



Remember—a positive attitude, a well-thought-out plan, and consistent self-discipline can help us improve our circumstances. Applying these keys in our daily work will help produce more income, and practicing them in our homes will help reduce expenses. . . . We can learn to become better managers of our time and resources and become financially secure.

—M. Russell Ballard⁹

Credit Unions

Credit unions are similar to banks, but they are not-for-profit organizations and are owned by their members. The members are those who invest in and borrow from the credit union. Since credit unions do not need to make a profit, they often offer slightly higher rates on savings accounts and lower rates on loans. Many credit unions have rules about who can become a member. In some cases, membership is based on where you live but more likely a credit union exists to serve a particular profession or institution (e.g., those who attend or are employed by a particular university). Most likely, there are several credit unions close to you that you are eligible to join. Credit unions offer many of the same benefits that commercial banks offer. Some common credit unions include Utah Community Credit Union (UCCU), Mountain America Credit Union (MACU), First Light Federal Credit Union (FLFCU), and University Federal Credit Union (UFCU).

Criteria for Comparing Financial Institutions

There are five simple criteria that can make the process of selecting one or more financial institutions easier: convenience, cost (and fees), consideration, security, and gain. Here are some questions to ask about each.

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? Will you have to travel much? What are the direct deposit options? What are the options for online or mobile banking? Can you deposit a check with your phone? Can you set up automatic payments? Can you transfer funds between accounts electronically? Can you set up multiple savings accounts to save for specific purposes? Do they have a notary you can use for free? Does the

institution offer overdraft protection, safety deposit boxes, credit cards, etc.?

Cost (and fees)

How much will it cost to do business with this bank? What are the monthly fees associated with checking and savings accounts? Are there minimum balances required? What happens if you fall below the minimum balance? Are there per check fees or balance-dependent scaled fees? What fees are associated with overdrafts or insufficient funds? What interest rates are charged on loans? In today's market you should not have to pay a fee for a checking account.

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? Do you have an unusual financial situation that would be better handled by a person than a rule?



Security

Are your accounts insured by the FDIC or NCUA? Do you have more than \$250,000 in one account (or \$500,000 if a joint depositor)? (Amounts above \$250,000 or \$500,000 are not insured.)

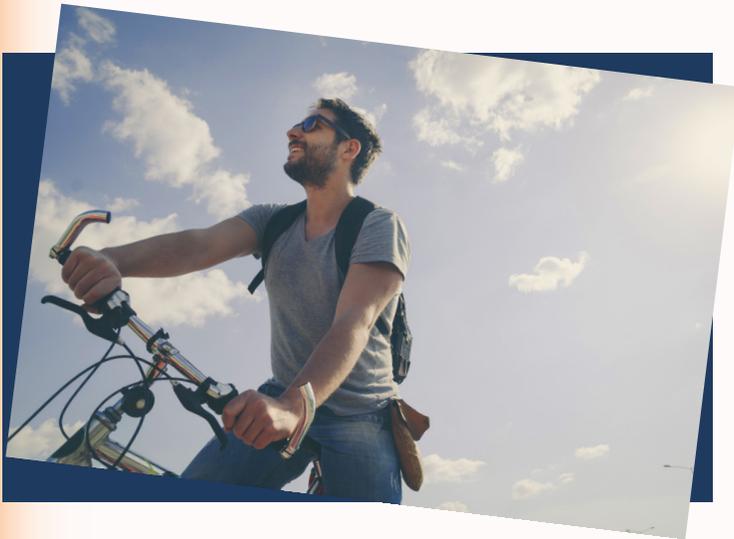
Gain

Is interest paid on your checking account? On your savings account? What are the inter-

The \$30.59 Gatorade®

It was a hot summer's afternoon. Jeremy was riding his new road bike to his favorite park. By the time he got to Will's Pit Stop at the mouth of the canyon, he needed some Gatorade®. He didn't have any cash with him, but he did have his Wells Fargo debit card. As he stood before the ATM he knew he had a low balance but wasn't quite sure how much that balance was. He thought, "Well, if I don't have the money in there, the ATM will decline my card, right?" Wrong! Because of courtesy fees on his debit card, this Gatorade® cost Jeremy a bundle.

Jeremy really only had \$12.15 in his checking account. He withdrew \$20 from the US Bank ATM at Will's Pit Stop and bought a \$1.59 liter of Gatorade®. The ATM honored his transaction but assessed a \$25.00 courtesy fee. In addition, since the ATM was out-of-network he paid \$2.00 to Wells Fargo and \$2.00 to US Bank. The Gatorade® quenched Jeremy's thirst, but the total cost was \$30.59! The moral of the story: Make sure you have money in your checking account to cover ATM or debit card transactions. 3.10. Also, when you sign up for your debit card, you either enroll in overdraft protection or decline the "courtesy fees" option, which declines your card if you don't have the money.



est rates? What is the effective annual yield (the "actual" amount of interest paid on the account)? One place to compare interest rates for cash management is www.bankrate.com.¹⁰

In today's market of extremely low interest rates and competitive services, the most important criterion is often convenience, especially when it comes to the location of the bank and ATM machines. With a convenient bank you save time and out-of-network fees. Cost and fees would probably be the second most important criterion, especially if you

have a knack for overdrawing your checking account.

Summary

In this chapter, you learned about cash management and how to effectively manage your family's monetary assets. This is an important component of your overall financial strategy. You learned about the importance of having an emergency fund on which you could survive for three to six months. You learned about several cash management alternatives, including checking accounts, savings accounts, CDs, and Money Market Funds. You also became familiar with three kinds of financial institutions: commercial banks, credit unions, and online banks. Finally, you learned five criteria for evaluating institutions and cash management alternatives: cost, convenience, consideration, security, and gain.

Now we are ready to move on to credit and loans!

Notes

1. President Gordon B. Hinckley, "To the Boys and to the Men," (Nov. 1998), 51.
2. <https://www.zionsbank.com/personal/comparison-table/checking/#checking>.
3. <http://www.bankrate.com/finance/checking/5-cities-with-highest-bounced-check-fees-1.aspx>.
4. <http://swanlowpark.co.uk/savingsinterestannual.jsp>.
5. <https://www.zionsbank.com/personal/comparison-table/checking/#money-market-savings>.
6. <https://www.zionsbank.com/personal/comparison-table/checking/#cd-ira>.
7. <http://www.bankrate.com/finance/cd/cd-early-withdrawal-penalties-sock-1.aspx>
8. <https://www.zionsbank.com/personal/comparison-table/checking/#money-market-savings>.
9. M. Russell Ballard, "Providing For Our Needs," (April 1981), <https://www.lds.org/general-conference/1981/04/providing-for-our-needs?lang=eng>.
10. www.bankrate.com.

4

Credit and Loans

How to Minimize and Eliminate Family Debt

John and Jennifer met through a mutual friend while attending State University. John was a mechanical engineering major and Jennifer was an accounting major. They were deeply in love and decided to get married after graduation. John got a great engineering job in Seattle. Jennifer was able to find an accounting job with a local company.

They bought a larger home than was necessary because it was always their dream to have several children. Their house payment stretched them a bit, but they managed to stay current with their bills and other expenses.

Jennifer soon found out she was pregnant with twins! They were overjoyed with the great news, but realized that their current vehicle would not be large enough for their growing family. They were excited to start researching the possibility of buying a SUV.

They didn't like the idea of going into debt for a vehicle since they were already stretched a bit thin with their income. They already saved about \$6,000 for their vehicle. After doing some research, they decided to purchase a used 2011 Dodge Durango for about \$12,000. They would get a modest two-year loan and pay back about \$250 per month. Then they would start saving for their next big purchase.

At the car dealership, all of the used SUV's looked well used. The salesman noticed they weren't too excited and asked to see



LEARN

- The role of a credit score in your family's financial health
- The benefits and dangers of credit cards, and know how to appropriately use them to build your family's credit
- About different types of consumer loans
- Effective strategies to eliminate debt

John's driver's license. The salesman disappeared for a few minutes and then came back with a big grin. "Did you know your credit score is 795? That's excellent! I'd like to show you what we can do for you." He guided them to the new 2018 Dodge Durango, which had every feature imaginable and some they had never imagined. "You are so fortunate to have been responsible with your credit; now you are able to qualify for such a vehicle," said the salesman. They took a test drive and loved every acceleration, turn, and stop.

Upon returning to the sales office, the salesman took \$2,000 off the price just because he liked them. He told them that because of their outstanding credit score, he could offer a very low interest rate (3.8 percent) for sixty months to lower their payments. He also offered to defer the first payment until after New Year's Day so that the purchase wouldn't impact their holiday spending. The final price would be only \$34,000. Their payments would be about \$500 a month. They thought for a few minutes and felt they could swing it. A little voice quietly prompted Jennifer, "You should sleep on this before making the decision," but John was so excited that she didn't mention it to him. In the end, they both signed for the minivan and drove the vehicle off the lot.

Then the dream of the new shiny vehicle ended and turned into a nightmare. In January, the payments started. John and Jennifer had to really scrimp and save to pay the \$500 car loan each month in addition to their mortgage payment and student loans. They cut their dating budget in half and shaved off other expenses. They were making it until the twins came eight weeks early. One of the babies needed surgery to correct a congenital defect and was in intensive care for a week. Fortunately, they had good insurance, and of the \$280,000 medical bill, they only had to pay about \$8,000. Still, despite their best efforts, it became impossible to make ends meet every month. For the first time, they didn't pay off their credit cards. One thing led to another and soon they had a \$10,000 credit card debt (on which they were



paying 18 percent interest) on top of the other debts they already had. They started arguing about finances nearly every day, making more poor financial decisions in their anger. All of this put a real strain on their marriage and their relationship. Soon they were considering divorce.

It is true that credit can be a wonderful tool and that it has enabled many families to meet important needs that they could not have met otherwise: a college degree, a home, a car. However, unwise debt has also been the financial downfall of many good people, such as John and Jennifer

Once in debt, interest is your companion every minute of the day and night; you cannot shun it or slip away from it . . . and whenever you get in its way or cross its course or fail to meet its demands, it crushes you.



Debt can crush families by driving a wedge between husband and wife, contributing to marital conflict. Indeed, research shows that financial difficulties, often based in exces-

sive debt, are associated with marital stress¹ and even divorce.² Marvin J. Ashton quoted a study by the American Bar Association that indicated that “89 percent of all divorces can be traced to quarrels and accusations over money.”³ Dr. Bernard Poduska reflected: “The saying ‘married for better or worse, or until *debt* do us part’ seems to reflect today’s marital realities more accurately than does the traditional vow.”⁴

Many of these financial problems come upon us because we do not have the self-control to wait until we can afford what we want. Instead, we borrow to get what we want right now. We have not sufficiently developed the virtue of patience.⁵ Benjamin Franklin must have chuckled when he wrote, “Tis against some men’s principles to pay interest, and it seems against others’ to pay the principal.”

Credit cards can become a particularly destructive financial instrument if not carefully watched and controlled. When credit card debt gets out of control, it not only contributes to financial troubles but to personal and relational heartache as well.

Avoid unnecessary debt like the plague.

The purpose of this chapter is to provide basic financial information about credit so that you can use credit wisely to meet basic needs while working to minimize and eventually eliminate your family’s financial debt. Your family should ultimately aim to be debt



A Matter of Marshmallows

Our struggle with waiting to purchase what we want until we have the money is key to developing the virtue of patience, which affects our success in life.

In the 1960’s, Walter Mischel at Stanford University began a modest experiment testing the willpower of four-year-old children. He placed before them a large marshmallow and then told them they could eat it right away or, if they waited for fifteen minutes, they could have two marshmallows.

He then left the children alone and watched what happened behind a two-way mirror. Some of the children ate the marshmallow immediately; some could wait only a few minutes before giving in to temptation. Only 30 percent were able to wait.

It was a mildly interesting experiment, and the professor moved on to other areas of research, for, in his own words, “there are only so many things you can do with kids trying not to eat marshmallows.” But as time went on, he kept track of the children and began to notice an interesting correlation: the children who could not wait struggled later in life and had more behavioral problems, while those who waited tended to be more positive and better motivated, have higher grades and incomes, and have healthier relationships.

What started as a simple experiment with children and marshmallows became a landmark study suggesting that the ability to wait – to be patient – was a key character trait that might predict later success in life.⁶

Other researchers have conducted similar studies with similar results. There are several very entertaining videos of these studies on YouTube.



free without credit card debt, student loans, consumer loans, a car payment, or a mortgage. Unfortunately, most families do not become debt free until they retire, if at all. That said, you can be different! By wisely managing your credit and using the principles learned in this book, many of you could be totally debt free by your forties or earlier. We invite you to learn these principles well so that credit is a blessing to you, so that debt never crushes you, and so that you can live joyfully within your means.



Avoid unnecessary debt like the plague!



Credit and Debt

Credit

A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future, generally with interest; the term also refers to the borrowing capacity of an individual or company.

Debt

Something owed to someone else.

What is credit, and why should you care about it? According to *Investopedia*, **credit** is “A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future, generally with interest. The term also refers to the borrowing capacity of an individual or company.”⁷

The key phrase in this definition is “generally with interest.” Because you pay back with interest when you borrow to buy something on credit, you almost always pay more than you would have had you saved and paid cash for the same item. My dad used to always tell me, “There are two kinds of people in the world: those who *pay* interest and those who *understand* interest.” It’s true. If you understand interest, you will do everything you can to minimize and eventually eliminate **debt**. Although you would think that reasonable people would stay out of debt, most do not. In fact, debt load is growing at every level. Let’s take a quick look at some revealing statistics about debt in the United States.



The Growth of Consumer Debt

The debt problem in the United States has grown dramatically over the past few decades. Between 1970 and 2010, the median family income in America increased 509 percent in *nominal* terms (before taxes) but only 10 percent in *real* (or purchasing power) terms. During the same time period, total consumer debt per capita increased 1,109 percent in *nominal* terms and 119 percent in *real* terms.

If you want a sobering picture of debt in the United States (and if you like numbers), go to www.usdebtclock.org, which projects debt in the United States in real time.⁸ Don’t go there if you are susceptible to heart problems, because what you will see is truly heart-stopping! I visited the site on January 25, 2018 at about 8:30 AM, and this is what I saw:

- Total Student Loan Debt: \$1,506,139,227,672
- Total Credit Card Debt: \$1,043,071,087,642
- Total Mortgage Debt: \$14,926,086,769,327
- Total Personal Debt: \$18,804,033,523,421



As I viewed this continually updating screen, I saw the total personal debt increase by thousands of dollars every second. Personal debt is rapidly exceeding 18 *trillion* dollars (a trillion is a million millions). That’s a lot! This amount translates into \$57,477 of personal debt for each of the 327,087,691 people living in the United States.

The United States national debt is also growing to astronomical proportions. As of January 25, 2018, it was \$20,61,906,940,769, which translates into another \$63,031 for each person in the United States. Fortunately, interest rates on Treasury bills (or T-bills), which finance our debt, are very low right now. The government only pays about \$400 billion in interest on the national debt each year.⁹ The rest of the world likes to invest in our Treasury bills, helping to finance the debt, because they are so safe and are backed by the “full faith and credit” of the United States. Altogether, foreign governments hold about \$6 trillion of our national debt. So if you combine personal debt with the national debt, there is enough debt for more than \$120,000 for each person in the United States.

We are truly a nation of debtors—both in Washington, DC and in our own homes. There are many downsides of debt; however, credit can be a tool if used responsibly. In fact, credit is a necessity for your family’s financial health. Let’s learn more about why.

Building good credit is very important for your family because of the need to borrow for legitimate family needs. Borrowing is often needed for three things: a modest home, basic transportation, and education. Let’s now look at five characteristics that lenders look for when you apply for a loan.

The 5 Cs of Credit

In order to use credit, you must meet the criteria of the lender. Lenders often use the following five Cs of credit to judge loan applicants: character, capital, capacity, collateral, and conditions.

Character is demonstrated by your honesty and reliability, your willingness to pay, and your record of financial accountability. When you set up a budget and maintain your household in a business-like manner, you demonstrate your commitment to the integrity of your financial matters. For many lenders, a good reflection of your character is your credit score, which is discussed later in detail.

Capital is measured by your assets—housing equity, automobiles, personal property, savings, emergency fund, investments, and life insurance. Lenders will often have you demonstrate your capital with a family net worth statement.

Capacity is your ability to repay the debt from your family’s income. This is a measure of your earned income, both present and expected, and a measure of your current debt payments.



Collateral is an asset that can be pledged against the loan (meaning that if you can’t pay back the loan, this asset is forfeited to pay off the loan). Lenders will be more likely to make a loan for a car than for a Caribbean cruise. However, if you were to pledge a CD (certificate of deposit) against the loan for a cruise, the lender would probably make the loan. If you cannot repay the loan on a car, the lender repossesses the car (the collateral). If you could not pay back the loan for a cruise, the lender cannot take the cruise (you’ve probably already returned from it anyways), but if you use the CD as collateral, the lender can take the CD. Loans without collateral generally have higher interest rates while loans with collateral have lower interest rates.

The economic **conditions** of the nation or community at the time of the loan request may also affect the lender’s loan decisions. If the local economy is in a nosedive and massive layoffs are expected, the lender may not be willing to make a loan—even to a borrower

Character

The amount of integrity you demonstrate.

Capital

The worth of all your assets.

Capacity

Your ability to repay the debt from your family’s income.

Collateral

An asset that can be pledged against a loan.

Conditions

The economic state of the nation or community at the time of a loan request.

Credit score

A three-digit number that is used by banks, insurance companies, and other financial institutions to determine how likely it is that you will be creditworthy and pay your debts on time.

Credit bureaus

Private companies that collect and report your financial information from creditors, public records, and various institutions.

Credit reports

Files of information that credit bureaus compile about specific individuals.

Credit evaluation

The process of turning the information in your credit report into a three-digit number to determine whether or not you deserve to be given credit.

who meets the other four Cs. For example, it was very difficult to get a loan during the great recession of the late 2000s.

Your Credit Score

Maintaining a high credit score is important to your family's financial health. A **credit score** is a three-digit number used by banks, insurance companies, and other financial institutions to determine how likely it is that you will be creditworthy and pay your debts on time. When you apply for a home mortgage, credit card, car loan, student loan, or automobile insurance, lenders will use your credit score to decide whether or not to loan you the money and what interest rate to charge. When a couple applies for a mortgage, the credit scores of both husband and wife are checked. That's why it is important to include both husband and wife on all credit cards and loans.

Personal financial information that is used to establish your credit score is gathered by credit bureaus. **Credit bureaus** are private companies that collect and report information from creditors, public records, and various institutions. There are many different credit bureaus, but the three major ones are Equifax, Experian, and TransUnion.

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

credit report. This report is extremely detailed and contains personal demographics such as age, social security number, employment history, criminal convictions, and information about your credit history.

Be aware that the information gathered by credit bureaus is not always correct. In fact, almost half of all credit reports contain incorrect or obsolete information. 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. Additionally, you can request a free copy once a year from each of the three major credit reporting agencies by going to annualcreditreport.com.



You should review your credit report annually to ensure its validity. Even simple mistakes can lower your credit score, which may prevent you from getting a mortgage or a consumer loan, or increase the cost of your auto insurance.

If you think there are mistakes on your credit report, you need to have them investigated. If an investigation does not clear up a mark on your credit report, but you still disagree with it, you can add a personal statement of up to 100 words to your credit report explaining what happened with a specific creditor. When you apply for credit, potential lenders can see your explanation of what happened and consider it when they make their lending decisions.

Credit evaluation is the process of turning the information in your credit report into a three-digit number—your credit score. A credit score is like a GPA: it is a specific num-



ber that is used to easily group individuals. Your credit score determines whether or not you deserve to get a loan and what interest rate you will pay on the credit offered. Generally, the higher your credit score, the lower the interest rate you will have to pay.

For example, consider the vast differences in interest rates on an auto loan for those with varying credit scores:

FICO® score	APR (%)	Monthly payment
720-850	3.399%	\$558
690-719	4.572%	\$571
660-689	6.308%	\$591
620-659	10.865%	\$645
590-619	15.320%	\$700
500-589	17.173%	\$724

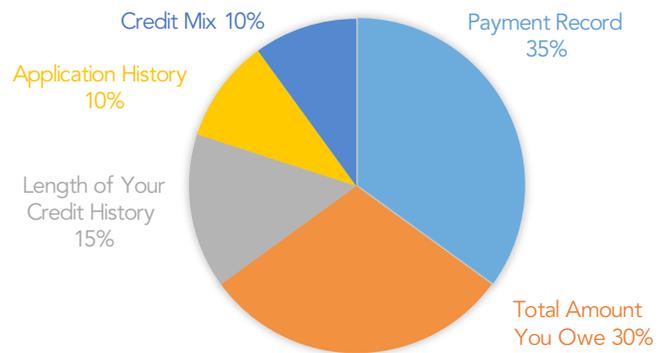
What Is a FICO Score?

The most common type of credit score is the **FICO score**. Lenders usually base your interest rate on your FICO score, which can range from 300 to 850. The higher the score, the better. Generally, a score less than 620 is considered poor, between 620 and 679 is fair, 680 to 719 is good, and 720 and above is considered excellent credit. You can 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. In addition, you can get your credit score for free at www.creditkarma.com and www.mint.com and from a variety of credit card companies.

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. The pie chart below shows the components that make up your credit score. The percentages are the amount each component impacts your credit score. Table 4.1 describes each component in more detail.

Components of Your Credit Score



Managing Your Credit Score

You must take an active role in managing your credit score. Ideally, you should review your credit score monthly on a free service like mint.com or creditkarma.com 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.

FICO score

The most common type of credit score.

Avoid careless management of your credit score like the plague.

Credit Scores and Marriage

As a family unit, couples should make decisions about finances together. When you apply for credit cards, make your spouse a joint



Always manage your credit score carefully.

Table 4.1 Understanding and Manage Your Credit Score

Percentage	Component	Questions to consider	Strategies to improve your credit score
35 percent	Payment record	Do you pay your bills on time?	Pay your bills on time. Paying even one bill late one time will reduce your credit score. Avoid late payments by paying off your credit card the day the bill comes, instead of waiting until the day it is due.
30 percent	Total amount you owe	What percent of your available credit or <i>credit limit</i> do you still owe? This is calculated based on the amount owed the day your credit score pulled, even if you pay off your credit cards every month.	Try to borrow less than 15 percent of your available credit limit. Pay off your credit cards several times a month to keep this ratio low. Ask to increase your credit limit on your cards, even if you have no intention of using the higher limits.
15 percent	Length of your credit history	How long have you held a credit account?	It is better to not close credit card accounts. If you don't want to use it anymore, cut up the card but don't close the account. Keeping your oldest accounts open shows you have learned to manage credit over a long period of time. A good rule of thumb is to rotate active use among two or three credit cards at a time.
10 percent	Application history	How many times and how often have you applied for credit?	Do not apply for credit too often but having enough credit is also important. Apply for a new credit card about once every one or two years.
10 percent	Credit mix	Do you have a variety of sources of credit?	You do not want to have too many of the same kind of card (ex. having a Sears' card and a Kohl's card). Cards for retail stores that offer a 10–20% discount on your first purchase can have a negative effect on your credit score.

Credit card

A form of open credit that allows you to borrow money up to a specific limit with no collateral, with the expectation that you will pay back the money at a specific interest rate and with specific terms.

Grace period

The period of time between a payment due and penalties.

account holder. When you apply for loans, cosign on the loan together. Although spouses have separate credit scores, both will be considered when applying for loans. Because of this, it is very important for both spouses to have a strong credit score.

Credit Cards

Obtaining and appropriately using credit cards is an important part of building credit and using it to its full advantage. A **credit card** is a form of open credit that allows you to borrow money up to a specific limit with no collateral. It is expected that you will pay back the money at a specific interest rate and with specific terms. Generally, the interest rate is comparably high because the loan is unsecured by collateral. You are required to make a minimum payment each month but are allowed to

carry the balance and pay interest on the balance from month to month.

Most credit cards have a **grace period**. If you pay the balance in full within the grace period, the interest is forgiven. If you do not pay back within the grace period, you are liable for all the interest charged from the moment you made the purchase. The key principle to make credit cards useful for your family is to pay them off before the grace period expires, every month without fail. In fact, we encourage you to pay your credit card bill the day you



get it. This helps you avoid interest and actually helps your credit score. The rest of this section will address some important concepts that will help you use a credit card effectively.

Eligibility

To be eligible for a credit card, you must be eighteen or older. If under the age of twenty-one, you must either have a steady income (the wage amount to qualify varies by credit card issuer) or cosign with an individual who is at least twenty-one years old. If you are twenty-one or older, you must either have a steady income or have “reasonable access” to a partner’s steady income either through a shared account or through proof of regular transfers made by the partner to your account. If you are married, both partners should be account holders so that the wise use of the credit card will improve the credit scores of both partners.

Before applying for a credit card, it is recommended that you conduct your own honest self-assessment to gauge whether or not you consider yourself qualified to be a responsible credit card holder. Credit card debt can be devastating to your family’s financial health. Remember that although buying on credit means a delayed payment, you still have to



pay it off. Furthermore, if you do not pay off your cards on time, you will have to pay the full amount plus large amounts of interest. It is almost always unwise to purchase anything with a credit card that you cannot pay off before the grace period expires. If you need to borrow money, it is better to get a loan with

collateral so that you are saved from the high interest rates of credit cards.

Avoid not paying off your credit card balance each month like the plague.

Think of your credit card as a more convenient version of cash: don’t spend money you don’t have. Pay it off regularly, perhaps the day you get the bill. Keep track of your spending to ensure you stay within your family budget. Using a financial app like mint.com can help you track credit card expenditures in real time. Those who cannot use a credit card in a responsible way should delay obtaining one until they can live by these principles.



Evaluating Credit Cards

Once you have decided that getting a credit card is right for you, you must decide which one will best suit your family.

If you carry a **balance** on your credit card (meaning that you *do not* pay off the balance due each month), you should select a credit card with the lowest possible annual percentage rate (APR). Whether or not the card has a grace period is irrelevant because a grace period only applies if you pay the full balance each month. If you pay your credit card bill in full each month, you should choose a card with a grace period and a low annual fee. The APR is irrelevant because you never carry a balance. Financial websites like creditkarma.com and mint.com provide great resources for evaluating credit cards. Creditcards.com also provides useful information.

A good rule of thumb to maximize your



Always pay off your credit card balance each month.

Balance

The total amount owed on a credit card at a specific time.

Evaluating Credit Cards

The following should be considered when evaluating credit cards:

- Annual fee (ranging from zero to about \$95)
- Perks (frequent flyer miles, cash back, etc.)
- Grace period (no interest is charged on new purchases if you pay your bill in full on time each month)
- APR (Interest rate charged on outstanding balances expressed as an annual percentage rate)
- Method of determining the interest rate (i.e. discount rate plus five percentage points, prime rate + 3.75 points, etc.)
- Minimum payment required

credit score is to not apply for more than one credit card per year. Generally, we recommend having about two or three credit cards in active use at a time. When you stop using a card it is usually better to leave the account open because even though you don't use it, having the credit line open will strengthen your credit score. However, if your card has an annual fee, it may be better to cancel the card and take a small hit to your credit score.

It is often difficult to obtain your first credit card. If you are denied, you could have a parent cosign for you. You could also get a secured credit card. With this option, you have a low **credit limit** and make a security deposit for the amount of the limit. After you establish a history of paying off your loans, the security deposit is refunded.

Credit limit

The available credit given to a specific account holder.

Appropriate Card Uses (Benefits and Drawbacks)

Although some popular financial advisors advocate not having a credit card at all, there are several benefits for having at least one credit card.

- *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 or deductible.
- *Reservations:* Credit cards can be used to guarantee hotel rooms, rental cars,

and other rental items. This is especially important if you travel frequently.

- *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.
- *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 money.)
- *Free services:* Often, credit cards offer rewards such as extended warranties, travel insurance, airplane miles, gasoline rebates, and cash rebates, which can reduce the overall cost of some items.
- *Credit score:* As mentioned previously, buying on credit and paying off your credit cards regularly is important to building a strong credit score. It demonstrates to lenders that you are responsible and capable of paying off loans. Even if you do not have a large budget, making your purchases (groceries, clothing, textbooks, etc.) via credit card will build your credit over time. Then when you go to get a mortgage loan, you will have a lower interest rate because of your good credit score.

There are also some important drawbacks to be aware of when using credit cards.

- *Increased spending:* You may not take as much time to think about how much you are spending when you use a credit card. Research has shown that, on average, people spend more with a credit card than they do with cash—sometimes as much as 100 percent more.¹⁰
- *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. Because of these fees, the cost of using credit cards is often double or triple the cost 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 you may need if emergencies arise.

Danger Ahead!

It is vital to handle credit appropriately because credit abuse can very quickly get out of hand. An alcoholic or smoker may think that one drink or one cigarette will not hurt. But soon it is two, then three, then a pack.

*Avoid becoming a **credit-holic** like the plague.*

Should any of the following danger signals occur, get your financial life together so that you can again be an effective household.

1. Are total consumer credit payments over 20 percent of your monthly budget?
2. Is an increasing portion of your income going to debt repayment?
3. Are your credit cards at or near their limit?
4. Are you always late on one or more bills?
5. Are you borrowing to pay for things you used to pay for with cash?
6. Have you taken out a new loan to repay an old loan?

7. Is your net worth decreasing?
8. If you lost your job, would you make it for 3–6 months?
9. Are creditors threatening to repossess?

If you responded “yes” to any of the above danger signals, take a moment to consider what you could do today to help yourself get back on track. If not corrected, credit-holic symptoms can quickly spiral out of control, resulting in serious financial consequences for you and your family.

As an additional suggestion, review the above checklist with your spouse and discuss and resolve any problems together. If done together and without resentment, this will strengthen your relationship as well as your finances!

If you find yourself becoming addicted to the lure of buying on credit but still want to build your credit score, don’t cancel your accounts unless they have an annual fee. Perform “**plastic surgery**” on your credit cards by cutting them up with scissors or running them through the shredder. If you have your credit card saved to your favorite on-line shopping sites for

Credit-holic

Someone who is addicted to credit and whose financial life is out of control.

Plastic surgery

Cutting up a credit card, making it unusable, but still keeping the account open.



Avoid becoming a credit-holic like the plague!



easy checkout, delete those details so you don’t “accidentally” use your card. That way, you won’t be using the cards anymore, and keeping your account open will still build your credit score slowly over time.

Additional Questions to Consider

The following section addresses two questions: What do I do if I lose my credit card? and What is the difference between a credit card and a debit card?

WHAT DO I DO IF I LOSE MY CREDIT CARD?

You have probably heard horror stories about credit card fraud. Here is some critical information to limit the damage in case your credit cards are lost or stolen.

1. First, inform your credit card company of the loss or theft immediately. You will then have limited liability for fraudulent use. It is a good idea to have the toll-free number handy so you know whom to call. They will immediately cancel the cards you have and re-issue new cards, often sending the replacement cards the next day.
2. If your credit cards were stolen, immediately file a police report in the jurisdiction where the theft occurred. This proves to credit providers that you were diligent, and it is a first step toward a possible investigation.
3. Most importantly, call the three national credit reporting organizations (Equifax, Experian, and TransUnion) immediately to place a fraud alert on your name and social security number. This alert notifies any company checking your credit that your credit cards were stolen, and they have to contact you by phone to authorize new credit.

WHAT IS THE DIFFERENCE BETWEEN A CREDIT CARD AND A DEBIT CARD?

When you use a credit card you create a loan that will be paid off later, preferably before the grace period expires. Money actually leaves your account weeks after you make credit card purchases. When you use a debit card the money for the transaction is with-



drawn immediately from your bank account. In this way, debit cards are like checks—you must have sufficient money in your account when you use a debit card, or else the transaction may be declined. Debit cards can also be used to withdraw cash at network ATMs without fees (in the United States). When you use a credit card to withdraw cash out of an ATM you may incur substantial fees and higher interest rates. Debit cards offer less protection in case of fraud than credit cards and usually do not offer reward points.

Consumer Loans

A **consumer loan** is “an amount of money lent to an individual (usually on a non-secured basis) for personal, family, or household purposes. Consumer loans are monitored by government regulatory agencies for their compliance with consumer protection regulations such as the Truth in Lending Act.”¹¹ It is called a “consumer loan” because that which is purchased decreases in value and is eventually consumed. Such items include electronics, automobiles, furniture, and recreational vehicles. Consumer loans are expensive, with high interest rates, and should rarely be used. These loans 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 your family can save for your goals because they require you to pay interest with money you might otherwise have saved and invested.

Consumer Loans

An amount of money lent to an individual for personal, family, or household purposes.

If you find yourself tempted to obtain a consumer loan to buy a new dining room table or bedroom set or ski boat or something else, ask yourself the following questions:

1. Do we really need to make this purchase? Is this a need or a want? Separate these two categories. Consumer loans should not be used to finance wants. In rare occasions it may be appropriate to use consumer loans to finance needs. A ski boat is not a need.



2. Is this item in our budget or in our financial plan? Could we wait, sacrifice, save, and buy this item in the future without borrowing money? You should save rather than borrow to buy most items.
3. What is the total cost of this item if financed by a consumer loan (including fees and interest)? What is the difference in cost between buying this item with cash and buying this item on credit with high interest? Compare these two alternatives.
4. What would be the impact of this purchase on our other goals? Can we maintain sufficient liquidity and still achieve our other goals? Choose wisely.
5. Will this purchase bring us closer to our family goals or take us further away from them? If the purchase brings you closer to your goals, make the purchase. If the purchase takes you further away from your family 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. Usually, the answer is not.

Different Types of Consumer Loans

It is important to understand that there are different types of consumer loans which have different characteristics. Some of the different types of loans include single-payment and installment loans, secured and unsecured loans, variable-rate and fixed-rate loans, and convertible loans.

Single-payment loans are also known as balloon loans. Normally, these loans are used for short-term lending of one year or less. They may also be used to temporarily finance a purchase until more permanent, long-term financing can be arranged; this is why these loans are also sometimes called bridge 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.

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

Secured loans use one of your assets, such as a car or boat, as collateral to guarantee that the lending institution will get the amount of the loan back even if you fail to make payments.

Because these loans are backed by collateral, they usually have lower interest rates. However, they are also very risky to you because you are in danger of losing whatever you put up as collateral, like your car.

Unsecured loans, also known as signature

Single-payment loans

A type of short-term lending repaid in one lump sum that may be used to temporarily finance a purchase until permanent, long-term financing can be arranged.

Installment loans

Loans that are repaid at regular intervals.

Secured loans

Loans which use one of your assets as collateral to guarantee that the lending institution will get the amount of the loan back even if you fail to make payments.

Unsecured loans

Loans which do not require collateral and are generally offered only to borrowers with excellent credit histories.



Fixed-rate loans

Loans that maintain the same interest rate for the duration of the loan.

Variable-rate loans

Loans which have an interest rate that is adjusted at different intervals over the life of the loan.

Convertible loans

Loans in which the interest-rate structure can change.

Loan contract

A document which describes what the lender requires of your family once you are granted the loan.

Truth in Lending Act

A law which requires that all lenders provide the consumer with certain information before they sign the credit contract.

Student loans

Loans which are often used to pay for higher education and have federally subsidized interest rates.

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 percent and 26 percent—sometimes even higher.

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

Variable-rate loans have an interest rate that is adjusted at different intervals over the life of the loan. There is usually a maximum interest rate (or cap) that can be charged on the loan, as well as a maximum amount that the interest rate can increase each year. These interest rates may change monthly, semiannually, or annually. The interest rate is adjusted based on an index, such as the prime rate or the six-month Treasury bill, as well as on an interest-rate spread.

Lenders usually charge a lower interest rate up front for variable-rate loans because the lender will not lose money if the overall market interest rates increase.

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

time in the future; the opposite process may occur as well.

The Loan Contract

The **loan contract** is the most critical document of the loan process. It describes what the lender requires of your family once you are granted the loan. Whenever you borrow, you put your family's 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. Remember that there is no pre-payment penalty for paying off the loan early.

TRUTH IN LENDING ACT

The federal Consumer Credit Protection Act, or the **Truth in Lending Act**, requires that all lenders provide the consumer with certain information before they sign the credit contract. This information must be conspicuously displayed and contain two important pieces of information relative to the cost of the credit: the total *finance charge* expressed in dollars and the *annual percentage rate* of interest (APR). The Truth in Lending Act also states that lenders cannot require you to purchase credit life insurance from them. They can, however, require that you have life insurance to insure the payment of your loan in the event of your death.

Other Types of Loans

There are a number of special types of loans that are different from traditional consumer loans. We will cover mortgage loans and home equity loans in Chapter 7. Other common types of loans include student loans, automobile loans, payday loans, and family loans.

Student loans are often used to pay for higher education and have low, federally subsidized interest rates. Examples of federal student loans that are available to parents and students include federal-direct loans, plus-

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

Automobile loans are secured by the automobile the loan is paying for. This type of loan usually has a term of two to six years. The advantage of an automobile loan is that it usually charges a lower interest rate than an unsecured loan. The disadvantage is that you must make interest payments, and since vehicles depreciate quickly, your family is often left with a vehicle that is worth less than what you owe on the loan. This is called being upside down on your loan.



Payday loans are short-term loans of one or two weeks and are secured with a postdated check. The postdated check is held by the payday lender and cashed on the day specified. These loans charge very high interest rates—some payday loans charge more than 500 percent on an annual percentage rate basis (APR). Let's just repeat that: 500 percent interest!

Avoid payday loans like the plague.

Family loans are generally the least expensive loans. You should be very careful in deciding to borrow from or loan to a family member. Many relationships suffer when such loans are made and then not paid back.

If you choose to loan to or borrow from a family member, we suggest you write up a contract and have both parties sign a legal document.

To summarize, your household should only borrow if it will help you accomplish your family's financial goals. Remember the difference between a need and a want! If married or in a relationship, it is wise to make decisions together with both parties having access to all information.

Debt Elimination

In order to accomplish your family's financial goals, debt elimination is imperative. This section will teach you two debt elimination strategies.

What if your family is already in debt? Is there a process that can help you get out? Thankfully, 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. In the words of Will Rogers, "If you find yourself in a hole, stop digging."¹²
3. Make a list of all your debts.
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, such as a **debt-elimination calendar**, and follow it.

DEBT-ELIMINATION CALENDAR:
MOST EXPENSIVE DEBT FIRST

Many financial planners, including Marvin J. Ashton in his article "One for the Money,"¹³ suggest organizing debts, then pay-

Automobile loans

Short-term loans that are secured by the automobile the loan is paying for.

Payday loans

Short-term loans of one or two weeks which are secured with a postdated check.

Family loans

Borrowing and lending between family members.

Debt-elimination calendar

A debt-elimination strategy in which you plan out all debt repayments, paying all minimum payments but focusing mostly on one until it is paid off, then using the amount of money previously paid toward that debt to pay off the next most important debt.



Avoid payday loans like the plague!

ing off the most expensive debt first. This can refer to either the largest debt or the one with the highest interest rate.

Ashton 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 4.2*.) 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.

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 all your debts, you can continue paying yourself in a way that is consistent with your family goals.

**Table 4.2 Example Debt-Elimination Calendar
(\$600/month allocated to debt repayment)**

	Credit Card	Auto Loan	Student Loan	Total Payment
Interest Rate	18%	8%	5%	
Amount Owed	\$2,000	\$4,400	\$3,600	\$10,000
Minimum Payment	\$20	\$200	\$100	\$320
July	\$300	\$200	\$100	\$600
August	\$300	\$200	\$100	\$600
September	\$300	\$200	\$100	\$600
October	\$300	\$200	\$100	\$600
November	\$300	\$200	\$100	\$600
December	\$300	\$200	\$100	\$600
January	\$200 (paid off)	\$300	\$100	\$600
February		\$500	\$100	\$600
March		\$500	\$100	\$600
April		\$500	\$100	\$600
May		\$500	\$100	\$600
June		\$500	\$100	\$600
July		\$400 (paid off)	\$200	\$600
August			\$600	\$600
September			\$600	\$600
October			\$600	\$600
November			\$400 (paid off)	\$400
December				\$600 (invested!)

DEBT-ELIMINATION CALENDAR: SMALLEST BALANCE FIRST

Dave Ramsey, among others, recommends that you pay off your smallest balance owed first.¹⁴ With this approach, you see success as debts are eliminated, which gives you more motivation to continue repaying your debts.

Either of these two methods can be helpful in eliminating debt. Most of the time, the difference is not significant, and either method will accomplish the same objective. The key is to act now.

An excellent tool to help accomplish both debt elimination strategies is <https://powerpay.org>. This website is an easy tool that creates the elimination calendar for you and will calculate how long it will take to eliminate your debt and the overall cost of eliminating the debt.

Summary

In this chapter we have learned that minimizing and eventually eliminating debt brings peace of mind and strengthens family relationships. We have learned that credit helps your family buy a modest home and, in some cases, finance an education and transportation. The key to borrowing for these needs is to make sure that you have sufficient available income to make the required payments without undue stress.

We also learned that it is important to build your credit score in order to qualify for and receive low interest rates on home mortgages, car loans, and automobile insurance. To improve your credit score, it is important that you pay all of your bills and make all of your loan payments on time. It is also useful to open up a number of credit lines, even if you do not use them.

Credit cards are a convenience and can help your credit score to grow. Because their interest rates are so high, you must pay off the balance on each credit card monthly before the grace period expires. For this reason, it is best to use no more than two or three credit cards

at a time. If you find yourself with lots of credit card debt, perform plastic surgery. In other words, shred the cards and operate on a cash spending basis instead.

We learned that consumer loans should usually be avoided. It is much better to save and sacrifice until you have the money to purchase wants. For needs, it is better to have a loan that is secured with collateral.

If you do incur debt, use an effective debt-elimination strategy to release your family from this bondage. Be consistent and diligent in paying off debts.



Other Resources

- ➔ www.annualcreditreport.com
- ➔ www.creditcards.com
- ➔ www.creditkarma.com
- ➔ www.mint.com
- ➔ www.myfico.com
- ➔ www.usdebtclock.org
- ➔ US debt clock (<http://www.usdebtclock.org/>)
- ➔ US student debt clock (<http://collegedebt.com/>)
- ➔ US debt graphically depicted (http://democracy.info/infographics/usa/us_debt/us_debt.html)
- ➔ How much is a trillion dollars? (<https://ihtd.org/festivalguide/resources/how-much-is-a-trillion-dollars/>)
- ➔ College debt (<http://www.surveyofthestates.com>)

com/#debt-repayment, <http://gradsense.org/gradsense/loan-payment>, <http://gradsense.org/gradsense>, <http://www.bankrate.com/calculators/college-planning/loan-calculator.aspx>)

- Saturday Night Live sketch: “Don’t Buy Stuff You Cannot Afford”
- <http://www.nbc.com/saturday-night-live/video/dont-buy-stuff/n12020>

Notes

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5

TAX REFUND

Tax Planning

Keeping More of the Income Your Family Makes

By Alex K. Gunnerson, Matthew K. Judd, and E. Jeffrey Hill

Let me, E. Jeffrey Hill, confess to you the biggest financial mistake I have ever made. It is pertinent because the reason for this mistake was that I did not understand the basics of the United States income tax system, and I did not keep up with changes to that system. It is my hope that this chapter will help you avoid mistakes like this.

Juanita and I began saving 10 percent of my income from IBM in a Traditional 401(k) early on in my career, investing it in a diversified, primarily stock-based mutual fund. I was delighted that my contributions reduced my income, which also reduced the amount of income tax I paid every year. Also, the tax on the gains in this account was delayed until retirement.

About twenty years ago, I did not pay attention when the Roth 401(k) was introduced. This would have allowed me to invest in a retirement account with after-tax dollars, keeping the principal and the earnings tax-free forever.

A couple of years ago I was so excited that I could start withdrawing money from my Traditional 401(k) without penalty. Imagine my disappointment when I withdrew my first \$30,000 and found that I owed more than \$10,000 in federal income

taxes. And then I realized how foolish I had been. Had I invested my retirement in a Roth 401(k) instead of a Traditional 401(k), the \$30,000 would have been tax-free. I was shocked to realize that, although I had only saved about 10 percent in taxes on my contributions, I would now have to pay about 30 percent



LEARN

- About different types of taxes and understand how they affect your family
- How to correctly calculate your family's federal income tax
- How to implement tax strategies to save your family money
- What resources can help you prepare and file your family's taxes



on everything I withdrew. We'll talk about this more in Chapter 8, but the bottom line is that because of the tax consequences of my decision to invest in a Traditional instead of a Roth 401(k), I will have hundreds of thousands of dollars less to spend in retirement.

All of this could have been avoided had I internalized the content of this chapter when I was your age. I invite you to pay attention in this chapter about taxes!



has steadily moved later in the year since 2009, when it was April 8.

The present federal income 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 dramatically. Currently, about 56 percent of the population pays income taxes. 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; it is important that you understand and plan for them so that you can achieve your family goals. We should all obey the laws of the land, including the laws that require us to pay taxes. However, we should learn to be wise financial managers so that we pay all the taxes we legally owe—and not a penny more.

Income taxes are essential to pay for the services that the federal government provides. These services include defense and international security assistance; Medicare, Medicaid, and CHIP; Social Security; transportation infrastructure, safety net programs; benefits for federal retirees and veterans; science and medical research; education; and interest on the debt.

The revenues the government receives are less than the amount the government spends. When our government engages in

Tax Freedom Day

The day of the year on which you have earned enough money to pay for all of your taxes for that year.

The Importance of Taxes

Benjamin Franklin wrote, “In this world nothing can be said to be certain, except death and taxes.” Given that taxes are certain, it is also certain that you must have at least a basic understanding of the tax structure in order to make informed financial decisions for your family so that you can live joyfully within your means. Paying unnecessary taxes reduces the amount of money you have for your family’s necessary expenditures. Your objective should be to legally minimize the amount of money you pay in taxes in order to maximize resources you have left for your financial goals.

Informed tax planning is important because taxes are the largest single annual expense for most families. In fact, the average American spends more on taxes than on food, clothing, and medical care combined. The day of the year on which the average family stops earning money for the government and starts earning money for themselves is known as “**Tax Freedom Day**.” In 2017, that day fell on April 23, meaning that Americans needed to work 113 days to cover the costs of their federal, state, and local taxes. Tax Freedom Day

deficit spending the government must choose to raise taxes, lower expenditures, or borrow more money. Typically, the answer is to borrow more money, adding to the national debt. Since 1967 the government has run a deficit 45 out of 50 years. The only years of surplus were 1969 and 1998-2001.

The primary way that the United States finances its debt is by selling treasury bills and bonds. These are purchased by individuals, companies, investment firms, even countries. You can purchase a treasury bill by going to www.treasurydirect.gov. As of January 1, 2018, the national debt in the United States was \$20.6 trillion. Of that amount, \$6.4 trillion is held by foreign countries.



Types of Taxes

Before we learn more about how taxes work, let's learn about some of the most common types of taxes in the United States.

TAXES ON PURCHASES

- **Sales taxes** are percentage taxes applied to the purchase price of taxable goods. Sales tax rates are set by state and local governments. There is no national sales tax in the United States.
- **Excise** (or quantity) **taxes** are levied against certain specific products or services (such as fuel, liquors, and cigarettes) on a per unit basis.

TAXES ON PROPERTY

- **Property taxes** are levied against the assessed value of land and buildings. Property taxes have traditionally been used to support public schools.
- **Personal property taxes** are levied by states on certain personal assets such as vehicles, farm equipment, cattle, recreational vehicles, etc.



TAXES ON WEALTH

- **Estate** (and gift) **taxes** are collected by the federal government on the value of a person's estate upon their death if the estate is sufficiently large.
- Similarly, **inheritance taxes** on money and property received by heirs are collected by many states.



TAXES ON EARNINGS

- Social Security, Medicare and **income taxes** are levied against the earnings of workers. Together, Social Security and

Sales taxes

A percentage tax applied to the purchase price of taxable goods.

Excise taxes

A tax levied against certain specific products or services (such as fuel, liquors, and cigarettes) on a per unit basis.

Property taxes

A tax levied against the assessed value of land and buildings.

Personal property taxes

A state and local tax against certain personal assets.

Estate taxes

A tax charged on the value of a person's estate upon his or her death if the estate is sufficiently large.

Inheritance taxes

A tax on money and property received by heirs.

Social Security taxes

A tax levied against the earnings of workers to fund the Social Security system.

Income taxes

A tax levied directly against the earnings of workers; this tax is one of the main sources of government funds.

Medicare constitute **payroll taxes**, also known as FICA taxes, which are calculated completely independent of the federal income tax that we address in the next section.

These payroll taxes mandate that all employees must pay a combined total of 7.65 percent (6.2 for Social Security and 1.45 percent for Medicare) on all wages and salaries they earn. You may not have realized you were paying 7.65 percent of your wages to the IRS but when your employer withholds money from your paycheck, some of those withholdings are likely to be for Social Security or Medicare taxes.

However, if you are a student employed by your school or university, you are one of the few Americans exempt from having to pay these FICA taxes. The withholding rules and percentages change slightly for high income taxpayers (over \$128,400 of wages for 2018).



Since the federal income tax is so ubiquitous, we will spend some time explaining the basic parts of filing your return. It is important to note that as of 2017 the income tax code is incredibly complex and contains over 74,000 pages. Just to read the code would require several decades of a 40-hour work week.

If you watch the news or like to keep up with current events, you may have heard about the successful passage of tax reform in December of 2017. Many congressional leaders and advocates of tax reform supported the notion that the existing tax law was past due for some much needed “simplification.” While some elements of federal taxation have indeed been simplified since the ratification of the *Tax Cuts and Job Act (2017)*, others have been made much more complex.

In this text, we are choosing to present the topics of taxation most relevant to families according to the latest changes in the tax law. It is our hope that the remainder of this chapter will prove invaluable to you and your family as you graduate and begin a full-time career in the industry and city of your choice. Then, as you contemplate important financial decisions, you will be blessed to understand more completely the impact that taxes can have on your family’s budget and long-term wealth. This will be an important tool in living joyfully within your means.

That said, let us begin by introducing the fundamental four-part tax formula that you will use to calculate your family’s federal income tax. Over the next few pages, we discuss each component of the tax formula in detail so take a moment to familiarize yourself with this important formula.

Payroll taxes

Taxes levied against the earnings of workers to fund the Social Security and Medicare systems. These taxes amount to 7.65% of employee wages and salaries.

Calculating Your Federal Income Tax

Almost every independent person with an income of more than \$12,000 (\$24,000 for married couples filing jointly) in 2018 in the United States is required to file a federal income tax form. For individuals age 65 or older, these figures are slightly larger and depend on a variety of factors. However, you *can* file at any income level, and you *must* file if you want your income tax withholdings to be refunded to you.



$$\begin{array}{r}
 \text{Gross Income} \\
 - \text{Adjustments to Income} \\
 \hline
 = \text{Adjusted Gross Income (1)} \\
 \\
 - \text{Deductions} \\
 \hline
 = \text{Taxable Income (2)} \\
 \\
 \times \text{Tax Rate(s)} \\
 \hline
 = \text{Tax Liability (3)} \\
 \\
 - \text{Taxes Credits} \\
 \hline
 = \text{Tax Due or Tax Refund (4)}
 \end{array}$$

Let's go through these steps one by one.

Step 1:

Calculate Your Family's Adjusted Gross Income

To do this, you will subtract your adjustments to income from your gross income.

$$\begin{array}{r}
 \text{Gross Income} \\
 - \text{Adjustments to Income} \\
 \hline
 = \text{Adjusted Gross Income}
 \end{array}$$

To put it simply, gross income is all of your income. In other words, it is what you were paid during that tax year. If you are married and filing jointly, it is the combined income of you and your spouse. Now we will give you just enough specificity to highlight how complex this process can actually become.

Gross income comprises income from all sources except that which is allowed to be specifically excluded or deferred by the IRS. It includes active income (wages, tips, salaries, commissions, and income from businesses in which you actively participate); passive income (earnings from a rental property, limited partnership, or other enterprise in which you are not actively involved); and investment income (earnings from interest, dividends, and capital gains from securities like stocks or bonds). Gross income also includes alimony received (but only if the divorce settlement to which the alimony relates is executed before January

Gross Income

Gross income includes the following:

- Active income
 - Wages
 - Tips
 - Salaries
 - Commissions
 - Income from businesses in which you actively participate
- Passive income
 - Earnings from a rental property
 - Earnings from a limited partnership
 - Earnings from enterprises in which you passively participate
- Alimony received
- Business income
- Distributions from taxable individual retirement accounts
- Tax refunds from the previous year (if the excess was deducted in the previous year)
- Royalties
- Farm income
- Unemployment compensations
- Taxable Social Security benefits
- Other income not specifically excluded by the IRS

Exclusions to income include the following:

- Employer-provided fringe benefits
- Life insurance compensation received because of a death
- Scholarships or grants not in excess of college expense
- Interest on US 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)
- Alimony paid
- Some welfare benefits
- Distributions from Roth IRA or Roth 401(k) retirement accounts

Adjustments to income include the following:

- Contributions to Traditional IRAs and Traditional 401(k) plans
- Interest payments on student loans, and tuition and fees deductions
- Contributions to flexible spending plans or health savings accounts (where money for medical expenses is paid before tax)
- Deductions for one-half of the self-employment tax

1, 2019), business income, distributions from taxable individual retirement accounts (such as Traditional IRAs and Traditional 401(k) plans), 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, scholarships or grants in excess of qualified education expenses, and any other income not specifically excluded by the IRS. You can see that this is fairly complex so you will want to take the time to really understand it.

Occasionally, the IRS allows certain sources of income to be excluded from your gross income.

These waived amounts are called exclusions to income. They include certain employer-provided fringe benefits, qualified contributions to your employer qualified plans, life insurance compensation received because of a death, scholarships or grants not in excess of college expenses, interest on US 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), and some welfare benefits. In addition, gross income does not include qualified distributions from Roth IRA or Roth 401(k) retirement accounts.

Once you know your gross income, subtract your **adjustments** to income. These adjustments are sometimes called “for-AGI” or “above-the-line” deductions because these reductions factor into the calculation for AGI. Common adjustments include contributions to Traditional IRAs and Traditional 401(k) plans, alimony paid to an ex-spouse (similar to the gross income rule for alimony, this only applies to divorce settlements executed before January 1, 2019), interest payments on student loans, and tuition and fees deductions. Other less common adjustments include contributions to flexible spending plans or health savings accounts (where money for medical expenses is paid before tax), and deductions for one-half of the self-employment tax. As your adjusted gross income increases beyond



a specific amount, certain adjustments to your income are phased out or eliminated. Such adjustments affect those making a substantial income.

Your gross income minus these adjustments gives you your **Adjusted Gross Income (AGI)**. You have now successfully completed Step 1. Way to go!

Step 2:

Calculate Your Family's Taxable Income

Once you know your family's AGI, the next step is to determine your deductions.

$$\begin{array}{r} \text{Adjusted Gross Income} \\ - \text{Deductions} \\ \hline = \text{Taxable Income} \end{array}$$

Deductions are IRS-allowed reductions to your AGI that decrease how much of your total income is subject to taxes. These deductions are often referred to as “from-AGI” or “below-the-line” deductions because they are subtracted from your AGI you calculated in Step 1. Each year, you must choose whether you want to take the standard deduction or whether to **itemize** your deductions (you can't do both). Remember, your challenge as a taxpayer is to minimize your taxes by maximizing deductions. Because the government allows you to choose between the standard deduction or itemizing deductions, it is almost always to your advantage to take whichever is larger.

The first method of calculating deductions is to let the government calculate them for you via the “standard deduction.” The **standard deduction** is an arbitrary dollar amount deter-

Adjusted Gross Income (AGI)

The first step of calculating your federal income tax, determined by subtracting your adjustments to income from your gross income.

Deductions

IRS-allowed reductions to your adjusted gross income that are used to calculate taxable income.

Standard deduction

The dollar amount set by the government that any tax filer may use as a reduction to AGI; the amount differs depending on filing status.

Itemized deduction

The sum of the possible deductions from AGI that you qualify for.

Filing Status

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. This is usually advantageous when one spouse makes much more than the other spouse.
3. **Married filing separately:** Married taxpayers may elect to file separate returns. This is usually advantageous when both marriage partners make significant incomes.
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 during the year you are filing for, you may file as head of household.

mined by the federal government and varies depending on your filing status. Your marital status on the last day of the year determines your filing status for the entire year. One of the biggest changes to individual tax brought about by the *Tax Cuts and Job Act (2017)* was to nearly double the standard deduction from \$6,350 for single filers (S) and \$12,700 for married filing jointly (MFJ) to \$12,000 (S) and \$24,000 (MFJ). Although the true effect of tax reform has yet to be witnessed, analysts project that the percentage of households in the US that itemize will drop from 30 percent to less than 10 percent. Because the standard deduction is indexed to inflation, it varies slightly from year to year.

Standard Deductions

Filing Status	Standard Deduction (2018)
Single	\$12,000
Married filing jointly	\$24,000
Married filing separately	\$12,000
Head of household	\$18,000

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 deduct certain expenses it deems important from a taxpayer's income. There are myriad possible deductions, but the four most common are home mortgage interest, charitable donations, state and local taxes paid, and medical and dental expenses.

Home mortgage interest. Because the government wants to encourage home ownership, you can deduct from your income what you pay each year in qualified interest for a loan secured by your main home and a potentially even a second home. Qualified interest is the interest you pay on your home loan(s) of up to \$1,000,000 if the mortgage loan was incurred on or before December 15, 2017 (\$750,000 if purchased after). The new tax law only permits an interest deduction on debt that is (1) secured by the home and (2) incurred when acquiring or substantially improving the home. This means that interest you pay on a home-equity line of credit is no longer deductible beginning in 2018 (we talk more of the dangers of these types of loans in Chapter 8). If calculating how much qualified interest you paid makes you nervous, don't let it get you down! You will usually get a 1098 form from your lender to document the exact amount of interest you paid during the year.

Charitable donations. What you donate to qualified charitable or nonprofit organizations is tax deductible. In most cases, you cannot deduct money if you got something of material value for the contribution. You can also deduct the fair market value of property



Taxable income

The second step of calculating your federal income tax, determined by subtracting your deductions and exemptions from your AGI.

Tax liability

The third step of calculating your federal income tax, determined by multiplying your taxable income by government-set tax rate(s).

donated to charitable organizations. Be sure to ask for and fill out a receipt to indicate the donation and the fair market value of the donation.

State and local taxes paid (limited to \$10,000 annually). Another savory itemized deduction that most taxpayers are eligible for is the state and local tax (SALT) deduction. In addition to the state and local income taxes, you may also deduct any property taxes (e.g. real estate taxes) you pay during the tax year. Whereas these deductions were previously unrestricted, the *Tax Cuts and Jobs Act (2017)* limits the total SALT deduction to \$10,000 beginning in 2018. The state or local government can provide you with a statement of the income taxes paid but that figure will also almost always show up on your W2 that you receive from your employer after the year end. For those with a mortgage, your annual real estate taxes are often reported by the lender on the same 1098 form that documents interest expense. Unfortunately, you may not deduct the federal income taxes that you paid, nor employment taxes such as Social Security and Medicare.

Medical and dental expenses. The government allows deductions for out-of-pocket, unreimbursed medical and dental expenses for the amount that exceeds 7.5 percent of your AGI. For example, if your AGI is \$40,000 and you pay \$4,500 in out-of-pocket medical expenses this year, your itemized deduction for medical expenses is \$1,500 ($4,500 - (40,000 \times .075) = 1,500$). If your payment for medical expenses are not greater than 7.5 per-

cent of your AGI, then your itemized deduction for medical expenses is \$0. It is important to note here that the 7.5 percent rule is a temporary rate reduction that is effective only for 2017 and 2018 tax years. Beginning in 2019, the floor rate for medical and dental expenses will revert to 10 percent. Be sure to document your expenses with receipts.

Now that we understand deductions more completely, let's go through an exercise to illustrate how to choose whether to take the standard deduction or whether to itemize your deductions. Assume the year is 2019 and you're preparing to file your 2018 federal income taxes with your spouse. Together in 2018 you paid \$6,500 in charitable contributions, \$8,000 in home mortgage interest, \$4,000 in state income taxes, and \$3,000 in property taxes. If you were to itemize your deductions, you would have a total of \$21,500 in eligible deductions. However, because the standard deduction is \$24,000 for married couples filing jointly, it would be to your advantage to take the standard deduction instead of itemizing.

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 and family goals. We'll talk more about tax strategies later.

Subtract your deductions from your AGI. The resulting total is your **taxable income**. Congratulations! You have now completed step 2.

Step 3:

Calculate Your Family's Tax Liability

Once you have determined your taxable income, you can calculate your **tax liability**.

$$\begin{array}{r} \text{Taxable Income} \\ \times \text{Tax Rate(s)} \\ \hline = \text{Tax Liability} \end{array}$$

This is done using 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 the top rate at which you will be taxed. The rate at which your next dollar earned would be taxed is called your **marginal tax rate**. This rate is important because it can quickly help you determine the taxes that additional income (e.g. seeking a second job) will incur. Above is a simplified example of a tax table for 2018. Note how the percentage of income that is due in taxes increases as taxable income increases. This demonstrates that the federal income tax is a progressive tax.

If you recall back to Step 1, you may remember when we calculated gross income, we included investment income like dividends and gain on the sale of securities. As it turns out, if your dividend income meets certain requirements or you held capital gain property (e.g. securities) for more than one year, the income from these items are taxed at preferential rates of 0%, 15%, or 20% instead of the seven ordinary income rates ranging from 10% to 37%. Although the taxation of investment income is beyond the scope of this textbook, you should be aware that part of your total taxable income (from Step 2) may be subject to different tax rates.

EXAMPLE:

Harry and Sally have \$121,000 of taxable income, and they are married filing jointly. The first \$19,050 is taxed at a rate of 10% ($\$19,050 \times .1$), the next \$58,350 ($\$77,400 - \$19,050$) is taxed at 12% ($\$58,350 \times .12$), and the final \$43,600 ($\$121,000 - \$77,400$) is taxed at 22% ($\$43,600 \times .22$). $\$1,905 + \$7,002 + \$9,592 = \$18,499$, so Harry and Sally have a tax liability of \$18,499.00.

Most tax filers use tax preparation software (such as TurboTax, TaxACT, H&R Block, or Tax Slayer), which calculates the tax liability for you.

That was an easy step! Just one more step to go!

2018 Federal Income Tax Rates		
Marginal Tax Rate	Taxable Income (Over x but less than y)	
	Single	Married Filing Jointly
10%	\$0 / \$9,525	\$0 / \$19,050
12%	\$9,925 / \$38,700	\$19,050 / \$77,400
22%	\$38,700 / \$82,500	\$77,400 / \$165,000

Step 4:

Calculate Tax Due or Tax Refund

After calculating your tax liability, you subtract tax credits and federal income tax withholdings to find your **tax due** or hopefully a **tax refund**.

$$\begin{array}{r}
 \text{Tax Liability} \\
 - \text{Nonrefundable Tax Credits} \\
 - \text{Partially Refundable Credits} \\
 - \text{Refundable Tax Credits} \\
 \hline
 = \text{Tax Due or Tax Refund}
 \end{array}$$

Tax credits are different from itemized deductions. Credits are more valuable because they are dollar-for-dollar reductions in your tax liability, whereas deductions only reduce taxable income. Put another way, one dollar of credit actually reduces your taxes by one dollar while one dollar of deductions only reduces your income that will be taxed by one dollar. Credits can be non-refundable (only able to reduce your tax liability to zero), refundable (paid back to the taxpayer as a refund even if the amount of the credits exceeds the tax liability), or partially refundable (a hybrid of the two). Credits are applied against your tax liability in the most tax-favorable way (i.e. nonrefundable credits first, then partially refundable, and refundable last).

Nonrefundable credits. These credits are the least valuable of the three because they are limited to your tax liability you calculated in step 3. This means that they can potentially reduce your tax liability to zero, but they cannot generate a tax refund alone. Examples of nonrefundable credits include the family credit (new for 2018), dependent care credit,

Marginal tax rate

The rate at which the next dollar earned is taxed.

Tax due/Tax refund

The final step of calculating your federal income tax, determined by subtracting tax credits from your tax liability.

Tax credits

Dollar-for-dollar reductions from your tax liability.

elderly and disabled care credit, adoption credit, and Lifetime Learning Credit. In addition, some of these credits are phased out for taxpayers in higher income brackets.

Partially refundable credits. Unlike nonrefundable credits, credits that are partially refundable can reduce your tax liability below zero and generate a refund. However, the extent of the available refund is limited by the specific rules governing the credit. The two most common partially refundable credits are the child tax credit and the American Opportunity Credit (AOC). Because these credits are so common, we discuss them in greater detail below.

Refundable credits. As the third and final type, refundable credits are . . . you guessed it, completely 100 percent refundable. For each dollar that your refundable credits exceed your adjusted tax liability (i.e. after subtracting both nonrefundable and partially refundable credits), you will get one dollar paid back to you in the form a tax refund. The most popular refundable credit is the earned income credit which we also explain in greater detail below. Although federal taxes withheld on wages and estimated income tax payments are not technically tax credits, it helps to think of them as refundable credits since they are treated exactly the same way when calculating your taxes.

Now that you understand the how credits are treated in the tax formula, let's explore some of the finer points of the credits that are most relevant and beneficial for families.

The child and family credits. Besides the dramatic increase in the standard deduction, few provisions in the *Tax Cuts and Jobs Act (2017)* affect the family like the modifications to the Child Credit and the addition of the Family Credit. The child tax credit is a \$2,000 credit permitted for each qualifying child in a household. A qualifying child is one whom the taxpayer can claim as a dependent and who was younger than seventeen (sixteen years old or less) on the last day of the tax year. Each child tax credit is refundable up to \$1,400 (although the refundability decreases for tax-



payers with relatively low earned income). For each dependent that does not meet the qualifying child test (e.g. children older than 16 years), taxpayers are eligible for a \$500 nonrefundable family credit. Taxpayers cannot claim a family credit for themselves, they may only claim the credit for their qualifying dependents.

The rules for determining whether a child or relative is your dependent can sometimes be tricky. If you plan on filing your own taxes without the help of software or a tax professional, be sure to verify that your family members qualify under all the tests of a dependent before claiming these credits.

Education credits. 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 paid for each of the first four years of college. The result is a credit of up to \$2,500 per year for the first four years of college with 40 percent of the eligible credit being refundable.

Qualifying expenses include tuition and books (but not room and board) at an accredited vocational school, college, or university. After the 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). Remember, however, that the Lifetime Learning Credit is not refundable.

Other credits. Another important credit

is the adoption credit, which allows for a credit of up to \$13,570 for the qualifying cost of adopting a child under the age of eighteen.

Taxpayers may be eligible for additional credits if they are disabled, are older than sixty-five with a low income, pay taxes in other countries, or overpay Social Security taxes because they work more than one job.

Once you have calculated your tax credits, subtract them in the correct order from your tax liability. The result will either be the amount of taxes you owe or the amount you will have refunded to you.

Wow, that was a lot of information, and calculating your family's federal income tax can certainly be a long process! But it's not the big, scary monster a lot of people think it is. Once you are familiar with the process, taxes aren't so bad after all!

And families that do it right end up with the largest possible refund, and more resources for the family budget.



Somebody said, "Money can't buy happiness," but his friend said, "Maybe not, but it does enable one to pick out the particular kind of misery that he enjoys the most." And someone has pointed out that if there is anyone who can't buy happiness with money it must be that he just doesn't know where to shop.
—Sterling Sill¹⁸

Tax Strategies

Your goal related to taxes is to pay just what you legally must—no more and no less. There are several tax strategies that can help you reduce the amount of taxes you pay so that you have more money to support your family and invest in the future.

Remember Your Roth Every Year!

In 1997, Senator William Roth from Delaware¹⁹ sponsored tax legislation that you should take advantage of every year. Investing in a Roth 401(k) (set up by your employer) and/or a Roth IRA (that you set up) is perhaps the most important tax strategy to reduce your lifetime income tax burden. We will talk much more about these in Chapter 8. For now, know that earnings from a Roth 401(k) or Roth IRA are tax free forever! Remembering your Roth is especially important while you are young, but as your career and income grow, you will want to consider consulting a tax advisor to ensure you're getting the best tax results with your retirement accounts. When you are older (like your Family Finance professor), that could mean saving 22 percent, 24 percent, or more in tax liability on your retirement withdrawals.



Itemize Your Deductions or Don't—But Get It Right

The government wants to encourage you to spend money in certain ways (e.g., contributing to education, your church, charities, etc.), so it offers itemized deductions for that purpose. However, the government also offers a standard deduction, even if you have no itemized deductions. When you file your taxes, you ought to claim the greater deduction, either the total of your itemized deductions or the standard deduction. Make sure

you get it right. The government won't choose your method for you.

Itemize Your Deductions Every Other Year

One strategy of getting the maximum benefit from itemized deductions for your family is kind of tricky but totally legal. Make all of your contributions that count as itemized deductions every other year. Then claim the standard deduction in the other years. This method is commonly referred to as **bunching**.

For example, during 2018 you donate to charity and pay interest on your house as normal. Then on December 31, 2018, you prepay any charitable donations you would make during 2019, your 2018 December housing payment (which would not be due until January), and any property taxes relating to 2019 that have already been assessed but not due (unfortunately, you cannot deduct prepaid mortgage interest). You itemize in 2018, claiming double charitable donations, an extra month of mortgage interest, and even an extra year of property taxes. Then in 2019 you pay no charitable donations and only 11 months of mortgage interest and claim the standard deduction.

Even if you are in a 12 percent marginal tax rate making about \$70,000 per year, this technique can save you about \$1,000 in taxes every other year. The more you make the more you save with this strategy. With an annual income of \$200,000 you could save \$5,000 or more every other year by bunching your deductions. With such a high standard deduction, the practice of bunching will prove to be



advantageous to many middle-class Americans since they won't generate enough deductions to itemize every year. Of course, you must have sufficient resources to pay your donations and other deductions ahead one year, but it is an option to think about.

File for Earned Income Tax Credit (EITC) If You Qualify

The Earned Income Tax Credit (EITC) is very special to some college students because it may give you a tax credit that goes beyond bringing your tax liability to zero; it may actually pay you money. It is the government's way to get money into the hands of the working poor in order to better meet their basic financial needs. Many college students who marry and have children qualify for this credit, and sometimes it is quite lucrative. For example, a married couple with three children in 2018 who makes between \$18,700 and \$24,400 per year would pay no taxes and actually get an additional \$6,444 back from the government. That is amazing!

Claim Your College-Age Emerging Adult as a Dependent

Parents often have college-age emerging adults who are making enough money to file an income tax return in order to get the tax refund for paycheck withholdings from their meager income. If that emerging adult meets the IRS requirements for being a dependent, then the parents should unquestionably claim the family tax credit on their eligible dependent. Because the child could not take a family credit on their own tax return, there is no strategy to be had by a parent not claiming their own eligible children.

Previously, many taxpayers erroneously thought that if they did not claim their qualifying child as a dependent, that child was free to claim the dependency exemptions for his or herself. However, with the redaction of the personal and dependency exemptions, the



decision of whether or not to claim a qualifying child should be crystal clear.

If you (or your parents) are on the fence about claiming an eligible child as a dependent, rest assured that the decision to claim a child as a dependent does not put the child at a tax disadvantage. Even for purposes of applying for federal student aid (e.g. FAFSA), neglecting to claim your child as a dependent does not improve their chances of receiving aid because they are only considered “independent” if they are at least 24 years of age, married, or a graduate student.²⁰

Have a Large Family

The government wants to encourage you to have children. In 2018, the tax credit for each dependent child (under age seventeen) is \$2,000 and an extra \$500 tax credit for each dependent (age seventeen or older). Having a large family can dramatically decrease your tax liability. For example, I knew of a family that had fifteen children. Fourteen children were dependents and eight were under the age of seventeen. For this family under the 2018 tax law, the child and family credits alone would reduce their tax liability by \$19,000 with



\$11,200 being refundable. Even if this family only takes the standard deduction, this family would need to earn over \$147,000 before paying any federal income tax at all. Of course, it goes without saying that sixteen-member families incur more expenses in the groceries, clothing, other miscellaneous categories. Nevertheless, the tax savings from having so many children clearly help offset these large expenses that would otherwise be quite burdensome.

Time the Births of Your Children

Babies who take even one breath within a tax year (i.e., are born at 11:59:59 p.m. on December 31) count for the full \$2,000 child tax credit. So, given a choice, give birth on December 31, not January 1.

Pay Your Charitable Contributions with Appreciated Stock

Appreciated stock is not stock that you appreciate (although you will probably be very grateful for it in the future) . . . it is stock that has increased in value. As you will learn in Chapter 8, we don't generally suggest purchasing individual stocks. However, if you disregard our suggestion and do buy individual stock, it has a tax advantage if you donate the stock directly to the charitable organization. Here is how and why that works: If you were to sell the appreciated stock, you would have to pay long-term or short-term capital gains taxes on the stock when you filed your income tax. However, if you contribute stock held for at least one year directly, you don't have to pay any taxes because you never sold the stock. You simply claim the value of the stock on the day you donate it as a charitable deduction when you file your taxes.

We hope you will consider using these tax strategies to lower the amount of money you pay in taxes so that you can have more resources with which to bless your family and others.

Filing Your Taxes

Resources

Although it is important to understand how to calculate your family's taxes, there are many resources available to you that can make the process much more efficient. Most families are moving toward online filing instead of pen-and-paper filing. These resources can be a great help, but it is unwise to rely entirely on a third party when dealing with taxes. Mistakes may cause you to either pay more taxes than is necessary or not pay enough. If you pay less taxes than you are legally obligated to, your family may be audited by the IRS, in which case you have to pay penalties plus interest.

A few of the resources that make taxes easier include tax professionals, online tax software, your local VITA program, and www.irs.gov.



Tax Professionals. While this is a more expensive option, there are obvious benefits to working with a real person who is an expert at taxes as opposed to working with software. Do your research to find a well-known, trusted professional in your area.

Online Tax Software. This is becoming a common way to get taxes done easily and cheaply. While some software is free, other software is available for purchase at a rate that is probably still cheaper than hiring a professional. TurboTax, TaxACT, H&R Block, IRS Free File, and TaxCut are some commonly used software.

Your Local VITA Program. This is a great option for those with an income of less than \$54,000, and it's free. VITA allows you

to schedule an appointment to meet with a trained student one-on-one. They are often very busy, though, so don't put it off until the last minute.

www.irs.gov. The IRS website is becoming more user-friendly. Often, you can find the answers to your tax questions by searching their website with keywords or by looking in the "Help & Resources" tab.

Again, if you decide to get outside help with your taxes, remember to take a critical look for yourself to make sure they are being done correctly. No one is as invested in your tax refund as you are. Be especially aware of any deductions or credits that they may have overlooked.

Tax Forms

Another thing to consider is which tax form(s) to use. If you use a tax software or another outside resource, they will use the correct form(s) for you. If you are filing yourself, it is important to be able to pick the right form(s).

Some of the most common forms include 1040EZ, 1040A, 1040, Schedule A Itemized Deductions, Schedule B Interest and Dividend Income, Schedule D Capital Gains and Losses, Schedule EIC (earned income credit), and Form 8863 Education Credit. Here is a little information about the most common tax forms:

1040EZ. This is the simplest form. If your taxable income is below \$100,000 and you are claiming no dependents, this may be the form for you.

1040A. This is a little more complicated than 1040EZ but still for those with taxable income below \$100,000. You must also be taking the standard deduction. If you have capital gain distributions, certain tax credits, or have made adjustments to income for IRA/401k contributions or student loan interest, this form will be able to handle your more complicated taxes.

1040. This is the longest and most complex form, but cheer up! The longer the form,

the more money you may potentially save. If you are fortunate enough to have an income above \$100,000, you must use this form. This is also for those who are taking an itemized deduction or have certain adjustments to gross income or tax credits.

Schedule A Itemized Deductions. If you are itemizing your deductions, you must use a 1040 form and attach this form as a report of your deductions.

Schedule B Interest and Dividend Income. This may be used with both 1040A and 1040. If the income you've received on interest and dividends exceeds \$1,500, you must list the sources separately on this schedule.

Schedule D Capital Gains and Losses. This is the government's way of promoting long-term stock investments. If you have sold a capital asset during the tax year such as stock, a house, a car, etc., you must report the gains and losses on this schedule. Long-term capital gains are taxed at lower rates than short-term gains, which are taxed at the rate of your ordinary income. Use this schedule with a 1040 form.

Schedule EIC Earned Income Credit. If you have a low income and/or children, you may want to look into this tax credit. This credit is refundable, meaning that even if you don't have to pay any taxes, you could receive a check from the IRS. Reference Publication 596 for details about the earned income credit, and if you claim it you should attach Schedule EIC to your tax return.

Form 8863 Education Credits. If you are itemizing your deductions and have paid tuition or other educational fees in the last year, you will want to take advantage of the American Opportunity of Lifetime Learning tax credit and attach this to the 1040.

More detailed explanations of these and all other tax forms can be found at www.irs.gov and other places online.

we build a productive life. In appraising our present attitude, we might ask: "Am I working to become my best self? Do I set worthy and attainable goals? Do I look toward the positive in life? Am I alert to ways that I can render more and better service? Am I doing more than is required of me?"
Remember, a good attitude produces good results, a fair attitude fair results, a poor attitude poor results. We each shape our own life, and the shape of it is determined largely by our attitude.
—M. Russell Ballard²²

Summary

In this chapter, we learned about different types of taxes. We delved into the federal income tax and how to calculate it. We presented tax strategies that may save your family money. Finally, we introduced various tax resources and tax forms. Death and taxes may be the only certain things in life, but at least one of them isn't so bad (we won't say which one). Understanding taxes is key to living joyfully within your mean.



Attitude is an important part of the foundation upon which

Other Resources

- ➔ <http://www.bankrate.com/taxes.aspx>
- ➔ <http://www.fairmark.com/>
- ➔ www.irs.gov
- ➔ <http://moneycentral.msn.com/tax/home.asp>
- ➔ <http://www.smartmoney.com/tax/>

Notes

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5. D&C 58:21-22
6. Matthew 22:21
7. <http://www.davemanuel.com/history-of-deficits-and-surpluses-in-the-united-states.php>
8. <http://www.usdebtclock.org/index.html>
9. <https://www.irs.gov/charities-non-profits/student-exception-to-fica-tax>
10. <http://finance.townhall.com/columnists/politicalcalculations/2014/04/13/2014-how-many-pages-in-the-us-tax-code-n1823832>
11. <http://www.investopedia.com/terms/a/activeincome.asp>
12. <http://www.investopedia.com/terms/p/passiveincome.asp>
13. <https://www.forbes.com/sites/ryanel-lis/2017/11/22/nine-in-ten-will-claim-the-standard-deduction-under-tax-reform-according-to-new-white-house-study/>
14. Internal Revenue Code Section 163(h)(3)(F)(i)(III)
15. <https://www.irs.gov/credits-deductions/individuals/sales-tax-deduction-calculator>
16. Internal Revenue Code Section 213(f)(2) as amended
17. Internal Revenue Code Section 1(j) as amended
18. Sterling W. Sill, “A Fortune to Share,” (Oct. 1973), <https://www.lds.org/general-conference/1973/10/a-fortune-to-share?lang=eng>
19. https://en.wikipedia.org/wiki/Roth_IRA#History
20. <https://studentaid.ed.gov/sa/fafsa/filling-out/dependency>
21. <http://tech.lds.org/forum/viewtopic.php?t=17263>
22. M. Russell Ballard, “Providing for Our Needs,” (April 1981), <https://www.lds.org/general-conference/1981/04/providing-for-our-needs?lang=eng>

Summary of Key Changes Brought About by Tax Cuts and Jobs Act (2017)

Item	Old Law (through 2017)	New Law (2018 – 2026)
Standard Deduction	Single/MFS: \$6,350 HOH: \$9,350 MFJ: \$12,700	Single/MFS: \$12,000 HOH: \$18,000 MFJ: \$24,000
Personal/ Dependency Exemptions	\$4,050 from-AGI deduction for each personal or dependency exemption claimed on taxpayer's return	Personal and dependency exemptions suspended.
Alimony	Alimony is deductible as a for-AGI adjustment for the payor spouse and included in gross income for the recipient spouse.	For divorce arrangements executed before Jan 1, 2019, alimony payments/receipts remain deductible for payor spouse, gross income for recipient spouse. For divorce arrangements executed after Dec 31, 2018, alimony payments are non-deductible for payor spouse and excluded from gross income for recipient spouse.
Home Mortgage Interest	Home mortgage interest is deductible as an itemized deduction on acquisition indebtedness up to \$1,000,000 and on home equity lines of credit up to \$100,000.	Home mortgage interest is deductible as an itemized deduction only on acquisition indebtedness up to \$750,000. There is no deduction for interest on home equity lines of credit. However, if the mortgage debt was incurred on or before Dec. 15, 2017, the old limit of \$1,000,000 applies.
Charitable Donations	A taxpayer's deductible cash contributions to qualifying charitable organizations is limited to 50% of taxpayer's modified AGI. Any excess contributions carry forward indefinitely.	A taxpayer's deductible cash contributions to qualifying charitable organizations is limited to 60% of taxpayer's modified AGI. Any excess contributions carry forward indefinitely.
State and Local Taxes (SALT)	State and local income taxes (or sales tax) and property taxes available as separate itemized deductions without limits.	The sum of state and local income taxes (or sales tax) and property taxes available as a single itemized deduction, limited to \$10,000. Excess does not carry forward.
Medical Expenses	Non-reimbursed out-of-pocket are deductible to the extent that they exceed 10% AGI floor.	Non-reimbursed out-of-pocket are deductible to the extent that they exceed 7.5% AGI floor for 2017 (retroactive) and 2018. Beginning in 2019, the AGI floor rate reverts to 10%.
Tax Rates	7 tax brackets for ordinary income range from 10%–39.6%.	7 tax brackets for ordinary income range from 10%–37%. Intermediate rates lowered and income spread expanded for each bracket.
Child Credit	\$1,000 nonrefundable credit for each child dependent under age 17 at year end. *While the child credit was nonrefundable, if it would have triggered a refund had it been refundable, taxpayer became eligible for refundable "Additional Child Credit" which equaled the amount the child credit exceeded tax liability if taxpayer meets income threshold test.	\$2,000 credit (refundable up to \$1,400) for each child dependent under age 17 at year end. \$500 nonrefundable credit for each dependent not qualifying for the \$2,000 credit. Most commonly used for children over 16 but under 19 (24 if FT student). Taxpayers can't count themselves as a dependent.

Department of the Treasury—Internal Revenue Service

Form 1040EZ **Income Tax Return for Single and Joint Filers With No Dependents** (99) **2017** OMB No. 1545-0074

Your first name and initial	Last name	Your social security number : : : : : : : : :
If a joint return, spouse's first name and initial	Last name	Spouse's social security number : : : : : : : : :
Home address (number and street). If you have a P.O. box, see instructions.		Apt. no. ▲ Make sure the SSN(s) above are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse
Foreign country name	Foreign province/state/county	Foreign postal code

Income Attach Form(s) W-2 here. Enclose, but do not attach, any payment.	1	Wages, salaries, and tips. This should be shown in box 1 of your Form(s) W-2. Attach your Form(s) W-2.	1	
	2	Taxable interest. If the total is over \$1,500, you cannot use Form 1040EZ.	2	
	3	Unemployment compensation and Alaska Permanent Fund dividends (see instructions).	3	
	4	Add lines 1, 2, and 3. This is your adjusted gross income .	4	
	5	If someone can claim you (or your spouse if a joint return) as a dependent, check the applicable box(es) below and enter the amount from the worksheet on back. <input type="checkbox"/> You <input type="checkbox"/> Spouse If no one can claim you (or your spouse if a joint return), enter \$10,400 if single ; \$20,800 if married filing jointly . See back for explanation.	5	
	6	Subtract line 5 from line 4. If line 5 is larger than line 4, enter -0-. This is your taxable income .	6	
Payments, Credits, and Tax	7	Federal income tax withheld from Form(s) W-2 and 1099.	7	
	8a	Earned income credit (EIC) (see instructions)	8a	
	b	Nontaxable combat pay election. 8b		
	9	Add lines 7 and 8a. These are your total payments and credits .	9	
	10	Tax. Use the amount on line 6 above to find your tax in the tax table in the instructions. Then, enter the tax from the table on this line.	10	
Refund Have it directly deposited! See instructions and fill in 13b, 13c, and 13d, or Form 8888.	11	Health care: individual responsibility (see instructions) Full-year coverage <input type="checkbox"/>	11	
	12	Add lines 10 and 11. This is your total tax .	12	
	13a	If line 9 is larger than line 12, subtract line 12 from line 9. This is your refund . If Form 8888 is attached, check here <input type="checkbox"/>	13a	
	b	Routing number <input style="width: 100px;" type="text"/> c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		
d	Account number <input style="width: 100px;" type="text"/>			
Amount You Owe	14	If line 12 is larger than line 9, subtract line 9 from line 12. This is the amount you owe . For details on how to pay, see instructions.	14	
Third Party Designee	Do you want to allow another person to discuss this return with the IRS (see instructions)? <input type="checkbox"/> Yes . Complete below. <input type="checkbox"/> No			
	Designee's name <input style="width: 100px;" type="text"/>	Phone no. <input style="width: 100px;" type="text"/>	Personal identification number (PIN) <input style="width: 100px;" type="text"/>	
Sign Here	Under penalties of perjury, I declare that I have examined this return and, to the best of my knowledge and belief, it is true, correct, and accurately lists all amounts and sources of income I received during the tax year. Declaration of preparer (other than the taxpayer) is based on all information of which the preparer has any knowledge.			
Joint return? See instructions. Keep a copy for your records.	Your signature <input style="width: 100px;" type="text"/>	Date <input style="width: 100px;" type="text"/>	Your occupation <input style="width: 100px;" type="text"/>	Daytime phone number <input style="width: 100px;" type="text"/>
	Spouse's signature. If a joint return, both must sign. <input style="width: 100px;" type="text"/>	Date <input style="width: 100px;" type="text"/>	Spouse's occupation <input style="width: 100px;" type="text"/>	If the IRS sent you an Identity Protection PIN, enter it here (see inst.) <input style="width: 100px;" type="text"/>
Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed PTIN
	Firm's name <input style="width: 100px;" type="text"/>	Firm's EIN <input style="width: 100px;" type="text"/>		
	Firm's address <input style="width: 100px;" type="text"/>	Phone no. <input style="width: 100px;" type="text"/>		

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11329W Form **1040EZ** (2017)

Figure 5.1 An example of a 1040 EZ form.



6

Risk Management and Insurance

Protecting Your Family's Financial Health

Scenario 1: A few months after my wife passed away, I was visiting her grave in the city cemetery. Just north, I noticed a gray-haired man angrily weeping. I had seen him there several times before and this time I felt impressed to visit with him. When I approached and started a conversation, he said he was there to chastise his son-in-law who had died and left his daughter a widow with four small children. However, the reason for the tongue-lashing was not his son-in-law's death; it was his lack of life insurance. A few months earlier, money had been tight in the family so the son-in-law had canceled their term life insurance policy. Now the man's daughter was a grieving widow with four kids, no income, no assets, and no job.

Moral of the story: If you have anyone dependent on your income, you have an ethical responsibility to have sufficient life insurance.

Scenario 2: My brother-in-law and his wife took a vacation to Hawaii and left their younger children in the care of their adult daughter. Late one night, the daughter was horrified to see smoke billowing out of the vents in the living room. She hurriedly got all of the children out of the house, and just a few minutes later, the whole house was engulfed in flames. Within an hour, most of the structure had burned to the ground. The house was completely destroyed. I talked with the family a few days later. Of course they were sorry to have lost their home—but they had good homeown-



LEARN

- The importance of insuring your family against catastrophic financial loss
- About different types of insurance and insurance policies
- To make informed decisions on which insurance policies are best for your family's situation



ers insurance, and they were excited to rebuild a brand new home. They saw in the event a silver lining whereby they could design a new home as an improvement of their old home.

Moral of the story: When you have adequate insurance, a so-called “disaster” can become a family opportunity.

Why Have Insurance?

Life is full of unexpected challenges, and some of them can be financially devastating. The purpose of this chapter is to help you protect your family from financial tragedies through prudent insurance coverage. When catastrophes occur—and they surely will—you can rest assured that you and your family are financially protected if you have adequate insurance.

Prudent financial planning helps make life less stressful for our families. When financial stress is minimal, there is less conflict in your home and your family is happier. However, unpredictable events (accident, injury, illness, fire, theft, legal action, etc.) may occur at any time and have potentially devastating financial consequences. Insurance protects your fami-



ly’s financial assets in the case of these unanticipated events, thereby reducing the stress and strain that your family may experience. Prudent risk management through adequate insurance will bless your family in times of trial. Even if none of these catastrophes affect you, you will have peace of mind that your family is financially protected. You will sleep better at night!

Insurance is “a contract (policy) in which an individual or entity receives financial protection or reimbursement against losses from an insurance company. The company pools clients’ risks to make payments more affordable for the insured.”¹ Every family faces the risk of significant financial loss every day; your house could burn down, your car could be totaled, your daughter could get leukemia, or your spouse could die. By pooling risk through an insurance policy, you can protect your family at an affordable cost. For example, according to rough extrapolations² from data provided by the United States Fire Administration,³ the chances of a house fire in any given year are about 1 in 200. Let’s say the average loss is \$100,000. If 200 people pay \$550 a year, there will be enough money to cover the one house fire as well as to pay the insurance company overhead. In other words, for a manageable cost (\$550), you and a pool



of other families are able to protect themselves from the 1 in 200 chance of losing \$100,000.

Acquiring insurance is an important step toward becoming financially self-reliant, and it is key to taking care of your family. Marvin J. Ashton offered the following counsel on insurance: “It is most important to have sufficient medical, automobile, and homeowner’s

Insurance

A contract in which an individual receives financial protection or reimbursement against losses from an insurance company.

[sic] 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.”⁴

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.”
 —Marvin J. Ashton⁵



Managing Risk

If you purchase too much insurance or the wrong kind of insurance, you are wasting money. If you purchase too little insurance, you are exposed to unnecessary risk. Understanding risk is an important part in determining the right level of insurance you should have. You can manage risk in four ways: you can avoid it, reduce it, assume it, or transfer it. Let’s talk about each of these as they relate to the risk management table. (See Table 6.1.)

Table 6.1 Risk Management

	Low Frequency	High Frequency
Low Severity	Assume (losing your wallet)	Reduce (common cold)
High Severity	Transfer (home fire)	Avoid (lung cancer caused by smoking)

You can avoid some risks by choosing not to participate in activities where you will likely be hurt, such as bull riding, bungee jumping, and playing in the National Football League. Similarly, you can choose to avoid the risks associated with smoking and drinking by sim-

ply not smoking or drinking. Insuring against high-severity, high-frequency risk activities is expensive (e.g., life insurance rates for smokers), so the cost-effective solution is to avoid them altogether.

You can reduce some risks. For example, regular exercise, adequate sleep, and good nutrition can reduce the need for medical care. You can reduce the risk of damage to your home by purchasing a fire extinguisher. You can reduce the chance of injury or death in a car accident by wearing your seat belt. The best course is to reduce risk wherever possible.

You can assume (or retain) some types of risk through self-insurance, setting aside some funds to cover potential losses. With self-insurance, you pay no premiums, but you bear all of the risk yourself. For example, I decided not to purchase collision and comprehensive insurance on my 2004 Camry because it was getting old. It saved me quite a bit on insurance premiums. However, when my son wrecked the car, I lost potential insurance compensation because I was self-insured.

You can transfer risk to others by purchasing insurance, thus transferring financial responsibility for a specific low-frequency, high-cost risk from yourself to an insurance company. This is why you should get some form of life insurance, homeowners insurance, health insurance, disability insurance, and automobile insurance.

As with everything in life, moderation is important. You should maintain a reasonable relationship between the cost and the benefit of insurance. Not planning for high-severity, low-frequency risks is foolish, but so is going into excessive debt to pay insurance premiums.

Premium

A specified amount paid regularly (usually monthly or annually) to an insurance company in exchange for coverage.

Deductible

A specified amount that you must pay to cover an expense that could qualify for your insurance coverage before your insurance begins paying for eligible expenses.

Life insurance

Insurance against the financial loss resulting from the death of the insured.

Beneficiary

The recipient of life insurance who benefits in the event of the death of the insured.

Cash value

The total account value that is available to the life insurance policy owner while he or she is alive.

Face value

The basic benefit the life insurance company will pay the beneficiaries upon the death of the insured.

Policy owner

The individual or business that pays for and owns the insurance policy.

There are a few terms that you should be familiar with before we delve further into insurance. First, you pay the insurance company a **premium** on a regular basis (e.g., monthly, quarterly, annually) in return for covering certain losses. The other main payment associated with insurance is called a **deductible**. The deductible is the specified amount that you must pay out-of-pocket before the insurance company begins to compensate you. For example, if you are in an accident and have \$2,000 in repairs and a \$500 deductible, you must pay the first \$500, and then the insurance company will pay the remaining \$1,500. Once the deductible is met in a calendar year, the insurance company will pay for any additional eligible costs incurred during the rest of that year. Typically, if an insurance policy has higher deductibles, it will have lower premiums. If it has lower deductibles, it will have higher premiums.

Now let's learn more about each of the main types of insurance: life, health, homeowners/renters, and automobile.

Life Insurance

The purpose of **life insurance** is to reimburse the financial loss resulting from the death of the insured. Life insurance is not for you (the insured); its benefits are for survivors. It replaces your earnings if you (the earner) die. If you have someone who is dependent upon your income or labor, you have a moral responsibility to have some form of life insurance. If there are children in the home this is true for both spouses even if only one has paid employment. A stay-at-home spouse is providing valuable labor in the home that would need to be replaced economically (e.g., hiring a nanny or housekeeper).

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

Face value: The basic benefit the insurance company is to pay the beneficiaries; the face value is due upon the death of the insured

Policy owner: The individual or business that pays for and owns the insurance policy



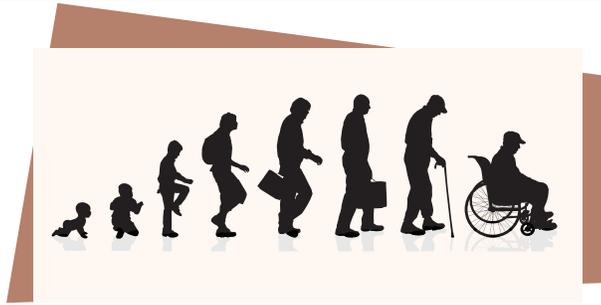
Four Questions Regarding Life Insurance

The purchase of life insurance involves four questions.

1. Do I need life insurance?
2. How much life insurance should I purchase?
3. What kind of life insurance should I buy?
4. How should the life insurance death benefit be received?

QUESTION #1: DO I NEED LIFE INSURANCE?

If your death will not cause financial loss to anyone, you do not need life insurance. However, if you provide for one or more people who depend on your income or labor, you have a moral obligation to have sufficient life insurance to take care of their needs in case of your death. Children are the most obvious financial dependents. But remember, dependents might also include parents or siblings. Life insurance also benefits your family if you have a lot of debt, expensive funeral plans, etc.



Again, both spouses should have life insurance when there are dependents involved.

Generally, as people get older, they are more financially able to be self-insured. High net worth as well as investments and savings may reduce the need for life insurance because your dependents would have enough to live on in the case of your death. Keep this in mind as your financial situation changes throughout your life.

QUESTION #2: HOW MUCH LIFE INSURANCE DO I NEED?

Simply put, you need enough insurance to replace your lost earnings and labor. Four common methods used to determine the needed amount of life insurance are multiple of income, desired income, human life value, and needs analysis. These are explained in detail in the *Fundamentals of Family Finance Workbook*.

QUESTION #3: WHICH KIND OF LIFE INSURANCE SHOULD I BUY?

All life insurance companies use mortality tables⁶ to determine life insurance premiums. Premiums that insure your life always increase with age because the older you get, the more likely you are to die.

Though other types of life insurance exist, in this book we will discuss the two major types—term and whole life insurance.

With **term life insurance**, the face value of the policy is paid to the beneficiaries if the policyholder dies while the policy is in force. There is no cash value building up within the insurance policy. As the policyholder gets

older, the premium increases. Term insurance usually cannot be purchased beyond ages between 65 and 75 (depending on the company). While you are young, premiums for term life insurance are much less expensive than premiums for whole life insurance. It pays to shop around to find the best rates for term life insurance. One site that does a good job of this is www.term4sale.com.

With **whole life insurance**, the premiums are divided between death protection and investment. The investment portion is put into an account that earns tax-deferred interest, dividends, or investment gains. This type of insurance is intended to provide the policyholder benefits over a lifetime. If you have the self-motivation to manage your own investments, then you are usually better off purchasing term insurance and investing in a broad, primarily stock-based mutual fund because you will likely yield a higher rate of return. However, if you are the kind of person who spends your paycheck every month and never gets around to investing, it is better to have whole life insurance. The required monthly payment will force you to be an investor.

Term life insurance

A policy in which the face value is paid to the beneficiaries when the insured dies.

Whole life insurance

A policy in which the premiums are divided between death protection and safe, relatively low return investments.

Table 6.2: Term and Whole Life Insurance (Pros and Cons)

	Pros	Cons
Term	Inexpensive (at young age) Easy to understand Low commissions	Premiums increase as the insured ages No cash value Can't be purchased after a certain age (65–75, depending on the company)
Whole	Builds cash value Cash value is tax-deferred Premium stays level	Expensive Low rate of returns compared to diversified stock investments Complex Can be misleading

QUESTION #4: HOW SHOULD LIFE INSURANCE PROCEEDS BE RECEIVED?

When an insured person dies, the named beneficiary is entitled to a tax-free cash death benefit. There are several options for how to receive the face value.

Lump Sum

One option is for the entire death benefit to be paid to the beneficiary in one lump sum. The life insurance benefit received by beneficiaries upon the policyholder's death is not taxable as income. The beneficiary then must decide how to invest the proceeds.

Interest Payment

There is also the interest payment option in which the face value is left with the insurance company to be invested. The interest from the investment is paid to the beneficiary over a stated period of years, at the end of which the face value is paid to the beneficiary. The portion of the payments received by beneficiary that corresponds to the interest will be taxable as regular income.

Installment/Annuity

Instead of receiving a lump sum from the insurance company, you may receive the money over a period of time, generally monthly, with an installment (or annuity) option. You can choose an amount (PMT) to be received each month and the insurance company will tell you how long the annuity will last (N) given their assumed interest rate (I). Alternatively, you can choose a period of time (N) that you would like the annuity to last and the insurance company tells you how much money you will receive each month (PMT) given their assumed interest rate (I). In many cases, the death benefit becomes a person's living allowance. A portion of it will be taxable as interest income.

Life Annuity

With a life annuity, you (the beneficiary)

are guaranteed to receive a monthly annuity payment for as long as you live. If you are willing to receive somewhat less each month, the annuity will last for a specified length of time, say ten years, regardless of when you die. If, say, you die in seven years, your beneficiaries (secondary beneficiaries) will receive the annuity payment for three years. For example: Husband dies first. Wife decides to receive a life annuity with a twenty-year guaranteed period. Wife dies in eight years. Her beneficiaries (two children) split the annuity for the next twelve years.



Summary

Adequate life insurance is an ethical responsibility if there is anyone who depends on your income or labor. Both spouses should have life insurance. If you are the kind of person who is a diligent and wise investor, it will be more financially rewarding to buy term life insurance and do the investments yourself. If you are not the kind of person who is a diligent and wise investor, you should probably invest in whole life insurance which will provide a forced investment plan while insuring your life.

Health and Disability Insurance

Health and disability insurance is a necessary part of any financial plan. There are two kinds of financial loss that are associated with health problems: the cost of medical care and the loss of income. The risk of financial loss associated with medical care is dealt with by

purchasing health or medical insurance. The risk of financial loss associated with loss of income (due to injury or illness) is dealt with by purchasing disability income insurance.

“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.”
—N. Eldon Tanner⁷



In the United States, health insurance has traditionally been provided by employers in group plans. In this situation, employers pay most of the health insurance premiums and employees pay a smaller amount. However, in 2016 only 49 percent of the population was covered by employer-sponsored healthcare; 7 percent were covered by other private programs (generally very expensive); 35 percent were covered by public programs such as Medicaid and Medicare; and 9 percent were uninsured.⁸ Many of the uninsured were working without employee-sponsored care and could not afford private coverage. In order to address this need and other perceived shortcomings in the health insurance domain, the Patient Protection and Affordable Care Act (PPACA) was passed and signed into law in 2010. This is

also known as the Affordable Care Act (ACA) or simply Obamacare.

The Affordable Care Act (ACA)

The Affordable Care Act (ACA) requires nearly everyone in the United States to have qualifying health insurance or to pay a penalty. The penalty for not having qualifying health insurance in 2017 is the *higher* of 2.5 percent of your household income or \$695 for each adult in the family and \$347.50 per child under 18. The maximum penalty per family for this method is \$2,085.⁹ This encourages young, healthy people to pay for insurance in order to subsidize other groups, such as the elderly.

However, with the ratification of the “Tax Cuts and Jobs Act” in December 2017, the penalty for not having qualifying health insurance will be \$0 beginning in tax year 2019.¹⁰

Some are exempt from paying the penalty for not having health insurance.¹¹ You may qualify if:

1. The lowest-priced coverage available to you would cost more than 8.05 percent of your household income
2. You do not file a tax return because your income is too low
3. You are uninsured for less than 3 months of the year
4. You are a member of a recognized religious sect with religious objections to insurance, including Social Security and Medicare
5. You are incarcerated
6. You are not lawfully present in the US

Some college health plans do not meet the qualifying standards of the Affordable Care Act. Students enrolled in these types of plans will have to pay a penalty unless they qualify for an exemption (see above, e.g., income is too low to file).

Popular benefits of the Affordable Care Act include: young adults can stay on their

Health insurance

Insurance for expenses relating to health and medical procedures.

Disability insurance

Insurance that provides payments to insured individuals in the event that regular income is interrupted by illness or an accident.

parents' health insurance until the age of 26; if anyone gets really sick, insurance companies cannot terminate coverage nor limit the amount of coverage; wellness and pregnancy exams are now free to the patient; and health insurance companies are required to use at least 80 percent of premiums on providing actual medical services.¹²

For those without other sources of insurance, the ACA provides for state insurance exchanges where insurance companies can compete for your business. These plans are grouped into three categories:

1. Bronze – least expensive premiums (high deductibles, catastrophic protection)
2. Silver – moderately expensive premiums (moderate deductibles)
3. Gold – expensive premiums (low deductibles and greatest choice in service)
4. Platinum – most expensive premiums



Generally, if you use healthcare services less than average, it would be a wise financial decision to choose a Bronze plan. If you use healthcare services more than average, it will generally be a wise financial decision to choose a Silver, Gold, or Platinum plan.

For more information on the ACA, visit <https://www.healthcare.gov/> and <http://kff.org/health-reform/>.

Health Insurance Terms

We've already learned about premiums. Here are a few more terms that will help you understand health insurance.

Remember the **deductible** is the amount the insured must pay before the insurance company pays anything. This payment acts as a deterrent to unnecessary medical care. The deductible usually renews annually and is based on the calendar year. For this reason it is financially advantageous to group medical procedures in the same calendar year if possible.

Co-insurance (or **co-payment**) is the portion of expenses beyond the deductible that the insured person pays—up to an annual maximum as stated in the policy.

Most health insurance policies have a **maximum annual co-payment**. Generally, after the deductible is met, the insured will pay a percentage of the medical expenses up to a maximum amount. For example, suppose



you have insurance with a co-payment of 20 percent of eligible expenses to a maximum co-payment of \$3000. If you had surgery and hospitalization that totaled \$50,000, you would have a co-payment of \$3000 towards the 20 percent of the first \$15,000 of expenses. The insurance company would pay the remaining \$35,000 of expenses at 100 percent. Altogether, you would pay \$3000 and the insurance company would pay \$47,000.

Maximum annual out-of-pocket cost is the most you can pay for health care costs in any calendar year. It equals the annual deductible + maximum co-payment. This figure is, in essence, the worst-case scenario in terms of total annual cost for health care. This is also renewed on an annual basis and can be used strategically. For example, my daughter came home from a trip in October and needed elective hip surgery. We scheduled that surgery

Deductible

A specified amount that you must pay to cover an expense that could qualify for your insurance coverage before your insurance begins paying for eligible expenses.

Co-insurance/ Co-payment

The portion of expenses beyond the deductible that the insured person pays, up to an annual maximum.

Maximum annual co-payment

The most you can pay towards co-insurance in any given year.

Maximum annual out-of-pocket cost

The most you can pay towards medical care in any given year (annual deductible + maximum co-payment).

for December because we had already met our deductible and our out-of-pocket maximum for the year. Because we scheduled it before the end of the year the surgery did not cost us anything out-of-pocket. However, had we waited until January it would have cost \$500 deductible plus our \$4000 maximum co-payment.

If you have more than one insurer, they will “coordinate” payments to hospitals, doctors, etc. so as to avoid double paying. This is called **coordination of benefits**.

If you forget to pay your insurance premium, you are generally allowed a **grace period** before your insurance is canceled.

Types of Medical Insurance

There are various types of health insurance, but there are three types beyond your normal health insurance that you should be familiar with and should possibly consider purchasing. These are health savings accounts (HSA), disability insurance, and long-term care (LTC) insurance.

A **health savings account (HSA)** is an account created by an employer on behalf of an employee to save money toward medical expenses. Money in the account can be used to help pay co-payments, deductibles, and other qualified medical expenses. In order to contribute to an HSA, you must also be enrolled in a high deductible health plan. Typically, a HDHP has a high deductible and high copayment amounts. The HSA philosophy is to encourage the insured to reduce health care costs by engaging in health promoting behaviors, reducing or eliminating behaviors that present health risks, and comparison shopping for medical services.



The benefits of having such an account include tax deductions (as an adjustment to income), portability (changing jobs does not mean that you lose your account), insurance benefits (reduced rates because of higher deductibles), and savings capability (earnings are tax-deferred). After age 65, money may be withdrawn from a health savings account for any reason without consequence. As such, the residual balance in an HSA account may complement retirement savings.

Disability insurance provides payments (between 50 and 80 percent of after-tax income) to insured individuals in the event that regular income is interrupted by illness or an accident. Anyone who depends on earned income should look into disability coverage. The risk of disability is even higher than the risk of premature death.

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 the expense and the many exceptions and conditions for coverage.

Homeowners and Renters Insurance

Home ownership may be the most expensive investment you ever make. It is essential for your financial security that you protect

Coordination of benefits

Multiple insurers coordinating insurance claims and medical payments so as to avoid double paying.

Grace period

The period of time between the payment due date and the cancelation of your insurance.

Health savings account (HSA)

An account that is created by an employer on behalf of an employee to save money toward medical expenses.

Disability insurance

Insurance that provides payments to insured individuals in the event that regular income is interrupted by illness or an accident.

Long-term care (LTC) insurance

Insurance that covers the costs of nursing home facilities and long-term home health care.

real estate investments with an insurance policy that provides adequate protection for the home, its contents, and the liability that comes hand-in-hand with property ownership.

Homeowners insurance is insurance that covers a personal residence combined with other personal protections for the owner(s). Most homeowners' policies contain three types of coverage:

1. Structure: cost of rebuilding or repairing the home
2. Contents: cost of replacing personal property that is damaged, destroyed, or stolen
3. Liability: cost to fulfill responsibility for injury to other people on your property or damage caused by family members to others' property

Let's now look at each of these types of coverage separately.

Structure

This portion of your homeowner's policy provides protection for losses that might occur to your house and to other structures attached to your home as a result of specific risks. Some risks that are usually covered include fire or lightning, windstorm or hail, explosion, riot, damage caused by aircraft or vehicles, smoke, vandalism, theft, breakage of glass, or volcanic eruption. Other perils which are often covered include falling objects; weight of ice, snow, or

sleet; collapse of building; leakage or overflow of water or steam from plumbing, heating, or air conditioning systems; cracking, burning, or bulging of a steam or hot water heating system or of appliances for heating water; freezing of plumbing, heating, or air conditioning systems or domestic appliances; and sudden and accidental injury from artificially generated currents to electrical appliances, devices, fixtures, and wiring. Most policies also list **exclusions**, which are not covered by the policy. Some common exclusions are floods, earthquakes, wars, nuclear accidents, and others which may be specified in an individual policy. To cover these exclusions you may have to get additional specialized insurance.



It is very important to have sufficient insurance to rebuild or repair your home. When you buy a home, your mortgage company or bank will require you to have adequate insurance to pay off the loan on the house. However, homes often increase in value so it is important that you evaluate your coverage and upgrade it as property values and construction costs increase.

Contents

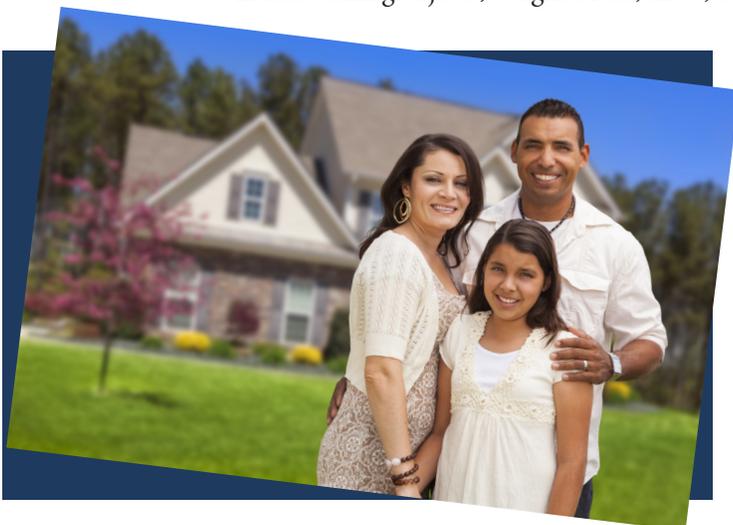
This portion of the policy covers the replacement value of all of the contents within the home that are damaged, destroyed, or stolen because of a covered risk or peril. Typical coverage for the contents of the home ranges from 50 percent to 70 percent of the insured value of the structure to the home. For example, if you have \$300,000 of cover-

Homeowners insurance

Insurance that covers a personal residence combined with other personal protections for the owner(s).

Exclusions

Specific conditions or items that are not covered by the standard insurance policy.





age on the structure of the home you would want \$150,000 to \$210,000 on the contents of the home. This portion of insurance also frequently has coverage limits for jewelry, computers, and musical instruments. To cover these items above the limits, you may need to purchase an endorsement. One nice characteristic of the insurance on contents is that it also covers your possessions outside of your home. For example, if someone stole your luggage while on a trip to Hawaii, you could claim the loss on your insurance.

As part of your insurance program you should have a complete inventory of all of your belongings. In order to compensate you in the case of a disaster, the insurance will need to have reasonable proof of ownership. One easy way to do that is to take detailed pictures of each room in the house. We recommend keeping all receipts for major purchases (TVs, computers, jewelry, cell phones, washer, dryer, refrigerator, lawn mower, suits, wedding dress, etc.). Since you do not want your receipts to burn in a house fire, it would be a good idea to scan them and keep them in the Cloud.

Liability

This covers the cost of damages to others that occur during accidents on your property. For example, if a neighbor slips on your icy walk and breaks his wrist, you are liable to pay for that injury. This portion of the homeowner's insurance also covers damage that you or family members cause to the property of others. For

example, my brother was attempting to jump over the hood of a neighbor's sports car on his skateboard. He didn't quite make it and made quite a dent in the hood that cost quite a bit to repair. My parents' homeowner's insurance covered it after the deductible was paid. Another example: if your daughter kicked a soccer ball through your neighbor's \$1000 plate glass window, your homeowner's policy would cover it, after the deductible was satisfied.

Renter's Insurance

Renter's insurance is often overlooked, especially by students. This policy offers coverage for personal property as well as liability coverage. If you have items in your apartment or house that are worth a lot of money (e.g., electronic equipment), consider purchasing insurance. Typically, renter's insurance is inexpensive for the amount of coverage obtained. When combined with your auto insurance, renter's insurance can be very inexpensive. If your possessions are not worth very much and would be somewhat easy to replace (in comparison to the cost of insurance) then you may not want to have the expense of purchasing renter's insurance.

Summary

Homeowner's insurance is essential for the financial security of those who own homes. It is important to have enough insurance for the structure to be completely rebuilt or to repair your home if it is destroyed or damaged. Because the cost of home construction varies over the years, make sure you update your coverage regularly. Also confirm that personal property insurance covers the replacement cost, not the depreciated market value of the asset. Finally, if you are renting and have any significant possessions, be sure to invest in renters' insurance.

Automobile Insurance

There are 30 million automobile accidents in the United States annually, which equals

Automobile insurance

Insurance against damage to your vehicle, damage to another vehicles, bodily injury, or damage to property resulting from an accident involving a vehicle.

Liability coverage

Auto insurance that pays for losses to others related to bodily injury, property damage, lawsuits, and defense costs.

Medical payment coverage

Auto insurance that pays for accident-related medical costs and funeral expenses incurred by you or your family members within three years of an accident.

Uninsured/ Underinsured motorist coverage

Auto insurance that covers your costs if you are injured in a hit-and-run accident, or injured by an uninsured motorist or a motorist whose insurance is insufficient to pay for your expenses.

Collision coverage

Auto insurance that pays for damage to your car when it is involved in an accident, regardless of who is at fault.

Comprehensive coverage

Auto insurance that protects from risks other than vehicle collision.

about one accident for every five licensed drivers. These accidents result in over \$100 billion in economic losses, two million injuries, and 40,000 deaths.¹³ Because of the frequency of accidents and the magnitude of the losses involved, everyone who owns a car that drives on public roads is required to have some automobile insurance or proof of financial responsibility.

Types of Coverage

There are six basic types of automobile coverage: liability, medical payments, uninsured/underinsured motorist, comprehensive, collision, and no-fault (or Personal Injury Protection – PIP).

Liability coverage is legally required in every state except New Hampshire.¹⁴ It pays for losses to others 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 lamp posts 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 is generally expressed with three numbers that reflect the maximum amount the insurance company will pay for each of the specific types of liability for each accident. For example, if you have

a 100/300/50 liability insurance policy, it means your insurance company will pay up to \$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 cost of the accident exceed these limits, you will be responsible for paying the difference. We recommend limits of at least \$100,000 per person and \$300,000 per accident with at least \$100,000 for property damage.

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 you (the insured) while walking, even though you are not in a vehicle. We recommend a minimum medical payment coverage of \$50,000.

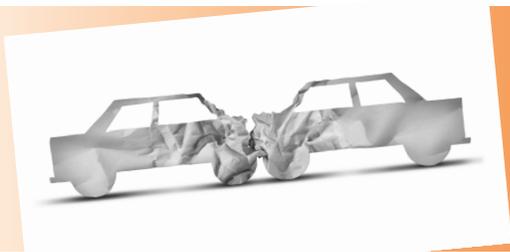
Uninsured (or underinsured) motorist coverage is legally required in many states. It covers your costs if you are injured by an uninsured motorist or if you are injured in a hit-and-run accident. It also covers your costs if the other driver's insurance is insufficient to pay for your expenses (in other words, if the other driver is underinsured). The other driver must be at fault for you to collect on this coverage. We recommend that you keep your uninsured/underinsured insurance coverage the same as your liability coverage.

Collision coverage, unlike liability coverage which pays for losses, pays for damage to your car resulting from any collision with another vehicle or non-living object regardless of whose fault it might be. For example, it covers a two-vehicle impact accident, backing into your brick mail box, hitting the side of your garage, or colliding with a cement pillar in a parking garage. For example, if you get into an accident with another car and it is your fault, your insurance company will pay to fix your car after you pay your deductible.

Comprehensive coverage is also called OTC (other than collision) coverage. It covers



damage to your vehicle that happens because of anything other than a collision. Your comprehensive coverage would cover damage to your car caused by a hailstorm, an earthquake, a lightning strike, a rock in the windshield, or a UFO. This coverage protects you if your car is stolen or vandalized. Surprisingly, it is this comprehensive coverage that pays for damages to your vehicle when you hit a deer, moose, rabbit, dog, giraffe, or other animal. When you get free rock chip repair on your windshield, it is your comprehensive insurance that pays the bill.



No-fault insurance is also called Personal Injury Protection or PIP. It was established as a way to reduce litigation costs. It provides those injured in an accident with direct payment from the company with which they are insured. This eliminates the need for accident victims to establish another's liability, or fault, through a civil lawsuit. As of 2018, twelve states (Arkansas, Delaware, Florida, Hawaii, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, New Jersey, New York, North Dakota, Oregon, Pennsylvania, Texas, Utah, and Washington) and the District of Columbia have no-fault auto insurance laws that in some way restrict the right of parties to file legal suits.

Saving Money on Auto Insurance

Because there are several different possible automobile insurance coverage plans, it is important for you to be able to choose the coverage that best meets your family's needs.

Are all the coverages necessary? For a new car, the answer is most likely yes. For an older car (perhaps more than ten years old), it may be prudent to either raise the deductible on collision and comprehensive or drop the coverage altogether. Raising the deductible reduces the size of your premium but increases your out-of-pocket cost in the event of an accident.

REDUCING YOUR AUTO INSURANCE PREMIUM

There are things you can do to lower the cost of automobile insurance for your family. Companies may differ in what premium discounts they offer, but the following are some common discounts:

- Completing a driver training program
- Maintaining a certain GPA level
- Maintaining a great credit score
- Participating in a carpool
- Driving fewer than a certain number of miles per year
- Insuring two or more vehicles with the same company
- Establishing a safe driving record
- Bundling with other types of insurance products like homeowner's insurance

On the other hand, premium rates may rise due to the following:

- Age (teenagers are expensive)
- Sex (males are more expensive than females)
- Marital status (it's good to be married!)
- Where you live (New York City costs more than Nephi, Utah)
- What the vehicle is primarily used for (higher rates for heavier usage)
- Accidents or tickets (if you do get a ticket, go to traffic school to get them off your record)

No-fault insurance (Personal Injury Protection)

Auto insurance where those injured in an accident receive direct payment from the company with which they are insured, eliminating the need for accident victims to establish another's liability through a civil lawsuit





- Type of vehicle (a Ferrari costs more than a Toyota Camry)

Basically, don't be a nineteen-year-old, single male in New York City driving a Ferrari!

Here are some additional tips for keeping your automobile insurance costs down:

- Shop comparatively – look online at www.netquote.com or www.carinsurance.com
- Consider only high-quality insurance companies
- Make use of all available discounts
- Buy vehicles that are inexpensive to insure
- Drive defensively
- Be cautious of allowing others to drive your car
- Improve your credit score
- Review your insurance coverage on a regular basis

Summary

Insurance allows you to protect yourself and your family against catastrophic loss. Now that you have completed this chapter, it is our hope that you are more familiar with key aspects of insurance (managing risk, premiums and deductibles, etc.) and with different types of insurance policies. Having this basic understanding will help you make informed

decisions about which policies are best for your family's financial situation. Obtaining the insurance that is best for you and your family will bring an added dimension of security, peace, and joy to your home. It is essential for living joyfully within your means.

Other Resources

- ➔ <https://www.healthcare.gov/>
- ➔ <http://www.ehealthinsurance.com>
- ➔ <http://kff.org/health-reform/>
- ➔ <http://www.carinsurance.com/>
- ➔ <http://www.netquote.com/>
- ➔ <http://www.term4sale.com/>

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 14. "Car Insurance Requirements by State," http://www.cars.com/go/advice/Story.jsp?section=ins&subject=ins_req&story=state-insurance-requirements



7



Understanding and Financing Major Family Purchases: Buying a Car

Sweetheart, we need a four-wheel-drive truck.”
She asked, “Why do you think we need a new truck?”

He answered her question with what he believed was the perfect response: “What if we needed milk for our children in a terrible storm, and the only way I could get to the grocery store was in a pickup?”

His wife replied with a smile, “If we buy a new truck, we will not have money for milk—so why worry about getting to the store in an emergency!”

—David A. Bednar¹

All families have transportation needs: you have to travel to work; you have to travel to school; you have to travel to Church; you have to travel on vacations. The choices you make to meet those transportation needs will make a big difference in your financial situation and determine whether or not you are a wise financial consumer.

I made several mistakes the first time I bought a car. In 1979, Juanita and I were expecting our second child and we needed more reliable transportation than the 1960 Chevrolet Malibu station

LEARN

- To buy a car that fits the needs and financial situation of your family
- That buying and financing a car that is too expensive for your budget can be a heavy burden on your financial health and family goals

wagon that we owned at the time. In purchasing this vehicle, we made numerous mistakes but we did do one thing right: we avoided debt by “paying our car payment in advance to ourselves” each month. We saved \$7,500 so that we could pay cash for the car. But then the mistakes came!

My first mistake was not bringing Juanita with me to the car lot. I went alone and was totally captivated by the first car I saw: a sporty-looking two-door Chevrolet Monza with only 7,000 miles on it. Had Juanita been with me, she would have helped me understand how difficult it would be to put a car seat in the back of that vehicle.



Then I drove the car. Wow! It had powerful engine pick up and was fun to drive. I wanted that car. I noticed the sticker price in the window was \$7,500. Divine intervention! I had found my car! Not! My second mistake was failing to test drive other cars in that car lot and failing to investigate options in other car lots. I was in too much of a hurry. I excitedly told the sales person what a blessing it was that the asking price was exactly what we had saved. He said with a grin, “Then you can drive it home today!” I went into the sales office, signed the sales contract, and gave him a check.

Here I made the next two mistakes. First, I didn’t check the bluebook value of the car. In my defense, in those days you had to go to the library and look up the bluebook value with a big blue book that was in the reference section.

Still, I didn’t do it! I later found out that the car I bought for \$7,500 had cost \$7,000 new, the year before! I felt so dumb. My second mistake was that I didn’t go home to talk about the decision with Juanita. You should never make a major financial decision without getting a good meal, talking about it with your spouse, comparing alternatives, making a joint decision, and sleeping on it.

The next and, thankfully, last mistake was that I hadn’t included taxes, licensing, and registration in the amount I had saved. I paid cash for the car, but things were tight for several months in our budget because I had neglected to account for the total cost of that car.

I hope you learn from my mistakes—which probably cost us about \$2,000 and some family stress. I do need to tell the rest of the story to show that I am not entirely a dork. Juanita and I drove that car for 120,000 miles in six years. I changed the oil religiously every 3,000 miles. I performed all of the scheduled maintenance. We never had a single mechanical problem. Even though I had been foolish on the front end, I was wise on the back end and our 1979 Chevrolet Monza ended up as a good investment.

Buying a Car

This chapter will address principles of effective car ownership, ways to finance a car, the decision to buy new or used, and the purchasing process so that you can live joyfully within your means.

Principles of Effective Car Ownership

Here are three principles of effective car ownership.

1. **Understand why you are buying a car.** Ideally, your purpose should be to provide safe, dependable transportation in a cost-effective manner. Your purpose should not be based on what others will think of you. Trying to buy a car that is too expensive so that you can look good

to others or have a “better” car than your friends is also a poor reason to buy a car. The car you drive does not define who you are as a person and having a dependable, cost-effective vehicle should be your goal. Realize that a car is a tool to achieve your other goals, not necessarily a goal in and of itself. With this in mind, not every person in every circumstance needs a car. For example, it may be more cost effective for a student to avoid the cost of car ownership and use the a car sharing program or to ride the bus.



2. Understand the total cost of owning the car. This includes depreciation of the value of the car (which is most significant when you buy a new car), taxes, licensing, fees, insurance premiums, financing charges, fuel costs, scheduled maintenance, and repairs. After determining the total cost of car ownership, you should also consider the opportunity cost—the potentially greater value of other things you could have purchased with the money you spent on the car. The website www.edmunds.com/tco.html provides an easy tool to calculate the total five-year cost of owning most new and used cars.

3. Be a wise manager of your resources: take care of your car. This means that you do the necessary repairs when needed and perform the maintenance on schedule to ensure that the car will last for many years. The most important thing you can do to maintain your car is to change your oil on time, every time.

Total Cost to Own a Car

On their website, www.edmunds.com/tco.html, Edmunds enables you to project the total typical cost of owning a particular car for five years. Whether or not you use the Edmunds website, their methodology is helpful to illustrate all of the different costs that quickly add up when you own a car. Edmunds uses the following seven factors:

- Depreciation: how much value the car loses each year
- Interest on financing: the amount of interest paid over five years
- Taxes and fees: the total of all sales tax, fees, and registry costs each year
- Insurance premiums: the average cost of insuring the car
- Fuel: how much you have to pay for the type of fuel that the car requires: regular gasoline, premium gasoline, or diesel fuel
- Maintenance: the total cost of performing all the scheduled maintenance found in the vehicle's owner's manual
- Repairs: the projected cost of fixing common mechanical problems for this vehicle



While skipping a scheduled maintenance may save you money short-term, in the long run it may result in higher maintenance and repair costs. It can also be dangerous.

If you view a car as a tool to help you achieve other more important goals, you will make better decisions when purchasing your car.



How to Finance a Car

Cash (least expensive). Buying a car with cash is the least expensive purchasing option,

if you can afford it, because you pay no interest and avoid debt. The easiest way to do this is to “pay your car payment to yourself each month.” If there is no pressure to purchase a car by a specific date, you can invest this money in stock-based mutual funds and, on average, earn a good return. However, with stocks there is always a risk that you will lose money in a down market for a few years. If you must have the car you are saving for by a particular date, it is best to save the money in the bank. For some emerging adults, saving enough ahead of time may be implausible. It may be necessary to get a loan.



Lease

Long-term renting with a number of conditions.

Depreciate

To lose value over time.

Loan (next best). If you decide to take out a loan to buy a car, the first principle is to make as large of a down payment as you can reasonably afford. This will reduce the amount of money you spend on interest. Next, remember that banks and credit unions will charge different interest rates than the dealer will charge. Financing provided through the dealership is usually the most expensive type of financing, so compare interest rates on auto loans from multiple institutions before you purchase a car. When comparing different loans, look at the term of the loan, the interest rate, and the fees. 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. Also, realize that nearly all costs are negotiable.

Lease (“lease”st best, i.e., worst). Leasing (or long-term renting) has become a popular way to acquire a new vehicle. About 25 percent of all new vehicles are leased rather than purchased outright.² In fact, you may have noticed that an increasing number of car ads give

prices in terms of leasing rather than buying. Carefully compare the cost of buying (including the interest associated with a loan) and leasing over time. See www.consumerreports.org/cro/2012/12/buying-vs-leasing-basics/index.htm³ for a great comparison of buying versus leasing. One of the biggest drawbacks to leasing is that you do not actually own the car and therefore do not have full freedom with it (when you can sell, how many miles you drive, customization, etc.). Most leases have a mileage cap, beyond which you may have to pay \$0.20 or \$0.25 per mile. This can be very expensive if you unexpectedly need to drive more often. Also, your leasing rate, like the interest you’d pay when buying a car, will be affected by your credit score. In summary, you generally come out money ahead if you buy rather than lease. The website <http://www.daveramsey.com/article/drive-free/> includes a six-minute video by Dave Ramsey entitled “Drive Free, Retire Rich.” This video explains how paying yourself first and buying a car with cash can save you thousands in interest, provide free cars for life, and make you a millionaire.

In summary, you generally come out ahead financially if you buy rather than lease and pay cash rather than take out a loan. Planning ahead and saving for an auto purchase can make a large difference in your financial well-being.

Buying New vs. Buying Used

A car loses some of its value the second you drive it off the lot, sometimes thousands of dollars! It is generally most economical to buy a car that is two to three years old because, by that point, it has already **depreciated** significantly but still has most of its useful life ahead. (See Table 7.1 for a typical depreciation schedule.) If you choose to buy a used car, you must be cautious as you evaluate the potential options. The nice thing about a brand new car is that you know it should be in perfect condition. Although you never quite know what you’re getting into when you purchase a used car, there are multiple steps you can take to

Table 7.1 Sample Depreciation Schedule of a Typical Vehicle

Period	Percentage	Depreciation Value	Residual	Loss in Most Recent Period
12 Months		25%	75%	25%
24 Months		40%	60%	15%
36 Months		50%	50%	10%
48 Months		58%	42%	8%
60 Months		64%	36%	6%
72 Months		69%	31%	5%

lower your chances of buying a lemon. Table 7.1 demonstrates that the depreciation of a new car is most rapid during the first two years of ownership. It is therefore generally most cost effective to buy a two- or three-year old car with low mileage.

Here are four bits of advice for buying a used car.

- 1. Contact the seller:** Create a list of questions before calling the seller, then use those questions to decide whether or not 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. Also check carfax.com.
- 2. Verify the vehicle history:** Ask for and verify information about previous owners. On www.carfax.com, you can determine the following information: number of previous owners, where each owner purchased the car, accident history, repair history, and maintenance history. To obtain this information, you must input the vehicle's VIN number on the site and pay a fee. CARFAX will then give you a detailed vehicle history, including mileage listed on the odometer and a title check to ensure that the vehicle was
- 3. Determine a fair price:** Know the blue book price (kbb.com) for the car you are calling about. The high blue book price is what you would likely pay for the car on a lot. The low blue book price is what you would expect to pay from a private party. If possible, come to an agreement with the seller on the quality of the vehicle (fair, good, or excellent) before you see the car. Coming to this agreement will allow you to determine a fair price beforehand.
- 4. Inspect the vehicle carefully:** When you see the car, note your first impressions. Does the car appear to be well cared for? Have a mechanic do a thorough inspection of the car before laying any money down. This could save you from some nasty surprises after it is too late to change your mind.

Don't use the all-too-common excuse that you don't know what you are getting when purchasing a used vehicle and therefore need to purchase a new vehicle. By following these steps, you can have more confidence in knowing you are buying a quality used vehicle. Allowing someone else to buy new and take the hit on depreciation so that you can purchase the car at a steep discount will free up money in other areas so that you can more

easily reach your financial goals. Bottom line: buying a quality used vehicle is smart.

The Purchasing Process

First, decide upon your financing plan before you go looking for a car. Know your family's financial goals, what kind of car would help you achieve those goals, and how much of your budget you would like to put towards car payments. Do not be swayed from your budget by the emotion you feel when you find a car you really want!

On today's college campuses you can easily find students (even those living on student loans) who drive expensive cars. As discussed earlier, buying a car that is too expensive for your current situation is due to comparing yourself to others and feeling that you are defined by what you drive. I have seen many new faculty members who are driving old, beat-up cars (like my 1999 Honda Civic I pur-

chased with cash for \$3200) while their students are driving vehicles over \$20,000. Every dollar spent on that more expensive car is a dollar you can't spend somewhere else. Know your financial goals and the purpose of owning a car and buy accordingly.

Second, it is critical that you comparison shop. You should compare prices, features, and quality to find out exactly what you want. Be informed. Go to car dealerships and look around online.⁴ As you look at different cars, determine what is available in your price range and budget. Choose a couple of makes and models based on your financial goals. Look at the pros, cons, and reviews for these vehicles. What is the total cost of each for a 2–3 year old model? Once you've narrowed the choices, test drive the exact vehicles you are considering. Do not buy any car without test driving it first. When making your final decision, it is critical that you remember to make your car fit your budget. Don't make your budget fit your car.

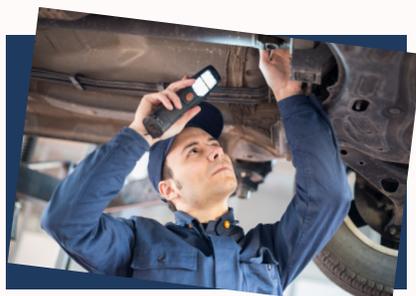
Once you have found the car you want to buy, negotiate a deal. Know the fair market value of the car and decide how much you can spend beforehand, then negotiate politely. Only enter into negotiations with a salesperson who makes you feel comfortable and who can make a deal. If you plan to pay in cash, let the seller know. Cash can do wonders for an agreement. 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 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.

Don't be afraid to walk away if you're not getting anywhere; you don't have to buy the car. Leave if you get tired, hungry, or angry, or if you feel pressured. Don't be hurried into

My Friend's Mistake

By Dr. E. Jeffrey Hill

A close friend of mine made a big mistake when he bought a sweet-looking truck from a car lot. He saw the truck and fell in love with it. The salesperson talked it up. The price was \$12,900—about \$1,000 under the blue book value. This was a bigtime deal. Then the salesperson said he'd lower the price by another \$1,500 if my friend would buy today and take the responsibility of getting it inspected and licensed. My friend bought the truck on the spot. When I saw the beautiful truck, I asked my friend if he had run the CARFAX Report on it. He had not, and when we ran it, we were amazed to see that this truck had been sold and re-sold six times in five different states, including Hawaii. It did not pass the safety inspection because of electrical problems (which had always been with this truck). My friend tried to take the truck back, but the dealership wouldn't take it. To make a long story short, \$6,000 and three major repairs later, my friend had a great truck. His total price: \$17,400 . . . only \$3,500 ABOVE the blue book value. Take it from my friend: when you buy a used car, get the CARFAX Report and have it checked out by a mechanic first!



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. If the seller cannot meet your price (that you predetermined you could afford), walk away.

Avoid buying a car under pressure like the plague.

Finally, 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 3,000 miles. Don't ignore warning signals when your car doesn't work as it should. When a light illuminates on the dashboard, find out what it means and take care of it. When problems arise, get them fixed. Find a good garage with well-trained and experienced mechanics and let them take good care of your vehicle. Then enjoy the ride!

Summary

In this chapter, we learned principles of effective car ownership. We learned about different financing options, and we discussed buying new versus buying used. We learned what to do before, during, and after purchasing your car. We learned that the most cost-effective way to purchase a car is to pay cash for a two- to three-year-old vehicle with low mileage and no mechanical problems.

Wisely handling the automobile purchase decision will contribute significantly to your wise financial management. It will help you live joyfully within your means. We hope that the important financial decision of buying a car now seems less intimidating and more exciting!

Other Resources

- ➔ www.carfax.com
- ➔ www.cargurus.com
- ➔ www.consumerreports.org/cro/2012/12/buying-vs-leasing-basics/index.htm
- ➔ www.edmunds.com
- ➔ www.kbb.com

How to Buy a Car

Before you make an offer

1. Develop an excellent credit score
2. Find cars you might want on websites such as www.cars.com or www.autotrader.com
3. Ask sellers several questions to determine the condition of each car
4. Run the CARFAX Reports at www.carfax.com
5. Determine five-year costs to own at www.edmunds.com
6. Determine fair prices at www.kbb.com
7. Decide which car to make an offer on

Making an offer and buying the car

1. Make a reasonable offer slightly below the fair price
2. Negotiate and agree to a price with seller
3. Take the car to a mechanic for a thorough inspection (if needed)
4. Obtain financing if needed (shop around, credit unions are often best)
5. Read and then sign the sales contract (no grace period)
6. Pay for the car, get the title, and drive away

Immediately after you buy the car

1. Add the car to your insurance policy
2. Go to the DMV
 - Pay license
 - Pay registration
 - Pay sales tax
3. Enjoy your car!

Notes

1. David A. Bednar, "Bear Up Their Burdens with Ease," (April 2014), <https://www.lds.org/general-conference/2014/04/bear-up-their-burdens-with-ease?lang=eng>.
2. <http://www.edmunds.com/about/press/leasing-is-shifting-the-new-car-market-but-it-isnt-the-best-choice-for-everyone-says-edmundscom.html>
3. www.consumerreports.org/cro/2012/12/buying-vs-leasing-basics/index.htm
4. www.craigslist.com; www.cargurus.com ; www.carmax.com; www.edmunds.com; cars.com; and autotrader.com are a few online sites.



Avoid buying a car under pressure like the plague!



8



Understanding and Financing Major Family Purchases: Buying a Home

There is nothing to compare with a young couple's feelings when they step across the threshold into the entryway of their first home. Generally, there have been a few years of financial challenges and sacrifice to save for the down payment. The young family has probably been living in a small apartment and coping with neighbors on either side of them, and often above and below them as well. Now the time has arrived to enter their own home. It seems so expansive. The yard looks beautiful. They are excited to start mowing their own lawn and planting flowers in their own yard.

"Be it ever so humble, there's no place like home." — John Howard Payne¹

If this couple has planned wisely and purchased a modest home within their means, it is likely this place of abode can be all they dreamed. However, if the couple has purchased an extravagant home beyond their means, this place may precipitate

LEARN

- To buy a home that fits the needs and financial situation of your family
- About different types of mortgage loans
- That buying a house that is too expensive can be a heavy burden on your financial health and family goals



financial ruin and family conflict, becoming a money pit. In this chapter, we want to provide financial information so that when the time comes for you to purchase a home, you will choose wisely.

“A house is a hole in the middle of land that you pour money into.” — Bryan Sudweeks²

Buying a home is not easy, and this purchase will likely be among the largest financial commitments you will ever make. You should not rush your decisions in these weighty matters. If you use wisdom and judgment in trying to decide what you *need*, what you *want*, and what you can *afford*, you will make wise decisions regarding your transportation and housing needs.

Buying a Home

Buying a home could be the biggest financial decision your family will ever make—so be wise. Everyone needs a roof over his or her head; the key is to be financially prudent.

There are many risks associated with purchasing a home. There are financial risks if you purchase too expensive a home, particularly if the housing market goes down. In fact, I believe the biggest financial mistake that young couples right out of college make is to purchase a home that is too big, costs too much, and has too large a payment. When a couple does that, other financial goals cannot be realized because of the large house payment. The couple becomes cash starved and unable to save. There is the added temptation if the value of the home goes up to get home equity loans to furnish and maintain the home. In this case, marriages and families may suffer from the added strain.

There are also skills risks if you purchase a “fixer-upper” at a low price, but you do not have the skills to maintain, repair, and/or remodel that home. And there is always the



risk of buying a home in an iffy neighborhood and becoming stuck there for many years.

At the same time, there are many benefits of purchasing the right home in the right neighborhood. A home can be a great financial investment. For example, my dad purchased a home overlooking Monterey Bay fifty years ago. In that time the home value increased 4000%!



Gordon B. Hinckley gave excellent home-buying counsel: “I recognize that it may be necessary to borrow to get 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 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.*”³

Please consider this chapter carefully so that you purchase the right home, at the right price, in the right neighborhood to bless your family.

Table 8.1 Advantages and Disadvantages of Housing Options

<i>Housing Option</i>	<i>Advantages</i>	<i>Disadvantages</i>
Renting	Easy and inexpensive to move No costs for repairs or maintenance Lower financial commitments One rent bill	Lack of stability (you may have to move at the end of the rental period) Lack of pride associated with ownership No modifications or renovations can be made Possibility for monthly payment to increase Restrictions on where you can rent because of zoning No tax benefits No potential for property appreciation Less privacy
Buying	Pride associated with ownership Permanence and security You can make modifications Unchanging monthly payment You can own the house using borrowed money Interest payments on a home are tax deductible You can borrow against the equity of your home	Low mobility—houses are not liquid Significant upfront costs (down payment, closing costs) Costs more to own and operate (repairs, utilities, landscaping, etc.) The home's value could decrease Large financial commitment Risk of losing your home
Building	All advantages of buying plus the following: Customization—exactly how you want it Sometimes cheaper than buying New appliances—few repairs in the first years Location of your choice Asset you can pass on to family members Potential for property appreciation	All disadvantages of buying plus the following: Difficult to interpret building plans Often exceeds original budget Often has delays Construction loan interest and renting costs during the building process High stress
Renovating	All the advantages of buying plus the following: Faster than building Some customization Cheaper—especially if you can do some of the work Can often stay in your home during the renovation	All of the disadvantages of buying plus the following: Could be more expensive than building Often over budget Frequent delays Additional unexpected expenses (yard, fencing, etc.) Construction loan interest and renting costs during the building process May encounter additional problems that were not noted before High stress

Housing Options

Every family needs a roof over its head, but there are many options to meet that goal. Will you rent, buy, build, or remodel? Each option has various advantages and disadvantages that are important to think about when considering your family's needs.

A key factor in the decision between renting and buying, building or renovating is the length of time you expect to be in the home. If you expect to be in a location for less than

three years it is almost always wise financially to rent instead of buying. If you expect to be in a location for more than five years it is almost always wise financially to buy instead of rent. If you expect to be in a location three to five years, either one could be optimal depending on the housing market. The exception to this might be the ability to purchase a home at low cost (usually a “fixer-upper”) and then add considerable value (especially if you do a lot of the work yourself).

Cost of Housing

Your monthly mortgage payment will typically be between 20 to 35 percent of your household budget. However, the difference in the cost of housing is largely based on where you live. For example, the median income for both Kokomo, IN and Los Angeles, CA is similar, but the median home price is \$88,000 in Kokomo and \$300,000 in Los Angeles! See Table 8.2 for the cost of housing in various regions from 1990 to 2015.

HOW MUCH HOUSE YOU CAN AFFORD

In order to figure out how much you can afford to spend on a home purchase, it is critical that you know your affordability ratios, or how much debt the bank thinks you can handle.

There are two main ratios: the housing-expense ratio (or front-end ratio) and the debt-obligations ratio (or back-end ratio). Your front-end ratio 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 a much greater chance that 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 twelve months, e.g., car payments, student loans, alimony payments, credit cards, etc.), all 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.

One of the worst financial mistakes you can make is to buy a home that is too expensive. When you go to the bank to apply for a mortgage loan, they will ask you to declare all your debts. Being house-rich and cash-poor



Table 8.2 Cost of Housing in the United States and by Region from 1990 to 2015

Year	U.S.	Northeast	Midwest	South	West
1990	\$122,900	\$159,000	\$107,900	\$99,000	\$147,500
1995	\$133,900	\$180,000	\$134,000	\$124,500	\$141,000
2000	\$169,000	\$227,400	\$169,700	\$148,000	\$196,400
2005	\$240,900	\$343,800	\$216,900	\$197,300	\$332,600
2010	\$221,800	\$329,900	\$197,700	\$196,800	\$259,300
2015	\$294,200	\$442,800	\$276,700	\$271,500	\$348,500
Percentage Change from 1990 to 2010	139%	178%	156%	174%	136%

occurs when your debt ratios go above the recommended limits and you are stretched to be able to make your mortgage payment. You can avoid this by calculating beforehand which mortgages you can afford and buying a house accordingly.

Avoid being house-rich and cash-poor like the plague.

Owning a home free of debt is an important goal of provident living, although it may not be a realistic possibility for some.

A mortgage on a home leaves a family unprotected against severe financial storms. Homes that are free and clear of mortgages and liens cannot be foreclosed on. When there are good financial times, it is the most opportune time to retire our debts and pay installments in advance. It is a truth that "the borrower is servant to the lender."

—James E. Faust⁴

Steps to Buying a Home

The most important things to remember as you engage in the process of buying a home are to take your time, do your homework, and avoid rushing into anything. Neglecting to do these things could easily leave you and your family stuck with a home that is above your financial capacity or below your desires and expectations.”

We have outlined nine steps to buying a home.

Before beginning to make offers on homes, complete the following three steps:

1. Carefully examine your monthly budget to determine how much you can afford to spend on housing.

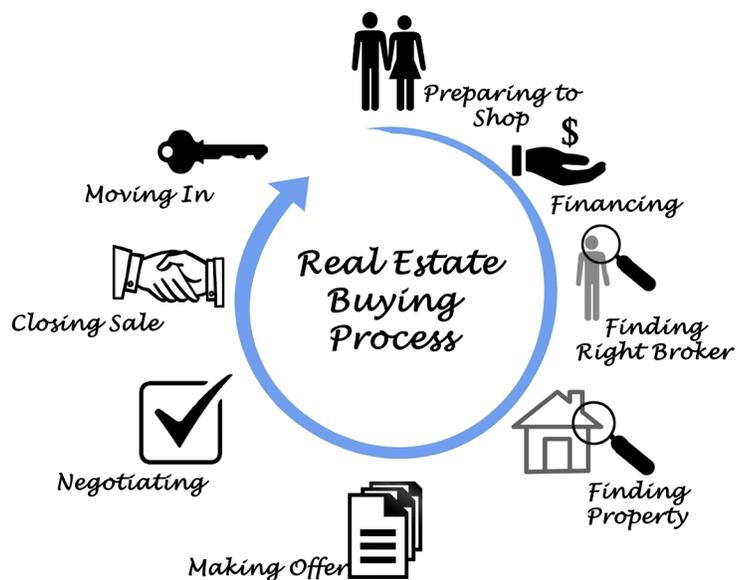
2. Go to a lender (bank, credit union, mortgage company, etc.) and pre-qualify for a loan. In this process, the lender will help you determine the mortgages that are in your price range.
3. Determine what you are looking for. How big do you want your home and yard to be? How many bedrooms and bathrooms would you like to have? What neighborhood would you like to live in? How near would you like to be (commute time) to work, school, church, or grocery stores?



Avoid being house-rich and cash-poor like the plague!

Once you have determined the above factors, you are ready to go house hunting!

4. 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 realtor who knows the neighborhood. Get a good appraiser who can help you make sure you don't pay too much for a house. Get a good realtor who knows the community and neighborhoods. Look for someone who works in realty full-time because they usually have more contacts, knowledge, experience, and determination than part-time realtors. Choosing a good lender is also important. The lender orders the appraisal to make sure you don't pay too much for the



house and organizes the closing attorney who will fill out the correct forms. You should also get a good home inspector because the last thing you want to do is buy someone else's problems.

5. Look at many different homes. There are websites that have excellent home search capabilities, such as zillow.com and realtor.com . Friends and relatives might also be able to refer you to people who are selling.

6. 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. This is the time to shop for the best lender who has the lowest fees, best APR, and best customer service. Earlier, we discussed

Home Buying Lessons I Learned in Atlanta

By Dr. E. Jeffrey Hill

I learned the hard way that buying the right home in the right neighborhood at the right price takes time. It cannot be rushed.

In ancient times, just after writing was invented, I got a great promotion at IBM with a 30 percent raise that required us to relocate to Atlanta, Georgia. IBM flew Juanita and me out for a week of house hunting. We made a goal to be prayerful and diligent, and to make a home-buying decision by the end of the week. It was a mistake to give ourselves this hard deadline.

On Monday, we looked at many houses for sale by owner to try to avoid the real estate commission and perhaps find a better deal. Most of these houses were not appealing, but we found one that we liked quite a bit. It had a large, open floor plan with four large bedrooms. The lot was a flat half acre with lots of play area, and it was located about four miles from my new office. The cost was \$75,000.

The rest of the week, we went out with a very pleasant real estate agent. She carefully asked us questions to find out what we were looking for. By Thursday, we had looked at several dozen homes, but only one home was as nice as the first "by owner" home that we liked so much. This second home had all of the same features as the first, except the price was \$89,500, and it was seven miles from my new office instead of four.

We decided to look at each of these homes again on Friday and then make a final decision that evening in order to meet our goal of purchasing our home before flying out on Saturday. On Thursday evening and all day Friday, we called the first "by owner" home, but no one answered. (This was LONG before cell phones.) We left several messages. On Friday evening, to meet our goal, we made an offer of \$87,000 on the second home. Immediately, the owners made a counter offer of \$89,000 and said it was their final offer. We didn't want to risk losing the home, so we accepted the offer.

The owners of the first "by owner" home called us back on Monday and were ready to sell us the home at a cost even below \$75,000. However, we felt committed to the second home since we had signed a contract and put down \$1,000 in earnest money.

This whole scenario was full of poor choices. The biggest poor choice was that we rushed the decision. Let me weep a bit as I tell you some of the consequences of that poor decision. First, we paid about \$15,000 too much for the home. We later found out that that was the highest amount anyone had ever paid for a house in that subdivision. Second, the home we purchased was three miles further from my office, but I later found that with the horrendous traffic, these three miles added fifteen minutes each way to my commute. Finally, we recognized that we had made a mistake just a few days after we signed the papers. It would have been better to get out of our contract, forfeit the earnest money, and then purchase the first home.

The moral of this story is to take your time when you purchase a home. Never rush into it. And if you make a poor choice, it is better to get out of the contract (perhaps forfeiting the earnest money) than to continue on.





getting pre-qualified to find out how much you qualified for. Now you want to get pre-approved, which is a commitment from the lender to lend you the money. The lender will need to pull your credit and gather some additional information from you. Because borrowers are expected to shop for the best loan and because each credit pull for the same loan should not hurt your credit, each lender can pull your credit and it will only count as being pulled once. The lender should help you determine whether you qualify for and should consider a conventional loan (requires a 5% down payment), an FHA loan (government loans, requires a 3% down payment), a USDA Rural Housing loan (lend up to 100% of the home, requiring a 0% down payment), or a VA loan (if in the military). The most common loans are FHA and conventional loans. It is VERY important to shop lenders because it won't hurt your credit and because buying a home is the largest purchase you will likely have in your life. We recommend you get a quote from a smaller local bank, a credit union, a larger national bank, and a mortgage company. Also be advised that the golden down payment is 20 percent—at that point you avoid private mortgage insurance (PMI) and save on your monthly payment.

In home buying, there is something called “points.” One **point** is equal to one percent of the loan value (two points on a \$200,000 loan would be \$4,000). Points are paid at closing by

the borrower to the lender in order to reduce the interest rate on the loan. For example, the interest on a \$200,000 loan might be 4.5% without points, 4.1% with one point, and 3.7% with two points. You are generally wise to pay for points for a lower interest rate when you plan to have the mortgage long enough to recover the expense. Work with the lender to determine which interest rate is in your best interest.

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. These costs are included in the closing costs.

7. Once you have found a house you are interested in, contact the seller of the home, either directly (if not using a realtor) or through the realtor, and make a written offer of purchase price with a statement of your intent to make an earnest money deposit.
8. The seller may reject your offer and counteroffer with a higher price. Negotiating the price of a home is a process that may take two or three iterations. One common strategy is for the buyer and seller to meet halfway between the asking price and the first counter-offer.
9. Once the contract has been agreed upon, both parties (buyer and seller) sign it. You now make an earnest money deposit, which is an amount held in escrow to be

Point

Equal to one percent of the mortgage loan value, points are paid to the lender in exchange for a lower interest rate.



given to the seller if you back out of the contract. This is why it is very important to be sure about your decision before purchasing the home. If you stay with your purchase and don't back out of the contract, the earnest money is applied toward the purchase price.

Mortgage Financing

Most of us do not have enough money at one time to pay cash for a house, so we must borrow money. A **mortgage** is a loan from a lending institution (bank, credit union, mortgage company, etc.) in which the home or property serves as the loan collateral. Your credit score (and that of your spouse) will affect the interest rate of your mortgage.

In order to determine if you are ready to purchase a home, the lender will require various documents. Most loans require that you have worked for at least two years in the same line of work (higher education counts toward these two years). For example, an individual who just graduated in accounting and has a new accounting job with a salary will qualify



for a loan because they have been in their “line of work” for the last two years. Other items the lender looks for are good credit, value of assets (for down payment, closing costs, etc.), two years of tax returns, three months of bank statements, the last two pay stubs, and your other liabilities (found on your credit report).

At the end of 2017, the amount of residential mortgage debt in the United States was more than \$14.7 trillion.⁵ Assuming a United States population of about 327 million people, this equates to about \$44,950 of mortgage debt *per capita* (i.e. for every man, woman, and child). Although mortgage debt is often necessary, too many people do not get out of debt as quickly as they could. Do not drag out your loan for longer than is necessary. For example, your family may consider a fifteen-year mortgage instead of a thirty-year mortgage (see Table 8.3).

Table 8.4 shows an example of the money you could save by getting a fifteen-year loan. Not only does a fifteen-year loan enable you to save interest money, you also get out of debt more quickly.

The following are some key terms and principles relating to mortgages that you should be familiar with before buying a home:

Amortization is simply the process of determining the amount and frequency of equal payments that will gradually repay a loan (including principal and interest) over the length of the loan. The homeowner can drop the mortgage insurance once their balance drops below 80 percent of the purchase price.

During the early years of a mortgage loan, the vast majority of the monthly payment goes

Mortgage

A loan in which the home serves as loan collateral.

Amortization

The amount and frequency of equal payments that will gradually repay a loan (including principal and interest) over the length of the loan.

Table 8.3 Fifteen-Year vs. Thirty-Year Mortgage

15-Year	30-Year
Higher monthly payments	Lower monthly payments
Lower interest rate	Higher interest rate
Lower total cost	Higher total cost
Automatic savings	Savings only if you prepay

Table 8.4 Fifteen-Year vs. Thirty-Year Mortgage Example

15-Year	30-Year
Loan Amount: \$300,000	Loan Amount: \$300,000
Amortization Period: 15 years	Amortization Period: 30 years
Interest Rate: 3.19%	Interest Rate: 3.95%
Monthly Payment: \$2,099	Monthly Payment: \$1,423
Total Interest: \$77,868	Total Interest: \$212,500
Difference in total amount of interest paid is \$134,632!	



to interest, not to principal. For example, the payment on a \$200,000 30-year mortgage at 4.5 percent will be \$1,013.37, of which \$750 will be interest and \$263.37 will be principal. The first year of the loan, the effective interest rate paid is 278 percent! Even five years later the owner will be paying \$684.92 to interest and \$328.45 to principal. The owner won't be paying more to principal than interest until 14.66 years into the loan (assuming they didn't refinance).

As you can see, most of the monthly payment goes to interest during the first half of the loan. One major issue is that people tend to refinance their home within 10 years of purchase or they move and purchase a new home with a new 30-year mortgage. This effectively causes them to pay much more to interest than if they paid off their mortgage in 30 years or less. The interest portion of the monthly payment is calculated by multiplying the loan balance by the monthly rate of interest. The principal portion of the monthly payment is calculated by subtracting the interest portion from the monthly payment.

Mortgage insurance is usually required

when the buyer of the home borrows more than 80 percent of the purchase price (20 percent is the golden down payment amount). This happens when the buyer makes a cash down payment of less than 20 percent of the purchase price. A lender takes greater risk in lending more than 80 percent of the purchase price to the homebuyer, as homeowners with less equity are more likely to default on the loan.

Payment Reduction Techniques

Joe J. Christensen warned, “How much house do we really need to accommodate our family comfortably? We should not endanger ourselves . . . economically by acquiring homes which are ostentatious, feed our vanity, and go far beyond our needs.”⁶

The principal amount of a loan will not change. However, there are things you can do to reduce the interest portion of the payments. Table 8.5 gives five common ways to reduce total interest paid to the lender over the life of the mortgage loan.

Mortgage Menu

Now that you are familiar with what a mortgage is, let's learn about different types of mortgages. But first, there are four key concepts that should guide your decision of how to finance a home.

1. Your time horizon: How long do you expect to have the mortgage, and how certain are you of that time horizon?

Table 8.5 Mortgage Interest Reduction Techniques

<i>Techniques</i>	<i>Benefits</i>
Make a larger down payment	Reduces the initial loan amount
Have a good credit score	You qualify for a lower interest rate
Pay points	You get a lower interest rate
Shorten the length of the mortgage	You will have a lower interest rate and will pay less interest installments
Pay more than the normal monthly amount	Every extra dollar paid goes directly to principal (loan) reduction, which shortens the length of the loan and the total interest paid

Fixed rate mortgage

A loan which has a constant (or fixed) interest rate throughout the life of the contract. Monthly PI (principal and interest) remains fixed the duration of the loan.

Adjustable rate mortgage (ARM)

A loan which allows the interest rate to rise or fall with changes in mortgage interest rates.

Balloon mortgages

Mortgages where all remaining principal is due a certain number of years into the contract.

Graduated payment mortgages (GPM)

Mortgages with lower initial payments that increase over time.

Refinance

To finance a home again with a new loan and a new interest rate, must pay off old loan and closing costs.

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? Where are interest rates now? Where do you expect them to go?
4. Your income and work status: Are you low income? Are you or have you been a member of the armed forces? If so, you may qualify for special mortgage programs.

Fixed rate mortgages have a constant (or fixed) interest rate throughout the life of the contract. This allows the borrower to be certain of payments, but the lender will be uncertain of the value of the payments as interest rates change. If the fixed rate mortgage is a first mortgage, the home is collateral for the loan. If the mortgage covers less than 80 percent of the appraised value, the home is the only collateral necessary. For mortgages greater than 80 percent of the appraised value, private mortgage insurance (PMI) is often required. The two most common types of fixed rate mortgages are 30-year and 15-year mortgages. Fixed rate mortgages are almost always the best option and should be chosen in most circumstances.

Adjustable rate mortgages (ARM), or variable rate mortgages, allow the interest rate to rise or fall with changes in mortgage interest rates over time. This effectively shifts the risks of the future from the lender to the borrower. In return, the interest rate extended to the borrower is lower initially. There is usually a cap (+ 6%) which is the highest the interest rate can rise. Interest rates can also be adjusted lower if interest rates fall. For that reason, adjustable rate mortgages make more sense in times of high interest rates than in times of low interest rates.

Balloon mortgages are similar to standard mortgages. However, balloon mortgages have a due date three, five, or ten years into the contract when all remaining principal is due. Some are self-amortizing, while some are inter-

est only. When the principal is due, the homeowner must either refinance or repay.

Graduated payment mortgages (GPM) are designed to allow younger people and those with a growing income to qualify for a home mortgage by initially reducing mortgage payments with contractual increases in the mortgage payments. Be cautious about entering into this type of mortgage because negative amortization could occur if your monthly payment is less than the interest-only amount would be.

Refinancing

If a homeowner has a high, fixed rate loan and market interest rates have decreased, the homeowner can **refinance** to a fixed rate loan with a lower rate of interest. The homeowner simply applies for a new loan (with a lower rate of interest) at the same bank or at a new bank and then continues to pay off the original loan amount.

On the other hand, a consumer with an adjustable rate loan may want to lock in a low, fixed rate loan. The benefits of a lower interest rate loan are lower payments every month and faster principal amortization. However, there may be closing costs (loan origination, appraisal, and legal fees), a prepayment penalty, and points on the new loan. Moreover, if the term of the new loan is greater than the number of years remaining on the original contract, the future payments are also a cost. In calculating the benefit of refinancing, the time value of money must be remembered. If one refinances for the remaining term of the original mortgage, then the sum of all costs of refinancing is a present value. The benefits occur

REFINANCE YOUR MORTGAGE



over time because each month the monthly payment decreases.

When refinancing, it is a good idea to keep the number of years you had left to pay the same for the new loan. In other words, if you had 25 years left on your loan and you refinanced in order to take advantage of a new lower rate, either get a 25-year loan or ask the lender what the payment would be to pay off the 30-year loan in 25 years and make that payment. A better option would be to keep your payment on your new lower interest loan the same as it was on your old higher interest loan; this would effectively apply extra money toward the principal and you would pay off your loan even more quickly.

Home Equity Loans

Also known as second mortgages, **home equity loans** and home equity lines of credit (HELOC) use the **equity** in your house (i.e., hypothetical amount of money you would have left if you sold your home and paid off your mortgage 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. One disadvantage of this type of loan is that it limits your future financial flexibility. 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. There are few instances in which it is worth risking your family's financial wellbeing to accrue further debt. In addition, if the housing market declines you could owe more on your house than you could sell it for. This is called being upside-down in your mortgage and limits your flexibility to sell your home. Try to stay far away from home equity loans.

Avoid home equity loans and home equity lines of credit like the plague.

Types of Housing

When deciding where to live, it's import-

Dream Home Exercise

The home you live in makes a big difference to your family life. It is never too early to start thinking about your future family, where you would like to live with that family, the characteristics of the home you would like to live in, and to understand the amount of income required to purchase and maintain such a home. Try this exercise.

1. Imagine you and your future family in your dream home 15 years from now.
2. Write down the answers to the following questions:
 - Are you married?
 - How many children do you have?
 - In what city do you live?
 - How many bedrooms and how many bathrooms are in your dream home?
 - Any special features in your dream home?
3. Go to www.realtor.com and input the city, bedrooms, and bathrooms; select the home that best matches your dream.
4. On www.realtor.com go to mortgage calculator and determine what your monthly payment for that house will be.
5. Multiply the monthly payment times 5 to find the monthly gross income that will be required to purchase and maintain this home.

ant to weigh the different options and decide which option best fits with your family's lifestyle and budget. Consider the following housing options:

- **Single family housing:** One house on one lot.
- **Duplex:** A lot with two dwellings under the same roof, but the lot is split into two separate legal parcels.
- **Condominiums:** You own your unit and are a shared owner of the surrounding property; you are required to pay a fee for the maintenance of the sur-

Home equity loan

A loan which uses the equity in your house to secure your loan (to be avoided!).

Equity

Hypothetical amount of money you would have left if you sold your home and paid off your mortgage today.



Avoid home equity loans and home equity lines of credit like the plague!



rounding property to the condominium owners' association. Condominiums are much like apartments—the difference is that you are the owner.

- Cooperatives: The mortgage is with the cooperative and you “buy in;” your share of assessments, operating costs, and property taxes are paid to the cooperative; however, your portion of the cooperative's taxes and interest are tax deductible to you.



- Mobile homes: The price is attractive, but mobile homes have a history of depreciating; as such, they are often taxed as personal property rather than real property. Moreover, lenders will typically charge higher rates on mobile home loans.

Summary

Gordon B. Hinckley counseled:

Be modest in your wants. You do not need a big home with a big mortgage as you begin your lives together. You can and should avoid overwhelming debt. There is nothing that will cause greater tensions in marriage than grinding debt, which will make of you a slave to your creditors. You may have to borrow money to begin ownership of a home. But do not let it be so costly that it will preoccupy your thoughts day and night.⁷

In this chapter, we learned about buying a home. We discussed types of housing, the

cost of housing, and how much house you can afford. We went through the nine steps of buying a home. Finally, we learned about mortgages, refinancing, and home equity loans. Remember, as with all debt, the goal is to pay off your mortgage and be debt free! As Dave Ramsey states, “The paid-off home mortgage has replaced the BMW as the status symbol of choice.” We hope you will agree!

We hope that these big financial decisions now seem less intimidating and more exciting! As you apply the principles and practices taught in this chapter, we hope you will be better equipped to make these decisions wisely and claim the blessings of a home that is a “heaven on earth” rather than a home “from below.” This will help you live joyfully within your means.

Other Resources

- ➔ www.bankrate.com/mortgage.aspx
- ➔ www.realtor.com
- ➔ www.zillow.com

Notes

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9

Investing for the Long Term

Family Financial Security Using the Get-Rich-Slowly Plan

The needs of a family are vast and varied. Some of these needs include providing for children, a home, transportation (cars), university educations, weddings, travel to family events, and retirement. That list is not comprehensive, and it doesn't even include wants such as skiing, renting a large campground for a family reunion, installing a lap pool and a hot tub in the back yard, or buying wave runners or a boat. Nor does it include your desire to help others with charitable donations.

Let me give you an example of what family and extended family financial needs can look like when you are in your fifties and sixties. Tammy and I have twelve children. Eight are married, and they live in five states: Maryland, Kentucky, New Jersey, New Mexico, and Tennessee. Three are unmarried teenagers or emerging adults. One of these children lives on his own, but the other four still live with us. Two children went to study abroad in Peru and Argentina from 2013 to 2015. The children are responsible for half the cost of their trips and activities, but we contribute the other half. Each wedding costs thousands of dollars. Since 2013, twelve new grandchildren have been born. For each grandchild we generally follow this same pattern: Tammy and I fly out to help when the baby is born. These twelve new grandbabies potentially represent twenty-four round trip airfares. Additionally, we have flown across the country to help out with health emergencies in our family. The list goes on and on.

You probably won't have twelve children, but I can guarantee that you will have significant financial needs with your family and your extended family as you grow older. The point I want to make



LEARN

- The differences between investing and speculating
- The seven principles of successful investing
- About the various asset classes
- To feel confident as you begin investing

is that finding a way to successfully acquire material resources for the long term is very important to your family.

The purpose of this chapter is to help you understand ways to invest money for the long term, so that when you have the opportunity to make significant expenditures to support your children and your families, you have the resources to do so.

Cryptocurrency

A digital currency in which encryption techniques are used to regulate the generation of units of currency and verify the transfer of funds, operating independently of a central bank.²



Speculation

The practice of engaging in risky financial transactions, often promising greater than market-rate return, in an attempt to profit from fluctuations in the market.

Investing vs. Speculating

Investing has a nefarious cousin who wreaks all kinds of havoc. This unscrupulous relative masquerades as investing but really is something much more sinister. Her name is *speculating*. She burns with the desire to become rich without work, to get something for nothing. She tries to entice all of us, and we must be firm in our resolve against her.

The key to understanding the difference between investing and speculating is a saying we want you to engrave in your heart: **If it sounds too good to be true, then it is too good to be true.** If they haven't already, many friends, relatives, or co-workers will come to you with "opportunities" that promise to make you rich. They will be very sincere and you will feel like you can trust them. But please remember this true financial principle related to investing: **Return on investment is positively related to risk.** To obtain greater than market-rate returns, you must take greater than market-rate risks, and such risks can bring upon your family devastating conflict and stress. After reading this chapter, we hope you will learn to politely decline any financial offers that sound too good to be true.



Avoid speculation like the plague!

Speculation

Speculation is defined as any investment that promises a substantially greater than market-rate return. Wikipedia (yes, this is sometimes a valid source of information) defines it this way: "**Speculation** is the practice of engaging in risky financial transactions in an attempt to profit from fluctuations in the market . . . rather than attempting to profit from the underlying financial attributes . . . such as capital gains, interest, or dividends. Many speculators pay little attention to the fundamental value of a security and instead focus purely on price movements."¹

The fundamental assumption undergirding speculation is that it allows you to get rich quickly—to make a lot of money in a short amount of time with little effort. An old motto says, "No pains, no gains." Every achievement comes from hard work and consistency.

Unfortunately, there are many speculators who recruit friends, neighbors, business associates, and community members to schemes that promise large returns. Most of these are scams or extremely high-risk ventures.

I know of a young widow who invested part of the proceeds of her husband's life insurance settlement with a close friend, with the promise of a guaranteed high interest rate. Though the investment paid out for several years, one day the checks stopped coming. Soon thereafter, the company filed for bankruptcy, and the widow lost many tens of thousands of dollars. She felt betrayed that the life-saving funds provided by her late husband had been lost in this way.

I feel the need to caution about speculating in cryptocurrencies. The most famous





of these is bit coin. It may be tempting to put your money somewhere that could provide dramatic returns. For example, the value of a bit coin increased from about \$900 to about \$19,000 in six months during 2017. However, as of the writing of this textbook (February, 2018) bit coin has lost about half of its value in one month.³ With this kind of wild fluctuation, this is no place in put the money your family relies on for security. You could lose it all!

Please avoid speculation like the plague.

What to Do before You Speculate

Many families have bankrupted themselves because of risky investments. These financial losses have led to stress, anger, and bitterness and have damaged and sometimes destroyed family relationships. Before you even consider an investment that promises greater than market-rate returns, be sure you have done (or are doing) EVERYTHING on the following list:

THINGS YOU HAVE DONE:

- Freed your family from credit card debt and consumer debt



- Paid off your vehicles completely
- Paid off student loans
- Made your spouse an equal partner in investing

THINGS YOU ARE DOING:

- Contributing at least 10 percent of income to a tax-advantaged, diversified, primarily stock-based IRA and/or 401(k) plan
- Meeting all the basic financial needs of the family for food, shelter, transportation, education, etc.
- Paying for adequate insurance (life, health, automobile, and home)
- Having at least 3-months' worth of living expenses as an emergency fund
- Meeting enough of the financial wants of the family to be happy (family vacations, entertainment, furniture, toys, etc.)
- Paying off your mortgage in a timely manner

If you have checked off everything on this list, then you have extra money that you are welcome to do whatever you want with, including investing in a risky deal. At that point, however, there is still opportunity cost. Even though you can afford to speculate, wouldn't you rather use that money for something more worthwhile? Let us add a comment about your own motivation. If your motivation for speculating is to make a lot of money with little effort, then realize that this motive may lead you to failure. If your motivation is to acquire resources steadily to achieve your and your family's long term goals, good for you!

Investment

An asset or item that is purchased with the hope that it will generate income or appreciate in the future.

Investment

An **investment** is "an asset or item that is purchased with the hope that it will generate income or appreciate in the future. In an economic sense, an investment is the purchase



of goods that are not consumed today but are used in the future to create wealth.”⁴

Investing is distinct from speculating in several ways. The first is that an investment has a long-term orientation. Compared to speculating, it is a very slow, disciplined process of acquiring wealth to be used to support your family and others. The second difference is that investing relies on true economic growth to fund its returns, while speculating tries to capture fleeting and temporary market fluctuations, not necessarily related to economic growth. Finally, in our worldview, investing is based on a collective perspective where returns are used to support others while speculating has an individual perspective with the goal to maximize wealth for wealth’s sake. Certainly this chapter is about investing, not speculating.

Wise investing has purposes beyond just getting a good return and making money. Here are some purposes we would like you to be aware of.

Investing helps you to do the following:

- meet your short- and long-term family goals
- demonstrate that you are a wise and responsible individual

Seven Principles of Successful Investing

Once you are ready to invest, you must recognize that there is not just one right way to invest. There are multiple methods of investing that depend on your budget, family goals,

and investment plan. The key to successful investing is to know yourself and what you are trying to accomplish by investing. Whatever you decide to invest in and whatever phase of investment you are in, it is critical that you adhere to correct principles. Here are seven principles that, if followed, will help you to invest successfully.

Principle 1

Invest as a Full Partner with Your Spouse

Investing is not an end in itself; rather, it is a means for acquiring resources for you, your spouse, and your family. It demonstrates a responsible way of living. Consequently, you need to invest as a full partner with your spouse. You work together to document thoughtful and well-written financial goals. These goals are critical because they help you determine what you and your spouse want to accomplish with your investment program. When specific alternatives for investing are considered, both spouses consider the options, provide input, discuss, and make the decision



together.

You and your spouse also need to know your family budget. After basic needs are paid for, you must agree on how much you can afford to invest. We recommend that as soon as you are financially able, you invest at least 10 percent of your gross income in long-term, low-expense, tax-advantaged, diversified, primarily stock-based investments.

Principle 2

Understand Risk and Stay Diversified

Risk is inherent in all investment activities. Some common risks include inflation risk, company-specific risk, interest rate risk, financial risk, market risk, political and regulatory risk, exchange rate risk, and liquidity risk. The key to managing risk is to understand the different types of risk and to invest at a risk level that is comfortable for you and your spouse. If your investments are too risky, this may cause stress and conflict in your marriage and family.

It is important to understand the tolerance you have for risk. Are you able to watch and not panic when the stock market plummets 25 percent in a few months and the value of your portfolio has decreased \$100,000? If the answer is no, you run the risk of selling your investments and permanently losing a lot of money. If you are risk-averse, you might be better off investing in less volatile instruments, like bonds. However, if the answer is yes, you will ride out the fluctuations in the market and reap a handsome long-term return a few decades from now.

Diversification is your best defense against company-specific risk. For example, if you invest in the stock of one company, you could win big if the company thrives—or you could lose everything if the company goes bankrupt. This is stressful, company-specific risk! However, if you invest in an S&P 500 mutual fund, you actually own a little bit of 500 different large companies. If one of the companies goes under, it is of little consequence to you. You are still invested in 499 others. Diversification in the stock market completely alleviates company-specific risk. It helps you sleep better at night.

It is also advantageous to invest in several different **asset classes**. Asset classes are broad categories of investments with specific and similar risk and return characteristics. The three major asset classes are cash (or cash equivalents), fixed income (bonds), and equities (stocks).⁵ Real estate and commodities (oil, gold, silver, etc.) are also considered assets.

You may want your **portfolio** (the sum of all your investments) to include not only stocks but also bonds, cash, real estate, and commodities. Mutual funds or investments like them are available in all asset classes. We will talk more about asset classes later in the chapter.

Principle 3

Make Low-Cost and Tax-Efficient Investments for the Long Term

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. Every time you buy and sell, you are charged something. Be aware that frequent trading incurs significant transaction and tax costs; avoiding this will help you keep your costs low and increase the effective return of your investment. Look for investments that have low expenses and low fees.

In general, there are two kinds of diversified investment funds. **Actively managed funds** are managed by large teams of intelligent, well-trained, professional investors who spend all day every day doing research and trying to take advantage of opportunities to make money. They are trying to “buy low” and “sell high” to make you as much money as

Asset classes

A group of financial assets with similar risk and return characteristics.

Portfolio

All of your various investments.

Actively managed funds

Funds that are managed by professional investors who constantly “buy low” and “sell high.”





"I am going to max out my 401(k) contribution this year."

they can. Unfortunately, every time they buy and every time they sell, there are transaction costs involved. Additionally, before you get your return you have to pay for their large salaries. **Passively managed funds** are managed by a few professionals who strategically invest your money using a "buy and hold strategy." It is possible that they may buy something for you and not sell it again for decades. Because of this, you have few transaction fees, and you have little to pay in the way of salaries and other overhead for the professionals. Actively-managed funds generally have a slightly better return on investment before expenses. However, after expenses, passively managed funds generally have the greater return on investment. If you are investing for the long term, we suggest you invest in passively managed funds.

You and your spouse should also defer or eliminate taxes on your investments as much as possible. The easiest way to do that is to invest in a 401(k) plan (a tax-advantaged retirement account set up by your employer, often with a match by the company) and/or an IRA (a tax-advantaged retirement account that you set up). Early in your career, it is generally best to invest in a Roth 401(k) and a Roth IRA. With Roth, you invest with after-tax money, so the government guarantees that forevermore the principal and all the gains will be completely tax-free. What a deal! We'll

talk more about retirement planning later. If you have a very large salary and a high marginal tax rate you may consider

a traditional 401k and/or IRA, where you get a tax break this year but pay the normal taxes when you decide to withdraw the funds later.

Avoid short-term trading or day-trading like the plague. In day-trading, the investor purchases selected stocks in the morning and then sells them before the end of the day. Short-term day trading is expensive and incurs a high level of transaction costs and taxes. I tell my students that day-trading is very much like gambling in Las Vegas, except for one thing: you generally lose more with day-trading than when you gamble in Las Vegas.

Avoid day-trading like the plague.

You will achieve your goals by investing for the long term. There are no "get-rich-quick" schemes that consistently work. If there were, everyone would use them, and we would all be rich!

Principle 4

Monitor Your Portfolio Performance

How can you know how the investments in your portfolio 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 by comparison. You can find these benchmarks on many different investing websites.⁶ Set your own portfolio benchmarks and then monitor your portfolio performance on a monthly, quarterly, and annual basis.



Passively managed funds

Funds that are managed by professional investors who invest money using a "buy and hold" strategy.

Benchmarks

Passively managed portfolios of financial assets that indicate how well your financial assets are performing by comparison.



Avoid day-trading like the plague!

Principle 5

Don't Try to Time the Market

Timing the market refers to the attempt to obtain greater than market-rate returns by buying when the market is low and selling when the market is high. These buy and sell decisions are informed by research, quantitative modeling, powerful computers, and traders' hunches. It is difficult, expensive, time-consuming, and just plain dumb to try to beat the market on your own. You are competing against hundreds of thousands of professional money managers who have much more time, money, and access to information than you have. Instead, it is more reasonable for you to engage in a "buy and hold" strategy where you invest broadly in diversified mutual funds and in different asset classes. The best investments are **tax-deferred** or **tax-exempt** retirement accounts (such as Roth and traditional 401(k) plans and Roth and traditional IRAs) because they reduce your tax liability.



the needs of their investors. Work with good companies that offer good products. Be careful with your money and invest it wisely. Work only with licensed and registered advisors. In some circumstances, salaried financial planners or advisors may be a better choice than financial planners or advisors that are paid on commission. Salaried financial professionals may be more objective and have your best interest at heart.

Principle 7

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. An **investment plan** is a detailed road map of your investment risk and return, investment strategy, constraints, and reporting and evaluation methodology. Think of your investment plan as a road map to successful investing. Follow this plan closely. 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.

Timing the market

The attempt to obtain greater than market-rate returns by buying when the market is low and selling when the market is high.

Tax-deferred accounts

Accounts which allow you to invest without first paying taxes on the principal; you then pay taxes on both the principal and the earnings when you withdraw money at retirement.

Tax-exempt accounts

Accounts which require you to pay taxes on the principal before you invest it, but you do not have to pay any taxes on the capital gains or future earnings.

Investment Plan

A detailed road map of your investment risk and return, investment strategy, constraints, and reporting and evaluation methodology.

Principle 6

Invest with High-Quality, Licensed, Reputable People and Institutions

When you need help investing, 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. Make sure you invest with financial institutions and investment companies that have a tradition of meeting

Table 9.1 Advantages and Disadvantages of Cash Assets

Advantages	Disadvantages
<p>Liquidity: (cash or can be turned into cash quickly) Especially useful for your emergency fund</p>	<p>Low rate of return: Unlikely to keep up with taxes and inflation on the long term</p>
<p>Security: Principal is often insured by FDIC</p>	<p>Fully taxable: Make sure you take taxes into consideration when deciding to put money towards a cash asset</p>
<p>Guaranteed returns: Interest rates are guaranteed</p>	

Asset Classes

Bond

A loan with a set interest rate purchased from a government or company.

Coupon bonds

Bond purchaser receives regular interest payments until maturity date.

Face value

Value of the bond when redeemed on the maturity date.

Maturity date

Date at which a bond is redeemed at face value.

Zero-coupon bonds

Bonds purchased at less than face value then sold at face value at the maturity date with no interim interest payments.

US Treasury Bonds

Bonds backed by full faith and credit of the United States.

Corporate bonds

Bonds issued by corporations.

Understanding asset classes is critical if you are to invest intelligently. Asset classes are broad categories of investments with similar specific risk and return characteristics. The three major asset classes include cash (and cash equivalents), fixed income (bonds), and equities (stocks). Real estate and commodities are also asset classes. We will discuss the first three to help you understand the benefits and risks of each specific asset class.

Cash (and Cash Equivalents)

The first and most common asset class is cash and cash equivalents. The major goals of this asset class are liquidity and preservation of capital. It includes money in savings, checking, and money market deposit accounts. Investments in Certificates of Deposit (CDs), money market funds, and Treasury bills (T-bills) are also included in this category. Keeping cash in the cookie jar would also be included. There is little risk of losing principal since many of these investments are insured with the FDIC and the rest are secure. These are good investment assets for money you plan to use in less than a couple of years and when you don't want to risk the possibility of losing principal. For example, if you are saving for a trip to Europe and you know you need the money in ten months, it would be wise to keep that money in a CD or other cash equivalent.

Fixed Income (Bonds)

Fixed income is generated by investing in bonds. A **bond** is a loan with a set interest rate purchased by an investor from a government or a company. The interest provides a safe, fixed income stream for the bondholder that is greater than the rate of inflation. Bonds are often used to finance retirement income. Because bond terms can range up to thirty years, they can provide a consistent and safe return for a long time. The typical return on bonds is lower than the return for stocks, but



higher than the return for cash. It has been said that “Bonds will not make you rich but can keep you rich.”

There are two major types of bonds. For **coupon bonds**, the bond issuer sells the bond for a set amount (**face value**) to the bond purchaser until the **maturity date**. The issuer makes regular interest payments to the purchaser until the maturity date. On the maturity date the issuer repays the face value of the bond to the purchaser.

For **zero-coupon bonds** the issuer sells the bond to the purchaser for a set amount that is less than the face value. During the term of the bond the issuer does NOT make regular interest payments. The issuer repays the face value to the purchaser on the maturity date. The difference between the purchase price and the face value is the return for the investor. Zero-coupon bonds do not provide a steady income stream.

Bonds may be issued by a variety of entities and may be taxable or tax-free. **US Treasury bonds** have terms of up to 30 years and are backed by the full faith and credit of the United States. They are considered to be the safest investment on the planet. Other bonds, such as **corporate bonds** and bonds issued by US government agencies like Ginnie Mae (Government National Mortgage Association) are also taxable.

Corporate bonds are typically coupon bonds and are issued in \$1,000 face value

Table 9.2 Advantages and Disadvantages of Bond Assets

Advantages	Disadvantages
Returns: Greater than cash; likely to beat inflation	Liquidity: Not as liquid as cash
Stable income stream: Excellent for retirees	Returns: Lower long-term returns compared to the stock market
Good for diversification: Returns are uncorrelated with stock market returns (when stocks go down, bonds may go up)	

denominations with a fixed rate of interest. Corporate bonds are riskier than government bonds because if the company goes bankrupt, you lose the value of your bond. The riskier the company, the higher the interest rate. Bonds with high yields issued by companies in distress are called **junk bonds**. In general, you should not invest in junk bonds. You can get similar returns with less risk by investing in a diversified stock portfolio.

Municipal bonds are generally tax-free and are issued by state and local governments. A bond issued by a school district to build a new high school or a bond issued by a city to build a new water treatment plant are examples of municipal bonds. Those with high incomes (and high marginal tax rates) often find the after-tax return on municipal bonds to be higher than the return on taxable bonds.

Bonds can be issued with various lengths until the maturity date. **Short-term bonds** (or short-term bond mutual funds) include bonds that generally mature in less than four years.⁷ 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 in an environment where interest rates are not likely to rise. **Intermediate-term bonds** (or intermediate-term bond mutual funds) are bonds with a maturity of about four to seven years.⁸ Because of their longer maturity, they are more susceptible to interest rate risk (the risk that interest rates will rise during the period you own the bond). **Long-term bonds** (long-term

bond mutual funds) are bonds with a maturity of seven or more years.⁹ 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.

Buying **bond mutual funds** is different than 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, so you are more diversified than when you buy 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 at a gain. In general, bonds increase in value as interest rates go down, and decrease in value as interest rates go up. The longer the maturity of the bonds, the more the value of your bonds will increase or decrease as interest rates change. A typical long-term rate of return for bonds is around three to six percent per year.

Equities (Stocks)

The major goals of investing in this asset class are to provide growth and to earn returns that significantly exceed the inflation rate. Historically, the stock market has been the only major asset class to consistently outpace inflation over long periods of time. However, stocks are unstable on the short-term, so if you

Junk bonds

Bonds with high yields issued by companies in distress.

Municipal bonds

Tax-free bonds issued by state and local governments.

Short-term bonds

Bonds that mature in less than about four years.

Intermediate-term bonds

Bonds with a maturity of about four to seven years.

Long-term bonds

Bonds with a maturity of about seven or more years.

Inflation protected securities

Securities whose yield is linked to the rate of inflation as measured by a specific inflation index.

Bond mutual funds

Diversified funds in which you buy a share in thousands of different bonds in a changing portfolio.

Dividends

Money paid to shareholders on a regular basis.

Stock Exchange

A market in which securities (bonds, shares, and notes) are bought and sold.

Growth stocks

Companies whose earnings are expected to grow very rapidly.

Value stocks

Companies that are inexpensive in terms of the underlying fundamentals of the market.

Blend stocks

Stocks that include components of both value and growth stocks.

Stock mutual funds

Funds that pool investor money to purchase many different stocks in groups or types of companies.

are investing for less than three to five years a smaller portion (if any) of your investments should be in stocks, due to their volatility. A key principle when you invest in the stock market is to avoid panic selling. When you own stock you can only actually lose money when you sell your stock for less than you paid for it. When the stock market drops 20% and you panic and sell because you are afraid it will go down even further, *then* you actually lose that 20%. However, a healthier attitude if you are investing for the long term is to say to yourself, “Sure, the market has gone down 20%, but it always goes up and down. I’m going to hang tight.” Then the market will recover, and you will continue on a track to earn 7% to 10% annual return on the long term.

An equity share is ownership in a business’s earnings and assets. When you invest in equities (or stocks), you actually become part owner of the companies you invest in. If you bought all the shares of a company you would become the sole owner of that company. You get a proportionate share of the profits of the company by receiving **dividends** and you also benefit from increases in the company’s share price. Mature companies are a likelier source of dividends—rapidly growing companies often prefer to reinvest profits and not offer dividends.

Shares of a stock are traded on a **stock exchange**. The New York Stock Exchange (NYSE) is by far the largest stock exchange in the world. About 2,800 companies trade their stock on the NYSE with a total market capitalization of about \$21 trillion.¹⁰ About 1.5



billion shares are traded each day.¹¹ The Dow Jones Industrial Average (DJIA) tracks the performance of 30 very large companies and is the most quoted number from the NYSE. The Standard and Poor’s 500 Index (S&P 500) provides a more accurate gauge of the overall stock market because it includes more companies.

The second largest stock exchange in the world is the National Association of Securities Dealers Automated Quotations (NASDAQ). It lists about 3,100 companies with a total market capitalization of \$8.1 trillion (2017). There is more daily volume on the NASDAQ (about 2 billion shares per day) than on the NYSE. The NASDAQ has also handled more than 1,000 IPO’s (Initial Public Offerings) for new companies since 2000. In general NASDAQ indexes provide higher long-term returns but with greater volatility than NYSE indexes.¹² There 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 that are inexpensive in terms of the underlying fundamentals of the market. These are companies that have potential for good long-term returns through both appreciation and dividends. Growth and value stocks tend to perform in alternating cycles, so it makes sense to own both types. **Blend stocks** are stocks that include components of both growth and value stocks.

Stock mutual funds are funds that own stock in specific groups or types of companies. When you own shares in a particular com-



Table 9.3 Advantages and Disadvantages of Equity Assets

Advantages	Disadvantages
<p>Excellent return on investments: When purchased as part of a diversified portfolio they offer highest return of the major asset classes (8 percent to 12 percent per year over the past eighty-five years)</p>	<p>Market volatility: The price of stocks can go up and down on the short-term, sometimes dramatically</p>
<p>Significantly beats inflation: Truly harnesses the power of compound interest</p>	<p>Less stability of principal: Compared to other asset classes, you can lose a lot of money in the short term</p>

pany, you have company-specific risk. If that one company goes under, you lose your entire investment. When you buy into a mutual fund, you are buying a share in multiple companies to protect yourself from company-specific risk. What you actually own in the mutual fund changes over time depending on the fund manager’s decisions. You are responsible for paying taxes on all distributions by the mutual fund, which are taxed at your level—not the fund’s level. If your investment is through a Roth 401(k) or Roth IRA, you pay no taxes.

Stocks are often categorized as large-cap, mid-cap, and small-cap stocks. **Large-cap stocks** are from companies with a **capitalization** (what you could buy the company for if you bought all of the stock) of more than \$10 billion. **Mid-cap stocks** are from companies with a capitalization of \$2 billion to \$10 billion. **Small-cap stocks** are from companies with a capitalization of less than \$2 billion.

International stocks (global stocks/

emerging market stocks) are stocks of companies based entirely outside the United States. These can be of any size (small-cap, mid-cap, large-cap), of any type (value, growth, blend), and from any part of the world (outside the United States). Funds that contain a mixture of US and foreign holdings are called **global funds**.

History of Asset Class Returns

In order to make informed investments for the future, 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. Figure 9.1 shows the **geometric return** (a type of compound interest rate) and the standard deviation for each of the major asset classes. The greater the geometric return, the more money you make. The greater the standard deviation, the greater the

Large-cap stocks

Stocks from companies with a capitalization of more than \$10 billion.

Capitalization

What you could buy the company for if you bought all of its stock.

Mid-cap stocks

Stocks from companies with a capitalization of \$2 billion to \$10 billion.

Small-cap stocks

Stocks from companies with a capitalization of less than \$2 billion.

International stocks

Stocks of companies based entirely outside the US or throughout the world.

Global funds

Funds that contain a mixture of US and foreign holdings.

Geometric return

The compound interest rate of an investment.

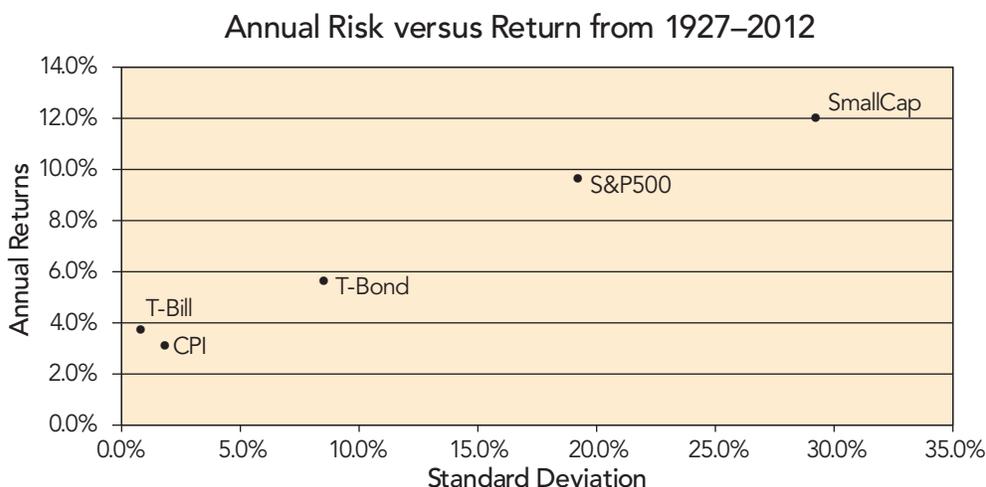


Figure 9.1 Risk and Return Relationship among Major Asset Classes

S&P 500 1 Year Annual Returns from 1926–2012

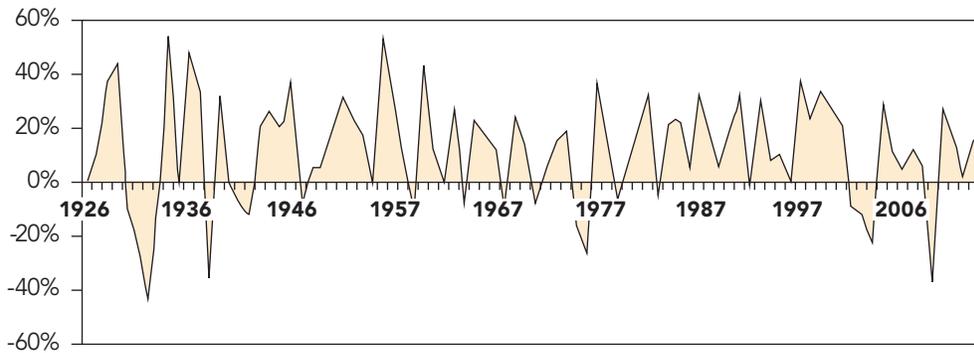


Figure 9.2 S&P 500 Annual Returns over Time

risk you take of losing money in any given year. As you can see from the graph, over an eighty-five-year period the average yearly return rates are 12 percent for small-cap stocks, 10 percent for large-cap stocks (S&P 500), 6 percent for treasury bonds, and 4 percent for treasury bills. You will also notice that the greater the return, the greater the standard deviation, and consequently, the greater the risk and volatility.

Let's talk a little about volatility. Treasury bills have made money every single year since 1927. They are a sure bet to be "in the black." Because of that certainty, the return is lower. On the other hand, large-cap stocks (S&P 500) have actually lost money nineteen out of the last eighty-five years (see Figure 9.2). Also, the range of returns and losses for stocks has been much greater.

The wide range of returns on stock seems to be risky. If you need your money in any particular year, it is risky. But when you hold stocks for a longer period of time, the risk diminishes. Notice in Figure 9.3 that if you take a 10-year perspective, there have only been three years (1938, 2008, and 2009) when the 10-year annual return was negative, and most of the time the 10-year return was positive, in the double digits.



S&P 500 10 Year Annual Returns from 1935–2012

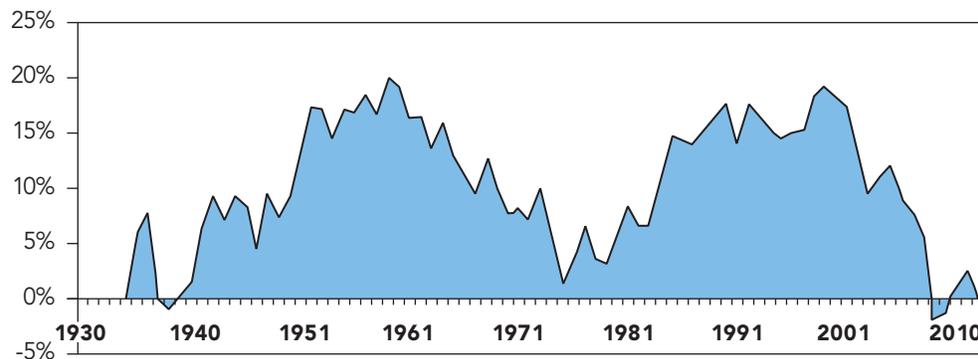


Figure 9.3 S&P 500 10-Year Returns over Time

Beginning to Invest

With this background information, let's move on to some practical advice for developing your own investment plan. In this section, we are taking a very basic approach. However, you would be surprised by the number of investors that do not follow these simple guidelines and priorities.

Six Guidelines for Basic Investing

1. PREREQUISITE

Create a livable budget with funds for debt reduction and investing

My view is that you, whoever you are, should be investing for the long term every single month until you retire. However, you should invest responsibly. You should create a livable budget with expenses categorized within your income. This budget should meet all of the basic needs for everyday living (food, shelter, transportation, education, etc.). After these needs are taken care of, additional money should be allocated simultaneously to debt reduction and investment. In general, it is best to pay off credit card loans and other consumer debt before investing significant amounts. That said, I believe it is wise to invest small amounts (\$10 or \$20 per month) while you pay off your credit cards. In addition, if your company matches contributions to a 401(k) plan, you should invest at least to the percentage of the match, even if it slows paying off the credit cards. The 100% return on the company match to your 401(k) contribution dwarfs the 18% you have to pay on the credit

card. In general, car loans and home mortgages can be paid off while you are also engaging in an investment program. Bottom line: get your financial house in order and invest responsibly.

2. BASICS

Invest in an emergency fund

Money in the bank should be considered essential investments. A good initial emergency fund includes enough money in your bank account to allow your family to survive for three months. It doesn't have to be three months of income, but it should be enough cash that you could survive for three months without an income. This emergency fund also becomes a buffer when unanticipated expenses occur (e.g., car repairs, appliance replacement, unexpected medical/dental expenses).

3. CORE

Invest in broad market index or core mutual funds

After you have your budget set up and your emergency fund in the bank, you are ready to start investing in earnest. You should generally start by investing with a reputable investment firm to create a portfolio designed to capture the overall market. There are many reputable firms to choose from. A few of these are Fidelity Investments,¹³ the Vanguard Group,¹⁴ T. Rowe Price,¹⁵ Homestead Funds,¹⁶ and Northern Trust,¹⁷ Acorns¹⁸, and Betterment¹⁹. Homestead Funds caters to the small investor and allows you to invest with no minimum in mutual funds as long as you set up an automatic monthly investment from your checking account. Most other funds require a minimum initial investment of \$500 to \$5,000. If you are investing through a 401(k), you will use the investment service provided by your company. These funds are usually managed by large, reputable firms. Two apps—www.acorns.com and betterment.com—are easy ways to get started investing.



4. DIVERSIFY

Invest in additional asset classes and several specialized mutual funds

After you have made some basic investments and acquired more money to invest, you can branch out to a more balanced and sophisticated portfolio. Though there are many ways to do this, I will share just one. You can visit with your financial advisor about other options.

Dr. Craig Israelsen, the legendary mutual fund guru, wrote an excellent book entitled *7Twelve: A Diversified Investment Portfolio with a Plan*²⁰ that outlines twelve separate investments in seven different asset categories in order to maximize growth while minimizing risk. The seven asset classes that he uses are US stock, non-US stock, real estate, resources, US bonds, non-US bonds, and cash. Your investments are equally distributed among twelve funds from these seven asset classes. Dr. Israelsen makes a convincing argument that this degree of diversification in the world economy provides the safest “get-rich-slowly” long-term investment plan. Because of the number of funds and the complexity of this plan, the investor needs a fairly substantial initial investment. If your investment funds are primarily in a 401(k) plan, you can accomplish diversification by opting for several different investment options.

5. OPPORTUNISTIC

Invest in individual stocks and sector funds

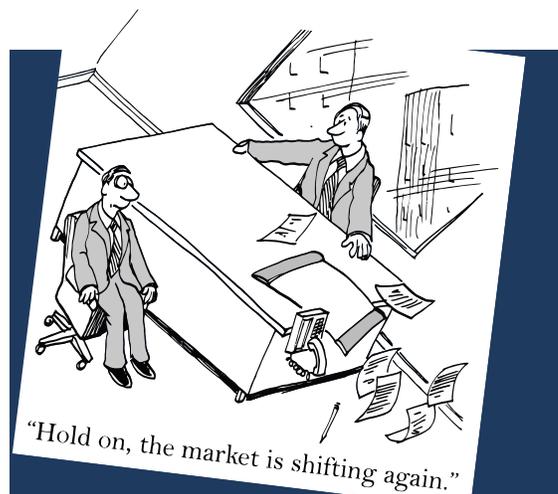
If, after completing the first four steps, you still have extra funds to invest, you can move on to riskier investments, some of which border on speculating. Opportunistic investing should only be done with money you can afford to lose. When you invest in individual stocks or sector funds, you can win big or you can lose big. When you invest in individual stocks, it is better to hold them for at least one year because the gains will be taxed at a lower

rate. One strategy involves doing your research and then investing in several individual stocks. It is possible that you may be lucky and beat the market.

6. INVEST AT YOUR RISK LEVEL

One of the key challenges of investing is to invest at a risk level that is comfortable for you and your spouse. Different investors can accept different levels of risk as they work to achieve their personal and family goals. 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 trade-off 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 obvious concerns. With higher risk, you have higher volatility but hopefully higher returns.

If you invest at a higher risk level than you are comfortable with, you will be very concerned every time the market declines. This can cause detrimental stress if you are risk-averse. Interestingly, most investors are torn between fear and greed. When the financial markets decline, fear kicks in. We think that we should take our investments out of the market and that we will know when to put them back in before the market goes up again (this is called market timing). No investor can



consistently time the market. Likewise, when the markets are going up, greed kicks in. We think we should put all our assets into one or two “sure things,” which in reality are anything but sure. Your challenge, then, is to find the happy medium between fear and greed so that you can build a portfolio that will give you the amount of risk you are comfortable with and that will help you achieve your goals.

There is a general rule of thumb regarding risk: The closer you get to needing your invested money (such as during the years approaching retirement), the less risk you should have. With retirement investing, perhaps the majority of your investments when you are in your twenties and thirties will be equities. As you reach your forties and fifties, perhaps your portfolio should be weighted more towards lower-risk investments such as bonds and cash. One way to think of this is to take 100 minus your age, and that is the percentage of your portfolio that should be equities. That general guideline will help you decrease your risk as you get closer to retirement. That said, some financial advisors now counsel that a more appropriate formula is 120 minus your age.

Final Cautions on Investing

Here are a few final cautions on investing:

- Do not go into debt to invest. This includes taking equity out of your home, buying on margin, or short-selling assets. Investing has enough risks of its own. Do not compound that with leverage.
- Beware of financial advisors who recommend shifting assets from one investment vehicle to another. Do not move your investments from one investment vehicle to another unless you fully understand all the costs and benefits.
- Beware of financial advisors paid on commission. Some advisors sell products based on their commissions, not what is best for you. Watch the turnover in your



portfolio. A high turnover usually indicates problems and leads to lower returns.

- Finally, listen to your gut. If it seems too good to be true, it probably is. Beware of members of your community, friends, relatives, and others who will try to use their associations with you to have you buy their products. There are no guaranteed returns. If it sounds too good to be true, it is likely a scam.

Summary

You are ready to start investing! As you do, keep in mind the seven principles of successfully investing. Remember to stay far away from that monster called *speculation*, who brings risk, loss, and get-rich-quick catastrophes. Diversify your portfolio between various asset classes to diminish risk. Finally, follow the basic guidelines and priorities you have learned in this chapter as you begin investing wisely. However small or large your income, consistently investing 10 percent of your income in long-term investments will bring your family financial security and help you meet your goals. Investing wisely and taking advantage of the power of compound interest is a way of demonstrating great financial responsibility of the resources with which your family needs to thrive.

Notes

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10

Retirement Planning

It's Never Too Early to Start

As a young person, it is easy to give nary a thought to retirement. That seems so far away! As a young couple in the late 1970s, Juanita and I were no exception. When Section 401(k) of the Internal Revenue Code was enacted in 1978, we were expecting our first beautiful baby girl. Things were very tight for us financially. We lived in a 300-square-foot trailer that we rented for \$95 a month, and we were saving money for a down payment on a home. Even though my employer was going to match the first 2 percent of our contributions to this new-fangled 401(k), we wondered if we could afford the \$40 per month we would have to contribute in order to receive the full match. We thought about it; we talked about it; we played around with our budget; and, kicking and screaming, we finally signed up. Truth be known, this decision ended up being painless. We never missed the money because it was withdrawn before we ever saw the paycheck.

Looking back now, forty years later, I am so glad we started investing back then. Through the miracle of compound interest, every single dollar we invested in 1978 is now worth about \$32. By the time I retire in in 2023, every dollar invested back then will likely be worth about \$64! By faithfully investing 10 percent of our income in tax-advantaged, low-fee, diversified, primarily stock-based mutual funds and index funds for forty years, I now have a



LEARN

- What you can do now to begin to be prepared financially for retirement
- How many years you will and your spouse need retirement income
- How much income you will need per month during retirement
- What sources of regular income you can have in retirement, and how to determine if there is a shortfall
- How to determine if you want to leave an estate or use up most of your retirement before you die
- If you are on track for retirement saving

seven-figure sum that can be used to fund retirement for Tammy and me.

There is a moral to this story: you should be planning and investing for retirement today, even if you are only twenty years old! Whether you invest a little or a lot, start now!



Start planning and investing for retirement today.

Introduction

People are living longer now than ever before. During the last century, average life expectancy in the United States increased from fifty-six to seventy-six for men and from fifty-nine to eighty-one for women—an addition of more than twenty years.¹ Experts project that as life spans continue to increase, the average individual will spend between twenty and thirty years in retirement. With fewer traditional pension plans available and modest payouts from traditional government and private plans, retirement planning is an increasingly important part of family investment planning. Without adequate retirement planning, you and your spouse could be working as night watchmen when you are in your eighties just to make ends meet! Please, please start planning for retirement now! It is key to living joyfully within your means.

Avoid putting off retirement planning like the plague.

In this chapter, we want to focus on information you need to know now so that you can make wise decisions in preparing for retirement in the future. We will address six questions that you will want to answer as you prepare.

Question 1

What can you do now to begin to be prepared financially for retirement?

To be prepared for retirement, you must start preparing now. Although you may be in school, perhaps struggling to get by on a meager income, you can still start by investing a

small amount, even just \$10 per month, into a Roth Individual Retirement Account (IRA). You can fund this account by shaving a couple of dollars off your food or entertainment budget every week. Simply by choosing not to eat out a couple of times every month, you may have something to invest. The principle is to get started investing earlier rather than later.



Once you graduate from college and obtain a real job, you should begin investing at least 10 percent of your gross income each month into your retirement accounts. Where you invest is important. As we explained in the previous chapter, if you are saving for retirement about forty years from now, it is best to invest in tax-advantaged, low-fee, diversified, primarily stock-based mutual funds and/or index funds. They will provide a return sufficient to allow you to claim the full blessings of the miracle of compound interest above and beyond inflation. Anyone who does that—whether a school teacher, attorney, plumber, social worker, or physician—can be financially independent when it's time to retire.

Because of significant tax advantages, you should invest your retirement dollars in the 401(k) offered by many employers. Companies are eliminating defined benefit retirement plans (these gave you a monthly pension for life in retirement) and replacing them with 401(k) matching funds. Oftentimes, companies match the first 5 percent (or more) of your contributions to the fund. To claim the match, you must make the contribution. You lose that free money if you don't invest! Don't miss out! It is almost always a wise decision to invest at least what the match is for your 401(k). In



2018, you could contribute up to \$18,500 to a 401(k).²

Avoid losing free money from matches to your 401(k) like the plague.

If your company doesn't offer a **401(k)** (and even if it does), both you and your spouse can open up **Individual Retirement Accounts (IRAs)**. IRAs are like 401(k)s except instead of the company managing the funds, you manage your own funds through investments offered by financial firms. In 2018, you can contribute up to \$5,500 per year into your own IRA and your spouse can contribute another \$5,500.³

The final fundamental thing you should be aware of for financial planning is the basic difference between a **Roth IRA/401(k)** and a **traditional IRA/401(k)**. With Roth accounts, you invest with after-tax dollars. Then, forever more, the principal and earn-

ings are tax free. With traditional accounts, you can use your contributions as a reduction to income and save money on your taxes this year. Your earnings are tax free until they are withdrawn; however, when you withdraw your funds, both principal and earnings are taxed as regular income. All this means is that while you are young, until you make lots of income (e.g., \$150,000 or more per year), you are generally better off with Roth than with traditional.

You might ask, what would I do to save



for retirement now if both my wife and I were working part-time jobs to try to graduate without student debt? I'll tell you what I would do: I would get started! I would invest \$20 per month through automatic withdrawal from my checking account into a Roth IRA at www.

401(k)

A defined-contribution (DC) retirement plan offered to employees in which a specified amount of money is taken from both the employer and the employee on a regular basis and invested.



Invest at least what the match is for your 401(k) and claim free money.

Individual Retirement Account (IRA)

A tax-advantaged retirement plan that is managed by the individual who owns the plan. Maximum contributions are \$5,500 per year until age 50. Money may not be withdrawn without penalty until age 59 ½.

Roth IRA/401(k)

A type of retirement plan in which contributions are taxed before they are put into the account and money is not taxed when it is withdrawn.

Traditional IRA/401(k)

A type of retirement plan in which contributions are not taxed and constitute an income adjustment when they are put into the account and money is taxed when it is withdrawn.

homesteadfunds.com or betterment.com. I would select these funds because they require no minimum investment as long as you elect for automatic monthly withdrawals from your checking account. I would probably invest my contribution into their small company stock fund because, on the long term, it has the highest return. And then I would sleep with pleasant dreams knowing that I had started preparing for a long retirement in which my wife and I could volunteer, visit grandkids, and travel the world!

Question 2

For how many years will you and your spouse need retirement income?

To adequately fund your retirement you will need to know how many years to plan for. The answer to this question requires one simple subtraction equation, although it may be uncomfortable to think about. All you need to know is in what year you plan to retire and in what year you are likely to die, and then include a little cushion just to make sure you don't run out of money in case you live longer than you expect.

In what year do you and your spouse want to retire?

There are several financial factors to consider when answering this question. The earliest you can make unrestricted, penalty-free withdrawals from an IRA or 401(k) is age fifty-nine and a half. For traditional IRAs and 401(k)s, you must start taking distributions by the time you are seventy and a half. The earliest you can receive social security payments is age sixty-two, but if you do, the monthly benefit is considerably lower than if you wait a few years. The maximum monthly benefit from Social Security is at age seventy. The few companies that still have defined benefit pen-

sions also have rules about age and the amount you receive. In general, you max out all of the monthly retirement benefits by waiting until age seventy to retire.

In what year do you and your spouse expect to die?

This is uncomfortable to think about because in our culture we typically avoid talking about death. However, you can get a fairly close estimate of when you are likely to die by going to an actuarial website. Actuaries predict when people will die, helping life insurance companies know how to have affordable rates and still make money. One interesting site is sponsored by Northwestern Mutual and is called "The Longevity Game."⁶ In this game it asks you thirteen questions and then tells you how old you will likely be when you die. Another helpful, yet admittedly morbid, site is www.deathclock.com. It asks you a few questions and then creates your death date and a clock that counts down the seconds you have left to live.

Once you know the year you will retire and an estimated year of death, you simply subtract your retirement year from your death year and add a cushion (I suggest five years) to determine how many years you will need to fund retirement. In my case, I expect to retire in 2023. The Longevity Game tells me I will live until I am ninety-two, or until 2045. It says that Tammy will live until she is ninety-three, or until 2057. We do the math: 2057 minus 2023 equals 34, plus 5 for a cushion, and we realize we need to plan for thirty-nine years of retirement.



Question 3

How much income will you need per month during retirement?

This is dependent on many factors. The cost of living in the city where you retire makes a big difference. For example, if you retired in San Diego, the cost of living would be about 30 percent above the national average, mostly because of high housing costs.⁵ However, if you retired in Idaho Falls, the cost of living would be about 15 percent below the national average, due in part to cheap potatoes!⁶ This means you would need \$10,000 per month in San Diego to have the same standard of living that \$6,500 per month would buy you in Idaho Falls.

The expense of the activities you want to engage in during retirement is also a factor. Do you want to explore the world and travel to exotic places, or do you want to be a homebody and explore your backyard? Do you have family members scattered across the country that you will want to visit for vacations and special occasions, or does all of your family live close by? Do you want to have a monthly amount for charitable work and helping out children and grandchildren? These are all questions to consider.

One other important consideration is how much to plan for health care. Medicare covers major expenses, but Fidelity estimates that a couple entering retirement at age sixty-five should have \$240,000 to cover “deductibles, co-payments, premiums for optional coverage for doctor visits and prescription drugs, out-of-pocket expenses for prescription drugs, and other expenses that Medicare doesn’t cover, such as hearing aids and eyeglasses.”⁷ Assuming a retirement of twenty years, this translates into a \$500 monthly expense.

Question 4

Beyond retirement investments, what sources of regular income will you have?

In planning for retirement, it is important to accurately estimate additional sources of income that you will have beyond your retirement investments. The most common of these is Social Security. Since it affects virtually everyone in the United States, we will examine it first.

Social Security

The Social Security Act was passed in 1935 as part of the New Deal during the Great Depression. Though it was designed to be a safety net, it is the primary source of retirement income for many of the 40 million Americans who are sixty-five and older. This is because many have not made wise investments into retirement accounts other than Social Security.

The Social Security program was designed to be a pass-through account. This means that the taxes you pay for Social Security (through the Federal Insurance Contribution Act, or FICA) are used to pay benefits to those who are currently retired, disabled, widowed, or orphaned. Because there are currently more people paying into Social Security than there are people receiving Social Security benefits, the tax reserves are maintained in interest-earning government bonds held by the Social Security Trust Fund. There was no investment or savings component to Social Security when it was originally set up because the government assumed that there would always be enough people in the working gen-



Plan to have additional sources of income beyond Social Security in retirement.



eration to pay for the retired generation's benefits. In 1935, there were 17 workers for each retiree who received benefits. Today, it is estimated that there are only 3.4 workers for each retiree who receives benefits. This is important to you because it is likely that your Social Security benefits will be reduced, either by a higher full-retirement age or by a reduction of the amount you will receive per month, or both.

Avoid relying entirely upon Social Security like the plague.

There are four main types of Social Security benefits: retirement, disability, survivors', and Medicare. These four main types are discussed in the following paragraphs.

Retirement Benefits. For those who qualify, Social Security provides a lifetime monthly retirement benefit that is indexed with inflation. Eligibility and the amount of retirement benefits are dependent upon your work history and salaries. The full retirement age has increased to age sixty-seven, though you may choose to begin receiving reduced benefits anytime starting at age sixty-two. You can also



delay receiving your benefits until age seventy to receive enhanced benefits. Someone with a long work history of good paying jobs would receive about \$2,000 a month starting at age sixty-two, about \$2,900 a month starting at age sixty-seven, or about \$3,600 a month starting at age seventy. As you can see, the longer you delay receiving your retirement benefits, the more your monthly check will be. If you live much longer than the average person, you will

receive much more total payout if you delay receiving your benefits as long as possible.

Disability Benefits. Workers who qualify for Social Security disability benefits are entitled to receive 100 percent of their primary insurance amount until one of the following situations occurs: the disability ends, the worker dies, or the worker attains full retirement age. The spouse's disability benefit is either 50 percent of the worker's benefit or the spouse's own Social Security benefit, whichever is larger.

Survivor Benefits. If the deceased worker was fully insured or currently insured, a lump-sum survivor benefit will be paid to eligible survivors. A monthly lump sum is available to the surviving resident spouse, nonresident spouse, or eligible children.

Medicare Benefits. Individuals who are at least sixty-five years old and who are eligible for Social Security retirement benefits on their own behalf are entitled to coverage under Medicare Part A. If the individual has applied for Social Security retirement benefits, no separate application is required. If the individual continues to work after age sixty-five and is not receiving Social Security benefits, an application must be filed in order for the individual to receive Medicare Part A coverage. Recipients of disability benefits are eligible for Part A coverage after they have been eligible for disability benefits for twenty-four months.

Employer-sponsored retirement plans

After Social Security, the second most common source of income for retirees is employer-sponsored retirement programs. Most companies offer retirement plans to their employees. They do this in hopes of attracting and retaining the best possible workers. Employers also receive some tax benefits by providing retirement plans. You can think of the payouts from these plans as a series of delayed payments you will receive during retirement for work you performed prior to retirement. Because they are tax-advan-

Defined-benefit plan (DB)

A type of retirement plan in which all contributions are made by the employer and the benefit is guaranteed for life and based on the number of years of service and the final salary.

Defined-contribution plan (DC)

A type of retirement plan in which contributions are made by both the employer and the employee, but the investments are chosen by the employee; the contribution amount is specified by a formula, but the benefit amount varies according to payment amounts, the market, and the management of the employee.

tagged and include money contributed by the employer, employer-qualified retirement plans provide free money. Obtaining this money should be the highest priority for your retirement and investment funds. There are two main types of employer-sponsored retirement plans: defined-benefit plans and defined-contribution plans.

In a **defined-benefit plan (DB)**, all contributions are made by the employer. The benefit, or final monthly amount that will be received by the employee upon his or her retirement, is often guaranteed for life and based on the number of years of service and the final salary.⁸ Because the employer is responsible for providing the final amount, he or she is the one that shoulders the risk of the investment plan. Defined-benefit plans are becoming less and less common. The percentage of employers offering a DB plan fell from 50 percent in 1998 to 5 percent in 2015.⁹ If you are fortunate enough to work for a company with a DB plan, a likely scenario would be to earn a lifetime benefit of approximately 1.5 percent per year of service multiplied by the average of your highest salaries. For example, if you worked for a company with a DB plan for thirty years and earned \$10,000 per month during the last three years of employment, you would qualify for a lifetime pension of \$4,500 per month (30 years \times 1.5% \times \$10,000).

In contrast, with a **defined-contribution plan (DC)** contributions are made by both the employer and the employee, but the investments are chosen by the employee. The contribution amount is specified by a formula while the benefit amount is uncertain and varies according to payment amounts, the market, and the wise management of the employee. Because they place less risk on the employer than defined-benefit plans, defined-contribution plans are becoming more common. The percentage of employees participating in DC plans has increased from 8 percent in 1980 to 31 percent in 2008.¹⁰ Most DC plans are 401(k) plans.

To understand the 401(k) plan offered by

your employer, it is important to compare it to an Individual Retirement Account (IRA).

- **401(k)**: a retirement plan that is offered to all of the employees in a company or firm. It is typically used by mid- to large-sized companies. A 401(k) is managed by an administrator who takes a specified amount from both the employer and the employee (taking a portion of the employee's paycheck) on a regular basis. It has a clear structure and the opportunity for free money (from the contribution of the employer), but it also involves management fees. No withdrawals can be made while a person is still employed by the company. There is a cap of \$18,500 per year for contributions (as of 2018).
- **IRA**: an individual retirement plan that is typically used by self-employed people. People who are not self-employed can also invest in an IRA apart from their employer-sponsored retirement plan, as long as their income is not too great. An IRA is managed by the individual who owns the plan, which allows that person to avoid management fees and gives them the freedom to contribute payments to the IRA on a flexible basis. There is a cap of \$5,500 for contributions.

Both 401(k)s and IRAs have two options: traditional and Roth. In general the Roth option is preferable until you are making large sums of money. Here are some of the characteristics of Roth and traditional retirement accounts:



Estate

The money, property, and other assets owned by a person at the time of their death.

- **Roth:** contributions are taxed as ordinary income when they are put into the account. Contributions and earnings are not taxed when they are withdrawn. Since contributions are taxed before being invested, they may be withdrawn at any time without penalty. Earnings cannot be withdrawn before age fifty-nine and a half without incurring a penalty. No withdrawals are ever required.
- In traditional 401(k) plans and traditional IRAs, contributions are not taxed when they are put into the account. Contributions constitute a downward income adjustment for the year they are made. Contributions and earnings are taxed as ordinary income when they are withdrawn. Withdrawals cannot be made without a penalty before age fifty-nine and a half. Distributions may begin at fifty-nine and a half and *must* begin by seventy and a half using an actuarial formula predicting how much you need to withdraw each year to get all your money taxed before you die.
- Penalties for early withdrawal may be waived when the money is used toward a down payment for a first-time home purchase, for educational expenses, or for unreimbursed medical expenses above 7.5% of the adjusted gross income.

Question 5

Do you want to leave an estate behind, or do you want to use up most of your retirement before you die?

The next question for retirement planning is whether you want to leave an **estate** to your descendants or to a charitable organization, or whether you want to use all of your money before you die. One of my relatives would say that his children and grandchildren needed to make their own way in the world, so he was going to use all of his money before he died. He would say that he wanted to “bounce his

last check.” He planned well, and by the time he died he had spent or given away everything except for his clothes, his old car, and a small dwelling.

If you want to leave an estate, you must decide how large you want that estate to be. This number will be the future value (FV) when you are calculating the amount of retirement you must save.

Question 6

How can you tell if you are on track for retirement saving?

Fidelity, one of the largest investment firms, has estimated a measure for being on track for retirement.¹¹ In this model, the goal is to have eight times your current salary saved by the time you retire. This is based on keeping an income stream of about 80 percent of pre-retirement income, factoring in Social Security income, and assuming a 5.5 percent return on investments and an inflation rate of 2.3 percent. To get to eight times the current salary, Fidelity offers the following retirement account benchmarks:

- Age 35 – one times current salary
- Age 45 – three times current salary
- Age 55 – five times current salary
- Age 67 – eight times current salary (beginning of retirement)

Because the rate of return is so important, it is essential to invest in the right places. In the



first twenty years or so of investing, the criteria for a good retirement investment includes the following attributes:

- tax-advantaged
- low-fee
- diversified
- primarily stock-based
- mutual funds and/or index funds

Many financial institutions offer retirement investment plans that automatically invest your money according to the criteria listed above. The funds are often named by the year in which you plan to retire. For example the Fidelity Freedom® 2050 Fund is designed as an investment mechanism for those who expect to retire in 2046–2050.¹²

The criteria changes somewhat as you get closer to retirement. Stocks are riskier investments than bonds but produce higher returns on the long term. However, when you are close to needing money for retirement, it is a good idea to move to safer investments. A common rule of thumb is to have roughly 80 percent of your assets in stocks and 20 percent in bonds while in your twenties, and then adjust that ratio every five to ten years so that by the time you reach your sixties, you have about 60 percent of your assets in bonds or cash. For example, at age twenty-five you would have 25 percent in bonds and 75 percent in stocks; at age forty you would have 40 percent in bonds and 60 percent in stocks; at age fifty-five you would have 55 percent in bonds and 45 percent in stocks; and in retirement at age seventy you would have 70 percent in bonds and 30 percent in stocks.

With all of this information, you are in a position to start running some numbers related to retirement. The *Fundamentals of Family Finance Workbook* will help you learn how to do this with your financial calculator.

I invite you to save money each week. The amount you save is not particularly significant;

that is up to you. As you develop a habit of saving, you will benefit personally. And you may also have opportunities to assist others financially as a result of your diligence. Imagine the positive outcome of saving money weekly for six months, a year, 10 years, or more. Small efforts sustained over time can produce significant results.
—Devin G. Durrant¹⁵

Summary

Hopefully this chapter has helped you see that it is never too early to start planning and investing for retirement! You have seen that by investing in tax-advantaged, low-fee, diversified, primarily stock-based mutual funds and/or index funds from an early age, you will be financially prepared and your retirement years will be truly golden. We have answered six important questions that will help you determine financial needs associated with retirement.

The goal is not just to have a lot of money when you retire—it is to have sufficient resources to serve your family and to achieve your personal and family goals. The ultimate goal is to be able to use your golden years to bring about much good in the world as you live joyfully within your means.

Other Resources

- ➔ www.deathclock.com
- ➔ <https://www.fidelity.com/viewpoints/retirement/8X-retirement-savings>
- ➔ www.homesteadfunds.com

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11

Tips for Frugal Living

How to Minimize Your Family's Expenses

At the heart of successful family finance is the principle of living within your means. Most families, at one time or another, have difficulty following this principle. If you find your family in this situation, there are basically two options for getting back on track. One option is to increase your income. You can ask for a raise in your present job, take a second or third job, apply for a new job in your current field that pays more, or get additional education or training to qualify you for a job in a different field with greater remuneration. Increasing your income, though sometimes viable, generally takes time and can prove very stressful, especially when taking on additional work.

The second way to move from deficit spending to living within your means is to decrease your expenses. You have more control over the spending side of the family finance equation than you do over the income side and can often make choices that have immediate and positive impacts on the family budget. You can decide to cancel cable; you can decide to sell one of your cars; you can decide to reduce the frequency of eating out; you can decide to ride your bike instead of driving your car; you can decide to have the thermostat set at 78 degrees instead of 72 degrees in the summer time. There are myriad decisions you can make to reduce spending. This chapter is designed to give you tips for frugal living—practical advice designed to min-



LEARN

- Practical tips for frugal living that will help your family decrease your expenses
- Strategies to save money on food, transportation, household expenses and recreation

imize your family's expenses. We will look at specific ways to reduce the amount that you and your family spend on food, household goods, vacations, and holidays—so that you can joyfully live within your means.

Saving Money on Food

Providing sufficient healthy food for the family is a basic responsibility that you and your spouse have. Whether we like it or not, each member of the family needs to eat almost every day. In fact, most family members need to eat three, four, or more times per day (especially if you have teenagers). The cost for fulfilling this responsibility can vary dramatically from one family to the next. According to the United States Department of Agriculture Center for Nutrition Policy and Promotion, the typical budget for food for a family with two parents and four children under the age of ten ranged from \$875 per month (\$10,500 per year) for the “thrifty” plan to \$1,735 per month (\$20,820 per year) for the “liberal” plan.¹ That is a very wide range and, in either case, a lot of money. However, there are many opportunities to save money on food while at the same time providing more healthy food alternatives for your family.

One easy way to save money and make food more healthy is to prepare meals from raw ingredients instead of eating prepared items. Let me give you an example. I devour a 2-ounce bowl of delicious steamy oatmeal each morning. If I were to purchase that most excellent oatmeal served in a fine china bowl at the Marriott Hotel, the cost would be about \$8. If I buy the oatmeal in a Styrofoam cup



from McDonald's, the cost is less than \$2. If I buy instant oatmeal that comes in individual pouches in a colorful box with a Quaker man smiling contentedly at me and then prepare my breakfast in the microwave, the cost is lowered to less than \$0.50 per serving. If I buy the same pouches with the Western Family label, the cost is reduced to less than \$0.30 per serving. If I buy a 3-pound round tub of old-fashioned oatmeal with that same smiling Quaker man, the cost goes down to less than \$0.10 per serving. Finally, if I buy a 25-pound sack of old-fashioned oatmeal from the food storage section at Maceys, the cost is less than \$0.05 per serving.

When we prepare food from raw ingredients bought in bulk, we often save a lot of money. It is ironic that food in its raw form is not only the least expensive, it is also the most nutritious. Of course, you pay for these monetary savings and improved nutrition with the time it takes to prepare the food. However, parents can include children in meal preparation, which can help strengthen family bonds.



Here is another example. I love fresh whole wheat bread. I can get an excellent, nutritious, fresh loaf from Great Harvest for \$5.50. However, the cost for the raw ingredients to make it in my own kitchen from scratch is only \$0.69 (\$0.50 for your own freshly-ground bulk whole wheat from your year's supply, \$0.05 for the yeast, \$0.01 for the salt, \$0.03 for the oil, and \$0.10 for the electricity). Of course, many parents don't have time to make homemade bread. In the Hill home, we taught our children how to make bread. We provided the ingredients and paid our children

\$2 per loaf for fresh whole wheat bread. The child could do two batches in about two hours and make \$20, providing us with ten loaves of fresh bread at \$2.69 per loaf.

Here are a few other ways to decrease the amount you spend on food for your family each month:

- **Remember H.A.L.T.** Don't go shopping when you are hungry, angry, lonely, or tired. Research has shown that if you go grocery shopping when you are hungry, you are likely to buy more and also to buy items that are less healthy (more sweets and high-calorie items).²
- **Make a menu and write out a shopping list.** Know what you are going to buy before you enter the supermarket. One helpful practice is to make a menu for the meals you are going to prepare and then create a shopping list from that menu. Another practice is to keep a shopping list on the refrigerator and write items on the list as you notice the need. My wife, Tammy, goes so far as to organize the shopping list by the different areas of the supermarket to make the shopping trip shorter and more efficient.



- **Take advantage of loss leaders and use ad match.** A loss leader is an item that the store sells at below-cost in order to get you inside the store. The idea is that the store may lose money on the one item, but they'll make money on all of your other purchases. Often, the loss leaders are featured in shopping ads. You can go to a store that ad matches (like Walmart)

and then get all of the loss leaders from all of the stores. There are a number of websites³ that identify the loss leaders in all the stores for free or for a small fee.⁴

- **Buy store brands.** Name brands (e.g., Kraft) and store brands (e.g., Western Family) often only differ in the packaging and advertising. Buying the store brand instead of the name brand will save you 10 percent or more on the item.
- **Reduce the number of trips to the supermarket.** You can reduce expenditures by going to the store once a week instead of multiple times whenever you have a need. This also saves you time, gas, and wear and tear on your car.
- **Pay cash.** A study by Drazen Prelec and Duncan Simester of the Sloan School of Management at MIT reveals that shoppers spend up to 100 percent more when using a credit card versus cash.⁵ One strategy is to put an amount of cash in the food shopping envelope each week (perhaps \$100 or \$150 or \$200). Take the cash with you on your weekly shopping trip. When the cash is gone, you stop shopping for the week and wait until the next week to continue.
- **Buy in bulk and prepare meals from raw ingredients.** Bulk food usually costs less per unit. In the Provo area, there are often case lot sales. By purchasing a case of food (e.g., tuna, tomato sauce, cream of chicken soup), you can often save 20 percent or more on your purchase. Before buying, be sure to check the price against the single unit price to make sure you are getting a good deal.



The skill of wisely shopping for food can be very beneficial to the long-term financial health of the family. Let me lay it out for you in dollars and cents. Let's say that instead of spending \$1,500 a month for food for your family of six, you are able to be frugal and only spend \$1,000 a month. Let's do a little time value of money calculation and figure out how much it would be worth if you invested the \$500 per month savings each month in a tax-advantaged, diversified, primarily stock-based mutual fund yielding 10 percent per year. In 30 years, it would be worth \$1,130,243.96. Need I say more?

Saving Money When You Go out to Eat

Food costs much more if bought in a restaurant instead of a supermarket, and yet American families are spending more and more money eating out. The total amount

spent in restaurants more than doubled during the past seventeen years from \$379 billion in 2000 to \$799 billion in 2017.⁶ In January 2015, for the first time in history, Americans spent more money in restaurants than they did in grocery stores.⁷

It is a national craze to go out to eat frequently. And it is very easy to spend a lot of money going out to eat if you are not careful. One way to decrease expenses significantly is to reduce the amount spent on restaurant meals. Here are some suggestions:

- **Bring your own lunch to work.** Unless you are networking, there is little value in taking the time to buy lunch when you are at work. Bring your lunch. It is healthier, less expensive, and takes less time. The average worker in the United States goes out to eat for lunch twice per week and spends \$936 each year doing so.⁸



- **Share a meal with your date.** In the United States, restaurants are known for their large portion sizes and calorie count. For example, at Outback Steakhouse one meal that includes one-half of a Bloomin' onion for an appetizer, a classic blue cheese wedge salad, an 8-ounce filet mignon with loaded mashed potatoes, a mini shake, and a slice of carrot cake runs about 3,637 calories and about \$50.⁹ Tammy and I learned to leverage this by sharing not only the appetizer but the entire meal. That cuts both the cost and the calorie count in half. The shared meal always satisfies us, and we save a lot of money and calories.
- **Order ice water, not soda.** Fountain drinks have the biggest profit margin of any food item in the restaurant. A 20-ounce soda that costs you \$1.99 costs the restaurant about \$0.10 to \$0.13.¹⁰ You can save big by not ordering soda. It isn't good for you anyway.



- **Go out for a late lunch instead of dinner.** If you go out to eat at 3:30 p.m. and order from the lunch menu, you will get the same food as dinner, but it will cost less. Sometimes the portion size is a little bit smaller, but you don't need the larger portion size, do you? It will also be less crowded, so you can talk more easily with your date or family members. In addition, eating the main meal earlier in the day aids your digestion, makes it easier to sleep,¹¹ and promotes weight loss.¹²
- **Use coupons/savings cards and books.** There are countless options for obtaining coupons to reduce the cost of a restaurant. Many two-for-one options are available in newspapers and online. Avoid two-for-one offers that require you to buy a drink, and look for the true blue two-

for-one offers with no strings attached. Here is one word of advice: When buying two-for-one, make the tip as if you were paying full price. The waiter or waitress had to do just as much work as if you had paid full price. Don't skimp on the tip!

Saving Money on Transportation

Our transportation choices have a big impact on the family budget. In 2016, the average American family spent just over \$750 per month (\$9,094 per year) on transportation costs.¹³ There is room in that number for savings. Here are some suggestions:

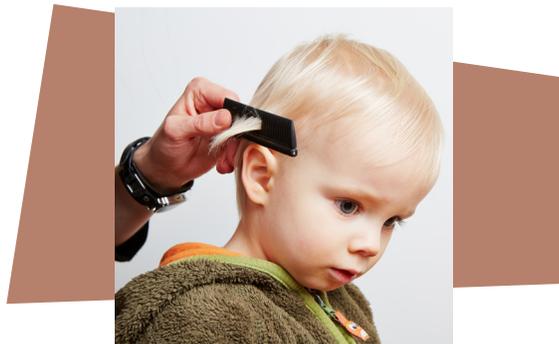
- **Buy a low-mileage, late-model used car instead of a new car.** A new car loses a significant amount of its value in the first year. For example, the 2017 Hyundai Genesis lost 30 percent of its value in the first year.¹⁴ Using very conservative assumptions, the 2017⁴ Genesis would still have about 92 percent of its useful life remaining in 2018, and yet the cost would only be 70 percent of the new model. Many websites make it easy to shop for a late-model, low-mileage used car.^{15 16 17 18}
 - **Pay cash for your vehicle.** If you make a car payment to yourself each month and then pay cash for your car, you will have earned interest rather than paid interest to the car dealership. You can also invest this money for greater returns.
 - **Look at the total cost of ownership.** A car will cost you much more than just the sticker price. You also need to account for the cost of gasoline, repairs, insurance, and service. Several Internet sites can give you the total cost of ownership for various models of new and used cars.^{19 20}
 - **Get an inexpensive car for male teenage drivers.** Male teenage drivers have astronomical insurance rates. You save your family a lot of money by rating your sons
- on a vehicle that doesn't have collision or comprehensive insurance on it.
 - **Service your car on time.** The most important thing you can do to lengthen the life of your vehicle is to change your oil on time, every time. A general rule of thumb is to change the oil every 3,000 miles or 3 months, whichever comes first. Clean oil is essential to extend engine life, and the engine is the most important part of a car to safeguard. Synthetic oil is generally better than traditional petroleum-based oil at protecting your engine and is less expensive over the long term because you only have to change it half as often.²¹
 - **Shop around for auto insurance.** Automobile insurance is required in the United States, and the price of insurance varies dramatically from company to company. Shop around to get a good price for your car insurance.
 - **Bundle trips.** You can save a surprising amount on gas and wear-and-tear on your car if you do some planning and bundle several purposes with one trip. For example, plan to go to the grocery store after taking your daughter to soccer practice. Carpooling is another example of this principle. Instead of all parents driving their kids to mutual every time, carpool so that several children ride together.
 - **Walk and bike places.** Walking or biking not only saves money but is also good for your health. Where feasible, walk to school and ride your bike to work.



Saving Money on Household Expenses

Household expenses—the cost of goods and services in the home—consume a significant amount of money each month. Here are some suggestions for reducing those costs:

- **Get rid of cable.** Cable can cost more than \$100 per month. You might consider canceling cable and using an HD antenna and streaming services for your entertainment. We canceled cable a couple of years ago and got a \$39.95 HD antenna. We were surprised that it picked up more than a dozen stations on the air for free in full HD. We haven't missed the cable, except during some live sporting events. New web-based streaming services like Sling, YouTubeTV, or Hulu also serve as great alternatives since most of them cost much less than cable and do not require long-term contracts.
- **Cut your family's hair.** Parents who cut their children's hair can save a bundle, especially in a large family. For example, in a family with six children, you can save almost \$1,000 per year in haircuts by cutting their hair at home. Using the time value of money, if you invested that \$1,000 per year savings in a tax-advantaged, diversified, primarily stock-based mutual fund that averaged 10 percent increase per year, you would have \$164,494.02 after thirty years. Go buy those clippers from Walmart!
- **Lower your thermostat in the winter, and raise it in the summer.** Every degree lower in the winter or higher in the summer will save you 3 to 5 percent on your heating or air conditioning bills. That can add up to hundreds of dollars every month. Likewise, be conscious of when you open and close doors and windows in your home. In the summer, open them when the temperature outside is cooler than inside to cool down the house. Use common sense.
- **Choose cell phone plans wisely.** Cell phone plans vary dramatically from carrier to carrier. Be smart about the plan you choose. Family plans are often much less expensive per phone than individual plans.
- **Turn off electronic devices.** When you are not using an electronic device, do not waste power by leaving it on. Be sure to turn off televisions and computer monitors when not in use. It saves even more money to unplug electronic devices when they are turned off.
- **Shop at garage sales in nice neighborhoods early in the day.** Many household items (especially toys, yard equipment, sporting equipment, and baby things) can be purchased for less money at garage sales. Many sellers are just trying to get rid of their junk, which may be your treasure. You may want to focus on garage sales in nice neighborhoods. Also, go before the sale is officially open; if you are the first one there, you'll get the nice stuff at a good price. Another way to save money at a garage sale is to offer one half of the asking price. Many times the seller will accept your offer.
- **Look online.** Websites like ksl.com and craigslist.com both have thousands of items, many at a fraction of the cost of store-purchased items. This is a good source for baby-related purchases. I have a daughter who bought a double jogging



How Frugal Living Can Be Beneficial

By Ashley LeBaron, Family Finance Research Assistant

I have personally experienced how frugal living can benefit families. My parents live a wonderful balance of frugality (toward things that don't matter in the long-run) and generosity (toward things that do matter in the long-run). My parents are great at spending their money on things that we value as a family. These values include strengthening familial relationships, gaining perspective-expanding experiences via travel, and investing in education. Because of my parents' wise use of their resources, I have gained an appreciation for money. Money itself may be meaningless, but the things you can do with well-managed money are truly wonderful.

Strengthening Familial Relationships

I am the fourth of five close-knit siblings, the four oldest of which now live away from home. We also live in four separate time zones. In these years of emerging adulthood, my older siblings and I don't have much money to spend on plane tickets, so we wouldn't see each other very much if not for our parents' help. My parents decided long ago to put family first, and I see that demonstrated in the way they finance how our family gets together. I see them sacrificing some of their own personal wants in order to do this. We continue to enjoy close, loving sibling bonds because we are able to be together multiple times a year.



Gaining Perspective-Expanding Experiences via Travel

Growing up, my friends always assumed that my family was filthy rich because we traveled often. That is not true. My dad sought out and created work opportunities in other countries so that we could experience and appreciate other peoples and cultures. This is something that my family values. My parents made a conscious decision to use their money on these experiences, while my dad drove a dumpy old Toyota Corolla for twelve years. We were not traveling because we had endless resources; we were traveling because we had saved and sacrificed in order to do so. To me, these international experiences have been life-changing and literally priceless.

Investing in Education

It is common knowledge that, generally, the more education you have, the more you are paid (not to mention the other countless benefits of education). Education, then, is simply an investment in your future. My parents have always stressed the importance of this, and they have always demonstrated their support. My parents paid for my needs and modest wants in high school so long as I continued to excel scholastically, and because of that support, I was able to focus on my studies and now enjoy a full-ride scholarship, saving me thousands of dollars each semester. My parents paid for my housing and living expenses my first year of college so that I could focus on building a good GPA foundation in order to keep my scholarship and be a desirable candidate for graduate school. I am so grateful that they have lived frugally, which has put them in a financial position to lend this help. Their support of my educational pursuits has influenced me and will continue to pay off for the rest of my life.



My parents have taught me that while money is not the most important thing in life, it can help make possible some of the most important things. That is why living frugally is a blessing so long as it enables you to spend money on what your family values.

stroller online for a fraction of the cost of a new stroller.

- **Shop at Goodwill or other thrift stores.** Similar to garage sales, these stores often have used items at a fraction of their new cost. In addition, by shopping there you are supporting a job training and placement program.²²
- **Set a waiting period before making major household purchases.** It is easy to give way to impulse household purchases that can rack up balances on our credit cards. You might consider setting a waiting period for any purchase over a certain amount, say \$100. This allows you to see if you really need that item and limits expensive impulse purchases.

Saving Money on Recreation

The Family: A Proclamation to the World names “wholesome recreational activities” as one of the foundational principles upon which successful marriages and families are based. Many vacations can qualify as wholesome recreation, and research has shown that they generally enhance family adaptability and cohesion.²³ Vacations are generally a good thing for families. However, not all vacations are created equal. Surprisingly, some vacations that cost the least are those that strengthen families the most. For example, camping and backpacking are among the least expensive vacation alternatives but provide an experience that promotes family adaptability while treating what has been called Nature Defi-



cit Disorder (NDD).²⁴ A family of six may save thousands of dollars by choosing to go camping in national parks instead of flying to Orlando to go to Disney World and Universal Studios. And it may also be that a camping trip would strengthen that family more than a trip to Disney World.

Here are some other suggestions for making your recreational dollars go further:

- **Leverage timeshare presentations.** Once you reach a certain income bracket, you will have many opportunities to attend timeshare presentations. Often, these marketing tools enable you and your family to stay at the sponsoring resort for two to three days for free, on the condition that you and your spouse both attend a timeshare sales presentation for about two hours. Doing this enables you to stay in a nice place at little or no cost to you. All you have to do is be comfortable saying “no” at the end of the sales presentation.
- **Use reward miles from your credit card to pay for air travel.** Many credit cards offer you the perk of accruing airline reward miles toward future travel. If you choose and use your credit card wisely, this can add up to two or three free roundtrip tickets per year. These free tickets can make the difference between a vacation being affordable or not.
- **Be flexible to go at the last minute.** Unused cruise tickets and hotel rooms are often sold at a large discount at the last minute. You can stay informed of these deals via many websites including www.travelzoo.com, www.greatvaluevacations.com, www.skyauction.com, www.travelocity.com, and www.hotels.com, to name a few.
- **Stay with family members.** If you enjoy renewing extended family ties, staying with family members around the country can be satisfying and save you money. Be

aware that if you stay with a family member, they may come and visit you as well!

- **Vacation at home.** Often, we do not take advantage of all the wonderful vacation opportunities in our own backyards. Tammy and I recently canceled an international trip and vacationed from home instead. We used www.tripadvisor.com and found highly-rated restaurants and tourist destinations to visit in Utah County. We had a blast and stayed in the best accommodations—our own home!



- **Go to the dollar theater.** If you like to see movies in a theater, just wait a few weeks and you can save 70 to 80 percent on the ticket price by going to the dollar theater. Avoid getting popcorn; the popcorn at the dollar theater costs more than the movie tickets.
- **Make good use of the library.** Instead of buying books, check them out of the library. The library also has low-cost DVDs and an online lending library.

Summary

To make it easier to joyfully live within your means, you can either increase your income or decrease your spending. In this chapter, we examined practical tips for frugal living. There are many ways to cut your expenses, such as spending less on groceries, cutting the cost of going out to eat, saving money on transportation, reducing household expenditures, and stretching your vacation dollar.

However, I would like to conclude this chapter with a caution. There are some who take frugality to an extreme. While it is a virtue to live within your means, any virtue taken to an extreme can become a vice. Don't miss out on meaningful experiences because of unnecessary frugality. Money, when used wisely (emphasis on *used*), can be significantly influential to our families and others. We must remember that we are responsible for our resources and that they are meant to be used to meet your values. They are not meant to be hoarded. As you try to live frugally, keep an eye on yourself and use your frugality in order to acquire resources to achieve your and your family's long-term goals.

Other Resources

- ➔ A rich life with less stuff: The minimalists: <https://www.youtube.com/watch?v=GgB-pyNsS-jU>

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12

Work and Family

Providing for and Nurturing Your Family in Harmony¹

To provide for a family, it is essential that we obtain employment that provides adequate income and that we manage our money wisely. However, the time and energy we invest in providing may make nurturing difficult. Being fully involved as a spouse and parent on top of adequately providing and being a reliable employee can feel like the weight of the world on your shoulders.

*The happiest people I know are those whose life-style centers around the home. Work is very important, and success in one's profession or business is also essential to happiness, but remember what we say so often: "No other success can compensate for failure in the home."
— N. Eldon Tanner²*

As we struggle to juggle our employment, our home duties, and other responsibilities, we may often feel stressed and unbalanced. We wrestle with the decision of whether to work late or leave on time to attend a child's activity. We agonize about whether or not to miss a previously planned family outing because an unexpected community assignment has come up. We wonder if we should study for a final when our help is needed with a sick child. Sometimes it seems like work, home, and other responsibilities are in a tug of war, each fighting for our personal time and energy. Juggling these responsibilities may eventually exhaust us



LEARN

- Strategies that can help your family experience greater joy as you juggle the demands of work, family, and other responsibilities in harmony
- To focus on the most important things

and cause us to lose interest in the very things we love most. We may even begin to feel inadequate, pessimistic, and discouraged.

Perhaps it is beneficial to view the situation from a different perspective. Recent social science research proposes that work, family, and other life domains can actually be complementary—not competing—priorities. Success on the job often contributes to our success outside of work and vice versa. A recent international study reveals that relationships and social interactions, physical and psychological benefits, and improved skills are some aspects of work that can enhance home life, and it also works the other way around.³ The key to harmony is to invest our time and money in activities that enhance multiple domains that we value in our lives. Regularly making the time and spending the money to engage in family relationship-building activities can be thought of as a long-term investment, like the stock market, which will yield long-term blessings of family unity.

This concept of enhancement—sometimes called *life harmony*⁴—utilizes a musical metaphor. Just as the different melodies in a well-composed piece of music unite in harmony, the different facets of our life can also

coordinate in peace. Using the perspective of life harmony, we no longer see work, family, and other responsibilities as fighting for our limited time and money. We see mortality as a great symphony, with the many different responsibilities in our own lives as instruments united harmoniously to a greater purpose. The way we manage our financial resources is a great orchestrator of these instruments.

There is no single formula for creating a life where we successfully provide for and nurture our families. However, there are a variety of strategies that can help us no matter our circumstances. Employing any of these strategies can help us experience greater joy as we bring the demands of job, family, and other responsibilities into greater harmony. In this chapter, we focus on suggestions in six areas: (1) enhance energy, (2) increase quality time, (3) learn to bundle, (4) focus on the most important things, (5) work flexibly, (6) and simplify your life.

1. Enhance Energy

Research has documented that it is the depletion of energy—rather than time spent on the job—that is the main factor in whether people feel like there is conflict between work and the rest of their lives.⁷ It is very possible that an invigorating job requiring fifty hours per week may have a less negative impact on the home than a depressing job requiring forty hours per week. When we feel that our employment is sapping our strength, there is little energy left for service at home or in the community.

One way to increase our energy without reducing work hours is to make a list of all the things we do at work that either drain or energize us. To create more work-family harmony, we may arrange to do the energizing things right before we go home so that we can carry more of that energy home to our families. For example, if I were an engineer who loves design work and hates paperwork and meetings, I might choose to get onerous paperwork tasks done earlier in the day and save the energizing



design work for the hours right before I go home.

Another way to increase energy is to choose to make time to do things that are personally renewing. Physical exercise often creates physical energy. Peaceful music may soothe our souls. Talking to a friend can be energizing. A short nap is often invigorating. Having a few minutes alone in quiet solitude can rejuvenate our hearts. Taking time for rejuvenating activities may appear to only add more to a to-do list full of high-priority tasks, but such moments can add the extra physical and spiritual strength we need to accomplish everything. It is important to see personal renewal as an investment, not as a waste of time.



The commute to and from work can also be a time of energy renewal rather than depletion. One mother reviews inspirational quotes she has memorized as she walks to work. She arrives on the job with a clear and active mind. One father listens to TED talks as he drives home from work. By the time he greets his family, he has forgotten about aggravating experiences during the work day and is ready for his most important work.⁶ After the incessant demands of many jobs, we often need a slower tempo for renewal before returning to our homes.

As we open our minds to better see ways we can enhance energy, we may discover activities that foster harmony in our lives without requiring additional time. We may find ourselves with less fatigue, conflict, and stress while actually doing more. Additionally, we

may find that seeking renewal helps us on a day-to-day basis to accomplish more than we thought possible.

2. Increase Quality Time

In many cases, we need to be available for extended lengths of time in order to meet the immediate concerns and needs of our children, making quality time the product of quantity time. Important interactions happen during lengthy periods of unstructured time. However, not all time is created equal. To obtain life harmony, we must find ways to put each moment to its best use. When Dallin H. Oaks was in his third year of law school and involved in church responsibilities, he had to make the most of the limited time he had with his daughters. He recalls,

My favorite play activity with the little girls was “daddy be a bear.” When I came home from my studies for a few minutes at lunch and dinnertime, I would set my books on the table and drop down on all fours on the linoleum. Then, making the most terrible growls, I would crawl around the floor after the children, who fled with screams, but always begged for more.⁷

There is no doubt this was quality time!

In his occupation as an airline pilot, Dieter F. Uchtdorf was required to travel away from home for long periods of time. He found family harmony by seeking quality time. His son Guido remembers, “When Dad returned home, we played, we talked, and we laughed together.” Guido added, “That was quality time!”⁸



Family mealtime is a great opportunity for high-quality family time. Ezra Taft Benson taught, “Happy conversation, sharing of the day’s plans and activities, and special teaching moments occur at mealtime because mothers and fathers and children work at it.”⁹ A life harmony study among a subsample of United States IBM employees who are parents revealed that regular family mealtime protected individuals from conflict between work and family life when they had to work long hours.¹⁰ In addition, extensive social science research has documented that regular family meal time is associated with less adolescent risk for a variety of internalizing behaviors such as depression, weak self-esteem, suicidal thoughts, attempted suicide, withdrawn or distressed behavior, and behavioral problems.^{11, 12, 13}

To be together for mealtimes is a challenge, especially in large families. It requires careful planning. One family holds a family council each week and carefully selects a dinner time each evening when everyone can be there. The time varies according to the activities of the week. Another family chose to share the big meal of the day at 3:00 pm each afternoon, right when the children came home from school. In this family, the father came home early from work for dinner with the family and then finished his workday at home via telecommuting.

Bedtime may also be a time of extraordinary quality. Children rarely want to go to sleep when parents want them to, but will often give parents undivided attention at bedtime. In an experiment consisting of 405 mothers and their infants or toddlers, it was found that having a consistent bedtime routine can lead to better sleep for children and a better mood for their mothers.¹⁴ Parents can read or tell stories, pray, cuddle, sing songs, and many other things. The peaceful feelings associated with bedtime stay with children throughout the night. Likewise, these bedtime interactions with children may be just what a parent needs to forget the frustrations of the day and to sleep peacefully.



The specific ways to increase quality time are innumerable. One may focus on creating time for carefree play with the children, or carefully plan a time when all family members can be available for family dinner, or make it a priority to be available during the bedtime hour. The specifics may vary, but the principle is the same: when we make the effort to engage in meaningful activities with those we care about, we are better able to provide for and nurture our families in harmony.

3. Learn to Bundle

Bundling, according to life harmony research, is when one activity simultaneously serves purposes in two or more aspects of life.¹⁵ Successful bundlers are often able to do two or more things at the same time harmoniously. In many cases, each facet of the activity is of greater value because it is bundled than if it were done as its own activity. For example, when a couple chooses to walk together, they may get needed exercise, relax and be rejuvenated, share ideas about community responsibilities, express their affection, talk about their children, brainstorm solutions to problems at work, and so on. This one bundling activity is of great value because it may contribute to so many facets of life.

Bundling can also be a benefit to the family budget and contribute to personal time. For example, if you have to take your son to and from soccer practice on the other side of town, you may choose to bundle that trip. Instead of two round trips, you could bring your daughter with you, drop off your son, and pick up some things at a nearby Home Depot with her

while your son is at practice. By doing so, you would get one-on-one time with your daughter, save the travel time, save gas, and get the shopping done.

A few years ago my wife Tammy gave me a tandem bicycle for my birthday. This has proved to be an ideal tool for bundling. We often ride together on a bike path up a beautiful canyon next to the Provo River. By doing so, we can both get as much exercise as we each want. (If you get tired, you can just put your feet up!) We stay close so it is easy to talk to one another and strengthen our marriage as we exercise. We are invigorated by the beautiful scenery on the trail. We greet and sometimes talk with members of the community. The list could go on and on. Riding a tandem bike with a family member accomplishes so much more than riding alone.

Another example of bundling is when a parent takes a child with them to run errands. A mother may take her child with her to purchase groceries. While shopping, she has the opportunity to connect with her child one-on-one and engage in relationship-building conversation. She can also teach principles of provident living by showing her child how to save money by comparison shopping.



In today's world, many parents provide transportation for their children to school and many other activities. This may be an excellent opportunity to bundle travel time with meaningful conversation. Robert D. Hales counseled parents, "As you drive or walk children to school or their various activities, do you use the time to talk with them about their hopes

and dreams and fears and joys? Do you take the time to have them take the earplugs from their MP3 players and all the other devices so that they can hear you and feel of your love?"¹⁶

When we do two or more things at the same time in harmony, we give that time period greater value. As we examine our lives, we will find many such activities that will enable us to provide for and nurture our families in harmony.

4. Focus on the Most Important Things

Bundling does not always work. There are many times when it is better to set firm boundaries and not let the drumming of paid work overpower the gentle melodies of home life.

Family vacation may be a time for muting work completely. In today's wireless world of smart phones, tablets, iPads, and laptops, it is easy to let work bring dissonance to the delicate tunes of vacation renewal. A few years ago, I took my wife and three of our children to enjoy the Big Island of Hawaii for an eight-day vacation. I brought my laptop with the thought that I could log on a few minutes each day and keep up with my e-mail. However, the few minutes turned into a few hours each day. It seemed that even when playing with the kids at the beach, I would become distracted by thinking about a work project or by becoming irritated because of something I read in an e-mail. It is true that where the mind is, the heart is sure to follow. A few days into vacation, my boss firmly demanded (via e-mail) that I join an important 9:00 a.m. conference call the next morning. After replying that I would attend, I realized that the 9:00 a.m. call in New York would be 3:00 a.m. Kona time. Sitting in on that tense conference call in the wee hours of the morning, with the sound of the waves crashing in the background, was the straw that broke this camel's back. I asked myself, "What am I doing? I'm supposed to be on vacation!" So after the call I locked up the laptop, put away the calling card, and crawled back into bed. I made a resolution: from then

on I would throw off my “electronic leash” whenever I went on vacation.¹⁷

Some families have decided to focus on the most important things by designating electronic-free family times. This might be during a family meal or during another hour of the day. For example, before sitting down to dinner a family might choose to silence all of the smart phones and focus on positive family interaction. Another family has a charging station on a bench in the hallway where the family places its electronic devices 30 minutes prior to retiring for the night. This half hour becomes a time for family interaction and conversation.

Another way to focus on the most important things is to set up family rituals and traditions that bring the family together. One father goes on an individual walk with each of his children once a week. As they walk alone, without any interruption, the natural cadence of the stride elicits genuine communication. Another couple has a date every Friday night. They budget for a babysitter and a dinner, movie, play, or other activity every week.

To focus on the most important things, like family relationships, takes planning and resources. However, as we focus on the most important things we can claim joy in our relationships.



5. Work Flexibly

Research has consistently shown that those who provide for their families in jobs with workplace flexibility are better able to nurture family members. Workplace flexibility is defined as “the ability of workers to make choices about when, where, and for how long they engage in work-related tasks.”¹⁸ Some examples of workplace flexibility include telecommuting (working electronically from home), flextime (being able to modify start times, meal breaks, and ending times), part-time (working reduced hours for reduced pay), and leaves (taking time off without pay for family responsibilities).

A large body of research documents the benefits of this flexibility to both work and family life. For example, one study in a large multinational corporation compared 279 mothers working part-time in professional positions with 250 mothers working full-time. Those working part-time reported that they used their extra discretionary time to care for and nurture their dependent children. They reported less work-to-family conflict as well as greater work-family success, childcare satisfaction, and family success.¹⁹

Another study compared 441 telecommuters who worked primarily from home to 4,315 workers who worked primarily from the office. Those who worked from home reported greater job motivation, career opportunity, work-life balance, and personal/family success. They also reported that they were less likely to be thinking about leaving the company.²⁰ Several other studies have revealed that those who have workplace flexibility are able to work longer hours without experiencing work-family conflict.^{21,22}

Over the years, I have personally used each of these options to facilitate work and family harmony. The strategy that probably helped the most was when I worked from home for IBM instead of commuting to and from the office each day. In 1990, I became one of IBM’s first telecommuters. For nearly ten years, I worked from my home in Logan, Utah, more

than 2,000 miles from my co-workers in New York. This enabled me to live in a quiet community, forego the stressful forty-five-minute commute each morning and evening, and be at home within earshot of my family for most of our waking hours. I found myself much more involved in the everyday activities of the home and much more in tune with the individual needs of my children. I also found that the flexibility and autonomy of telework enabled me to do my job more effectively and efficiently.

However, working with so many children in the background sometimes made it difficult to maintain professional boundaries between work and home life. Let me share one humorous story of mine on telecommuting that appeared in a *Wall Street Journal* article²³:

One morning while I recorded my daily voice mail greeting, my wife Juanita was folding clothes in the laundry room across the hall. My six-year-old daughter Emily had just taken a shower upstairs and could not find the clothes she wanted to wear. She came downstairs draped in nothing but a towel. When Juanita saw her, she said in a loud, giggly female voice, “Look at you! You have no clothes on!” After several colleagues commented with a chuckle about my voice mail greeting, I listened to it, and this is what I heard:

Male Voice: This is Dr. Jeff Hill with IBM Global Employee Research . . .

Giggly Female Voice: Look at you! You have no clothes on!

Male Voice: I’m not available right now . . .²⁴

The plethora of electronic tools available in the digital age opens up many possibilities for when, where, and how long work is performed. Most large companies and many smaller ones offer these flexible work options. Whether it is flextime, telecommuting, part-time work, or leaves, a key component for achieving life harmony is to choose to work



flexibly. Those who are successful at this choose to work when it makes sense to work and to be with family members when it makes sense to be with them.

6. Simplify Your Life

Voluntary simplicity—deliberately choosing to accumulate fewer possessions and engage in fewer activities than possible—aids in creating life harmony.²⁵ The key to accomplishing this financially is to distinguish between needs and wants. We should first plan to meet our needs and then simplify by purchasing fewer items that are simply wants. L. Tom Perry counseled, “In our search to obtain relief from the stresses of life, may we earnestly seek ways to simplify our lives.”³⁴



Many of us seek diligently to please and help those around us. Sometimes we agree to do too many things that are not part of our primary mission. If we really want to focus on those activities with value, then we need to learn how to kindly but firmly say “No.”

That may be easier said than done, especially for those of us who want to please others. I have learned a simple way to do this. When

The Mexican Fishing Village Story

Author Unknown

An American entrepreneur, father of two young children, was standing on the pier of a small coastal Mexican village when a small boat, containing just one fisherman, docked. Inside the small boat were several large yellow fin tuna. The American complimented the Mexican on the quality of his fish.

"How long did it take you to catch them?" the American asked.

"Only a little while," the Mexican replied.

"Why don't you stay out longer and catch more fish?" the American then asked.

"I have sufficient to support the needs of our home," the Mexican said.

"But," the American then asked, "What do you do with the rest of your time?"

The Mexican fisherman smiled and with a twinkle in his eye said, "I do a lot at home, señor. I play with my niños, lend a hand with the comida, and then take a siesta with my wife, Maria. After helping the kids with their homework, we stroll to the plaza in the evening where we listen to the guitar and sing with our amigos. I have a full and wonderful life, señor."

The American scoffed, "I am a Stanford MBA and could help you. You should spend a lot more time fishing, and with the proceeds you could buy a bigger boat, and with the proceeds from the bigger boat you could buy several boats. Eventually you would have a fleet of fishing boats. Instead of selling your catch to a middleman, you would sell directly to the consumers, eventually opening your own can factory. You would control the product, processing, and distribution. You would need to leave this small coastal fishing village and move to Mexico City, then LA, and eventually New York, where you would run your expanding enterprise."

The Mexican fisherman asked, "But señor, how long will this all take?"

The American replied, "Not long, maybe fifteen to twenty years."

"But what then, señor?"

The American laughed. "That's the best part. When the time is right, you would sell your company stock to the public and become very rich; you would make millions."

"Millions, señor? Then what?"

The American said slowly, "Then you would retire and move to a small coastal fishing village where you could do a lot at home. You would play with your grandkids, help with the comida, take a siesta with your wife, and stroll to the plaza in the evenings where you could listen to the guitar and sing with your amigos . . ." ²⁷



someone asks me to do something, I respond, "Thank you very much for this invitation. I appreciate it. Let me think it over and I'll get back to you tomorrow." If, after consideration, I decide it is an invitation I'd rather not accept, I think of others who might want to do it. Then when I get back to the person, I say something like, "I thank you again for the invitation, but with what's going on right now, I am not going to be able to accept. However, you might want to contact Thom Curtis or Wally Goddard. One of them might be interested, and they would probably do a better job than I would." Using such a dialogue, I can say no without a twinge of regret.

In order to obtain life harmony, we must also look for ways to compose a life of modest means. We live in a materialistic world. With our many materials and pursuits, we may run the risk of obscuring the simple but powerful life melody we hope to compose.

A family may work together to simplify life by reducing the number of demands outside the home. This will eliminate some low-value activities, making room for activities of greater worth. For example, a father may choose to go golfing with the office group every other week instead of every week. A bishop may decide to reduce the length and frequency of ward leadership meetings. Youth may choose to reduce the number of extra-curricular activities that they are engaged in during the school year and the amount of time they spend "hanging out." Though the ways to simplify life vary, remember the principle of reducing the number of low-value activities and the time spent engaging in them.

Summary

Providing for and nurturing our families in harmony may appear to be an unrealistic ideal when it seems the best we can do is "struggle to juggle" our extensive demands. However, utilizing strategies such as enhancing energy, increasing quality time, learning to bundle, focusing on the most important things, working flexibly, and simplifying our



lives can lighten the burden and bring greater joy and purpose to the work of life. As we seek life harmony, we will be more able to both provide for and nurture our families and compose of our lives a magnificent symphony. When we do these things, we are more effectively able to live joyfully within our means.

Notes

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13

Marriage and Money

Successfully Sharing Your Family's Financial Management as a Couple

Melissa was exhausted. She woke up tired every morning and could hardly move until she had an energy drink. She felt fatigued all the time and often went to bed totally drained. Although Melissa loved her newborn, he wreaked havoc with her sleep schedule. When she married handsome and fun-loving Michael last year, she had no idea that the transition to family life would be so challenging or so exhausting. Melissa and Michael had to adapt in many ways, but their greatest trials concerned money.

Melissa was a saver, and Michael was a spender. Melissa had made her first budget at age eleven and had lived within her own budget ever since. She was responsible; she paid all the bills on time, she balanced her checkbook, and she carefully considered every purchase. After she was married, she would consult with her husband on every major purchase. Michael, on the other hand, grew up in a wealthy family and was used to buying what he wanted. He wasn't careful with their money and would often make purchases that Melissa considered foolish. Even worse, he didn't have the courtesy to consult with her before making those purchases.

When they were first married, they were very happy, and Melissa was able to overlook Michael's financial carelessness. He was just so good-looking and fun to be around! However, as the stress, expense, and fatigue of working, finishing school, studying, and having a baby set in, it became much more difficult to stay calm. The result was numerous volatile arguments which often degenerated into shouting matches and name-calling. One time



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- Financial questions to discuss while dating
- Effective and efficient ways to finance the engagement and the wedding
- Principles and practices for successfully sharing your family's financial management as a married couple

it got so loud that their neighbors knocked on their door to see if someone needed help. Right now Melissa is wondering if she made a mistake marrying Michael. She has an appointment to see a therapist next week.



Introduction

Money really matters to a husband and wife and to their marital relationship. When couples act as equal partners in the economics of the home and leverage their individual talents, financial challenges can generally be avoided, and when they do occur, they can become stepping stones to deeper love and respect. However, when the couple lacks financial skills, cannot cope with financial differences, or are not equal partners, financial difficulties are often associated with family stress¹ and even divorce.² Marvin J. Ashton quoted a study by the American Bar Association that indicated that “89 percent of all divorces can be traced to quarrels and accusations over money.”³ Dr. Bernard Poduska reflected, “The saying ‘married for better or worse, or until *debt* do us part’ seems to reflect today’s marital realities more accurately than does the traditional vow.”⁴ It is not surprising that economic trials can be at the heart of marital difficulties because how you spend money reflects your priorities and what you value. It can send a message that you value things more than you value your spouse, and that message can poison a relationship.

The purpose of this chapter is to outline principles and practices for successfully sharing your family’s financial management as a couple so that you can joyfully live within your means. First, we will look at dating and finances. Then we will examine financing the engagement and the wedding. Finally, we will discuss some principles and practices for handling money matters joyfully as a married couple.

Dating and Finances

When you are ready to get married and are actively seeking a spouse, it is important to consider the way a potential partner handles money. Just like you would want to see how a potential mate interacts with children before getting engaged, you should also carefully evaluate how a potential spouse deals with economic matters.

Here are some financial questions to answer about your potential spouse, either by observation or direct questioning, before getting engaged.

Are you a saver or a spender?

In many marriages, one partner is a saver, and the other partner is a spender. Both play an important role. Early in a marriage, it is a great blessing when the saver can help the spender stay within the budget. Later in the marriage, if the family is doing well financially, the spender can take the lead in budgeting for some special expenditures that would strengthen relationships: perhaps a second honeymoon or a nice family vacation. Couples fare better financially when at least one of the spouses is a saver and neither is materialistic.^{5,6}

What is your net worth?

Net worth is simply the total value of your assets minus the total value of your liabilities (debts). It is not necessary to know the net worth of your potential spouse to the penny. However, it is essential to know if your future fiancé is bringing a large amount of debt into

the marriage. I heard of a wife who found out her new husband had more than \$100,000 in debts the week after the honeymoon. How do you think she felt? She was as angry as a horned lizard! She felt deceived and betrayed.



The transparency you have in your finances is a reflection of the trust you have in your relationship. It took this wife a long time to regain trust in her husband. Debt is not necessarily a relationship show-stopper, but it should certainly be disclosed and discussed before engagement.

What is your attitude about debt?

Look for someone who desires to minimize and eventually eliminate debt. If a potential mate is fine with carrying a balance on credit cards, buying furniture on revolving credit, purchasing a new car with a 72-month contract, getting as many student loans as possible, and obtaining the latest fashionable clothes on credit, then that person is waving a big warning flag in front of your face. Be careful! It is better for a potential spouse to be financially wise than to be drop-dead gorgeous!

What is your attitude about financial help from family?

Of course, it's fine to have some financial help on occasion, but it is healthiest for a new couple to be as financially independent as possible from his parents and her parents. If a potential spouse expects family support on a long-term basis, be careful!

What is your credit score?

Your credit score affects the amount of interest you will pay on a home loan, an auto loan, or even the premium for auto insurance. When you apply for a mortgage, the credit score of both partners will be considered. You can obtain your credit score in minutes for free from www.creditkarma.com or www.mint.com. If you are young, either a high score or no score is acceptable. However, if your prospective spouse has a low score (in the 500s or lower), this is a warning flag that this person has not handled money well in the past and may have issues in the future. It will also be difficult or expensive to get credit until that score is improved.

Do you currently have and live within a budget? If so, what are your living expenses each month?

If the answer is "yes" to the first question, you know you have someone very special, because many students do not even have a budget. If the answer to the second question is "less than my budget," then you know you have someone who is careful with money and will probably help your marriage avoid financial pitfalls.

How are you paying for your college education?

The answer "mostly with student loans" is a warning flag. It's hard to get off to a good start financially when you are saddled with paying off student loans for ten, fifteen, or more years. It is impressive when someone is debt-free and especially impressive if he or she put themselves through college debt-free independent of his or her parents (through scholarships, savings, and work). Some loans may be necessary but you and your partner should do all you can to minimize your loans. Loans should be below the national average of \$25,250.⁷

How do you foresee sharing finances and assets with your spouse after marriage?

In general, an attitude of equal partnership with finances is best. You are looking for someone who expects to have joint checking accounts and both partners' names on deeds and titles. If you are expecting to be a stay-at-home parent, be very wary of someone who expects to have a greater say in the finances because he or she is "earning the money." You want a partnership with equal say in all financial matters.



How many children do you desire in your family?

The specific number may not be as important as whether or not the desire is for a large, medium-sized, small, or child-free family. This matters financially because the latest figures show that in the United States, on average, it costs parents \$233,610 to raise each child to age eighteen.⁸ On the other hand, a desire for a large family may indicate family-centeredness and, when accompanied with a saver's mentality, this may be absolutely wonderful!

What is your expectation about who is going to earn the money in your family?

It is important to understand if there is an expectation of a traditional earner situation with a full-time employed husband and a stay-at-home wife or whether both partners

are expected to be employed to provide family income. There are many options in this regard, and decisions are often emotionally-charged. It is important to talk about this before getting engaged.

In an article entitled "in Defense of the Stay-at-Home-Mom," Rachael Marie Collins shares her story of leaving a highly successful career as an attorney to be a stay-at-home mother (<http://archive.is/RCVFt>). She explains how hard she had worked to climb the ladder of achievement and how everyone around her knew she would do wonderful things with her life. But she was under a lot of strain and felt miserable until she made the decision to devote herself to raising her newly adopted daughter.

What do you think about charitable giving?

It is a very good idea to not only discuss religion and faith but also your beliefs on charitable giving (whether to a church or to other non-profit organizations). If one of you is used to paying 10 percent to your church and the other believes \$200 a year to the Red Cross is enough, you need to have a discussion. Religion and money are two areas that can either strengthen or weaken your relationship. It is nice when husband and wife are on the same page in this regard.

Financing the Engagement and the Wedding

The Engagement Ring

Purchasing an engagement ring is one of the first major financial decisions that you will make related to your marriage. If at all possible, an engagement ring should not be purchased with borrowed money. It is much better to save and sacrifice and pay cash for a smaller ring than it is to go into debt to buy a larger ring. Many couples start with a smaller ring and then get a second ring after they are well-established financially. If your future

spouse is expecting to go into debt for a large engagement ring, that could be a warning flag. Be careful!

Since buying an engagement ring is a major purchase, it is generally wise that both the bride and the groom have a say in the ring. One way to make this possible is for the engaged couple to go ring shopping together and decide on several possible selections. Then the groom can surprise the bride with the specific selection. Here is another word of caution: the ring decision is something you should make without undue outside influence. If one of your parents is giving too much input, politely ask them to “mind their own business.” 😊

In Laura Vanderkam’s article, “What else could that ring buy” she explains how it could be beneficial to spend less on the ring and wedding and save the money for future years when it is more needed. She explains that the \$5,000 cost of rings and the \$20,000-plus average wedding tab “is spent when a marriage least needs it, when love is gleaming as bright as a diamond. It’s later that life gets in the way of marriage.” She explains that the money could help strengthen the marriage if spent on babysitters for date nights, weekly laundry service for two years, weekly thinking-of-you bouquets for a decade, and more. (http://usatoday30.usatoday.com/printedition/news/20100210/column10_st.art.htm). It might just be worth it to spend less money and time on your wedding day and more time and money on preparing to be married and improving your relationship after marriage.

The Wedding Budget

The average cost of a wedding in the United States is now \$35,329!⁹ This includes rings but not honeymoon expenses. The most expensive place for a wedding is in Manhattan (\$82,299), and the least expensive is Utah (\$13,301). Wedding costs include everything spent by everyone: the bride and the bride’s family, and the groom and the groom’s family. The decisions you make related to wedding expenditures are indicative of the principles you will follow later on in the marriage.



The first principle you should follow is to avoid debt. When it comes down to it, what is the minimum amount you must spend for a backyard wedding? Depending on the yard or venue, the only expense that you **MUST** make is the purchase of a wedding license, with an average cost of \$50. Everyone can afford that! There is no need to go into debt. Have the best wedding you can within the resources you have. If you can’t afford it, just don’t do it! Learn to say no!

The second principle is to jointly create and stick to a budget. Usually it is best if the bride and groom sit down with both sets of parents to create a wedding budget. Different families do this in different ways. In some cases, a parent, usually the mother of the bride, does most of the work and is responsible for most of the budget. In other families, the bride and groom are given a budget. In my family, we give our child a check and give them total responsibility for how they spend it. Whether they have a reception or not is up to them. If they have it in a reception center or a church



cultural hall is their choice. Whatever money they have left, they can keep to help them get off to a good start.

Here is one other bit of financial advice: Don't over-spend on the honeymoon. That special time right after the wedding is not designed for elaborate sightseeing; it is designed to have a quiet, private time together to get to know one another as husband and wife. For the honeymoon, "less" is often "more." A quiet, private, inexpensive getaway is often better for the marriage than an elaborate, expensive tour of some sort. Save that for an anniversary.

Principles for Handling Money in Marriage

Principle 1: Equal partnership

There is nowhere that equal partnership is more important than in marriage. Equal participation in financial decisions by both husband and wife is an important part of this equal partnership. Both husband and wife should agree before major purchases are made. Every financial decision of substance should be made by consensus and if consensus cannot be achieved, the purchase should not be made.



Principle 2: Total trust and transparency

Trust is a large foundation stone for a healthy marriage. The way a couple manages money is indicative of their trust level. In general, there should be total transparency

in finances. The couple should write checks and use debit cards out of the same checking account. Both names should be on the deed to the house, on the home mortgage, on the titles to the cars, on the utilities, on the cell phone plan, on the credit cards, on everything. Besides trust, there is another reason for this transparency: Credit scores are achieved individually and both credit scores are considered when a married couple applies for a mortgage. Having official joint responsibility for finances will positively build the credit score of both.

There is one caveat to this principle: In remarriage, where significant assets are involved, it is often advisable to have a pre-nuptial agreement in which the assets from the former marriage are secured for the children of that marriage. For example, when Tammy and Jeff were married, they made a pre-nuptial agreement. Everything that Juanita and Jeff had accrued in twenty-nine years of marriage (e.g., home equity, 401(k) accounts, and other investments) was kept for Jeff and his children. Everything that Mark and Tammy had accrued in eighteen years of marriage was kept for Tammy and her children. In this way, the children felt secure. Blending a family is hard enough, but by doing this, there couldn't be the rationale of "she married Dad for his money." However, all of our financial gains after the day of the wedding were kept in common (joint checking account, 401(k), etc.).

Principle 3: Reduce and eventually eliminate debt

Both partners should agree on how they will reduce and eventually eliminate debt. The saver in the marriage will have an easier time eliminating debt than the spender. However, it is essential that both partners agree to avoid credit card debt and consumer debt like the plague. They should also work together to pay off car debt and student loans and eventually pay off the mortgage. They should rejoice together when the last payment is made and they are debt-free forever.

Both partners should avoid credit card debt and consumer debt like the plague.

Practices for Handling Money in Marriage

Practice 1: Do your budget together, and review it frequently

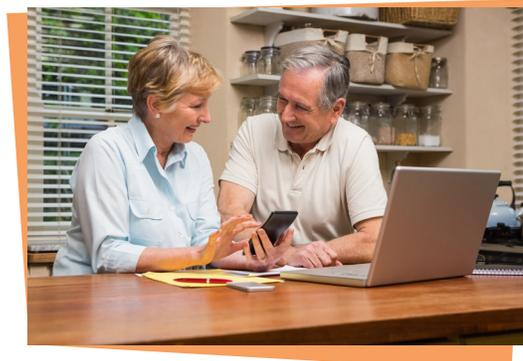
Create your monthly budget together, track it together, and modify it together. This budget is your family financial roadmap. It is where, together, you give each dollar a name. It should reflect the needs and wants of both spouses and the children. Whether income is earned by one spouse or both, whether you have separate or joint bank accounts, agreeing how money is spent in the budget is key. In marriage relationships, both husband and wife should have a say in budget creation. One spouse may be the “hands on” person for the budget (e.g., entering expenditures into a spreadsheet, monitoring mint.com, etc.). However, there should be a frequent reporting of the budget status. Tammy and I review our weekly calendar after church every Sunday afternoon. Right afterwards, we log onto mint.com and review where we are on our monthly budget. By reviewing it frequently, we can apprise ourselves of course corrections if we are spending too much money.

Practice 2: Make major purchases together

It follows from the principle of equal partnership that all financial decisions of substance should be made by consensus—both husband and wife should agree on the purchase. Failure to heed this counsel has been the cause of many divorces. For example, I heard of a husband who spontaneously purchased a new Harley-Davidson motorcycle. Their family was on a tight budget already, and when the wife realized what the monthly payment for this foolish purchase meant, it was the last straw. She left him.

Practice 3: Agree to spending limits

Each partner in the marriage should agree to the family budget and to a spending limit beyond which the approval of the other spouse is required before the purchase is made. This limit may be very low early in the marriage, even as low as \$10. Later on, after the family has been financially wise for years, that limit may rise to several hundred dollars or more.



Practice 4: Sleep on it

Another helpful practice is to never make a major purchase on the spot. It is so easy to get carried away with irrational emotions when you see a car, house, or boat for the first time. It is advisable to “sleep on it” and make a final purchase decision the next day or later. The husband and wife then have time to look objectively at the purchase, absorb the cost of the purchase, consider the pros and cons of the purchase, and contemplate the opportunity cost for what else they might do with that money that would be of more worth. In this relaxed scenario, both the spender and the saver can make their cases. When both the husband and the wife have fully discussed the purchase and feel good about it, buyer’s remorse is less likely, and couples are less likely to blame one another if the purchase doesn’t work out well.



Both partners should avoid credit card debt and consumer debt like the plague!

Practice 5: Deal with financial disagreements constructively (remember H.A.L.T.)

All couples have disagreements about finances. These disagreements are normal and are to be expected. The key is to make the discussions engendered by these disagreements productive rather than allow them to spiral towards anger, bitterness, and contempt. Spiraling disagreements over finances contribute to stress and even divorce. One way to make financial discussions productive is to remember the H.A.L.T. principle. Be very careful when you discuss finances if either spouse is hungry, angry, lonely, or tired. Hunger contributes to anger. Referring to a study of 107 couples he conducted at Ohio State University, Dr. Brad Bushman found that low blood sugar levels made disagreements contentious. He commented, “If couples have a sensitive topic to discuss, it would be really smart to do it over dinner or better yet after dinner. They should definitely not do it on an empty stomach.”¹⁰



Practice 6: Mad Money

As a general principle, be transparent in financial matters: Both spouses should know and have a say in family income and expenditures. However, individuals may vary quite a bit in what purchases they believe are worthwhile or unwise. Contention can ensue over even small items if the two spouses disagree. One way for you to limit this contention over small purchases is to implement the practice called *Mad Money*. This practice dictates that each spouse should have a monthly amount

of money over which they have total control. This money is “off budget,” and there is no accountability to the other spouse for how it is spent as long as it is moral and ethical. The monthly amount of this personal Mad Money may vary as financial circumstances change.

Let me share an experience of how Mad Money helped my first wife and me avoid conflict. Juanita was considerably more frugal than I was. I still remember her getting after me one afternoon for buying two hot dogs for my son and me at a football game. “I could have fed our whole family (of six) a good dinner for what you spent on those two hot dogs!” she said. And she could have! But it still irked me. I worked hard, and I felt I should be able to buy some hot dogs at the stadium if I wanted. Anyway, we reduced this contention when we started allowing each other \$50 per month in Mad Money. Now, if I wanted something inexpensive that Juanita considered frivolous, I could just go ahead and get it and not worry about it (as long as I didn’t spend more than \$50 Mad Money in a month). Mad Money is an idea worth trying!

Summary

Fortunately, the story of Melissa and Michael, mentioned at the beginning of the chapter, has a happy ending. After listening carefully to Melissa, the therapist counseled with both of them together. It was clear that Michael loved Melissa dearly and wanted their marriage to thrive. The therapist suggested they take a family finance class together and they agreed. Melissa’s sister agreed to watch the baby. In class they learned to budget together, to respect each other in purchases, to allow for Mad Money, and how to minimize and eliminate debt. Now they are getting more sleep, they have more money, and things are going well with their marriage.

Money does matter in marriage. In this chapter, we have discussed questions you should ask before getting engaged. We then talked about financing an engagement ring and a wedding. Finally, we proposed princi-



ples and practices for how to manage money in marriage. Money can be such a blessing in our lives! When spouses are equal partners and handle their money responsibly, money can be a tool, not a vice. Like all things in life, money is another opportunity for couples to work together and grow closer together. We hope these principles, practices, and tips will help you on your journey together as you live joyfully within your means.

Other Resources

- ➔ <http://www.bankrate.com/finance/personal-finance/couples-cash-money-management-with-your-partner.aspx>
- ➔ www.creditkarma.com
- ➔ www.mint.com
- ➔ <http://www.focusonthefamily.com/marriage/money-and-finances/money-management-in-marriage/money-and-marriage>

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14

Children and Money

Teaching Financial Responsibility to Your Offspring

By Ashley B. LeBaron, Christina M. Rosa, Carly Schmutz, Alex K. Gunnerson, Nicholas A. Jones, Travis J. Spencer, Jarna N. Knickerbocker, and E. Jeffrey Hill

Throughout this book, we have tried to teach you financial skills to help you live joyfully within your means. You have the responsibility of teaching your own children these same principles and skills. If you do so from the time they are young, you will raise financially independent young adults who will successfully navigate their way through the economic landscape. If you fail to teach these principles, your children may depend upon you and your financial resources to support them for the rest of your life. This is a high-stakes game. Winners may very well enjoy their golden years visiting grandkids who live in financially secure homes. Losers may see many of these blessings evaporate. We invite you to be diligent in teaching your children practical skills of family finance.

Marital intimacy problems and financial problems are often the result of a failure to communicate. Sex and money—it seems like they are often lumped together. For some reason, parents have difficulty talking with their children about sex. Because of this, children often get erroneous ideas from their friends and from the media about sex and its purposes. Our society pays a big price for this communication failure: early sexual activity, sexually transmitted diseases, unwanted pregnancy, births to unwed mothers, etc. Likewise, many parents have difficulty talking with their children about money. Because of this, children often get erroneous ideas from their friends and from the media about finance and its purposes. Our society pays a big price for this communication failure



LEARN

- Effective practices for teaching your children sound financial principles

as well: frivolous spending, large credit card debt, the student loan crisis, high bankruptcy rates among the young, etc. As Dave Ramsey says, “Children are sponges—they are going to absorb whatever is around them, so we need to be intentional about what surrounds them.” We must overtly teach our children about finances (as well as about sex).



In this chapter, we focus on how to teach financial responsibility to your children so they do not become a statistic on student loan debt. Although you might not have children yet, we believe that by carefully studying these principles, you will be prepared to teach them in the future. Most of this chapter will be built around a qualitative research study conducted at BYU in 2015 entitled *Whats and hows of family financial socialization: Retrospective reports of Millennials and their parents and grandparents*.¹ For this study, a BYU research team conducted 151 interviews with students from three universities and with some of their parents and grandparents. These participants were asked to specifically identify *what* their parents taught them about finances and *how* they did it. Using thematic content coding, the researchers distilled more than three dozen themes which they then consolidated into eight general financial principles that were taught. Within each principle, they also identified specific practices of *how* parents successfully instill these principles. This chapter is organized around those eight principles and associated practices.

Principle 1: Open Financial Communication in the Home

Effective parents communicate openly about their finances with their children. They make finances a regular, comfortable topic of family conversation. They instill confidence that their children can make good financial decisions.

Effective parents often use the everyday activities of the home as a context to freely talk and teach about finances. One student remembered his parents talking openly about finances around the dinner table:

[My parents] would talk about the stock market, and they would talk about how to distribute their wealth. My mom would talk about how she wanted to purchase some financial instruments, but my dad would disagree, and then he would tell her the reason, and then they would talk about things like that. . . . A lot of the time it would be brought out at the dinner table. . . . They talked about interest rates on savings accounts, and they talked about just the economy.

Another theme that arose was how parents would be open enough to sensitively share financial difficulties with their children. Another student said the following:

My parents are also fairly open about our family’s finances. When my dad lost his job, they held a family council in which we prioritized our needs from our wants in order to deal with the change of income. They also told us that they had ordered my mom’s dream car—a green Mini Cooper with two white racing stripes—but that they wouldn’t be going through with it because of our recent unemployment. This taught me to be responsible and adaptable to changing financial situations.

Natural teaching moments will occur if you work on your finances in a place where your children can see you. Several students

commented that they learned a lot as their parents took the time to explain what they were doing when working on family finances. One student said,

I remember seeing my dad spend hours on the computer calculating taxes and other financial documents. Some nights I would just pull up a chair and ask him a bunch of questions about what he was doing. I learned a lot about what all the financial terms meant and how he decided where to put all of his money. I still call my dad very frequently to ask his opinion about what I should be doing now to secure my financial assets for the future.



Principle 2: Save and Sacrifice

Effective parents teach their children to save and sacrifice for what they want. They do not spoil their children nor foster a sense of entitlement. They make their children wait to make purchases until they have the money.

Media advertising and marketing campaigns teach our children to crave what they want and to demand it right now. As a parent, you must teach your child the virtue of patience. When you are at the store and your son sees a PlayStation that he wants, tell him, “That’s great. When you have saved enough money to buy the PlayStation, I’ll bring you back, and we can get it.”

A few years back, CNN quoted a study on college students at the University of Illinois at

Family Matters

Tammy and I were newlyweds (with twelve children) when we found ourselves in a real financial crunch: one of our investments, which brought in \$750 per month, suddenly failed. Without warning, our after-tax spendable income dropped significantly. We decided to be totally open with the children about this misfortune and to include them in figuring out what we could do about it. We held a special family council to deal with this issue. Prior to the council, Tammy and I wrote down \$2,300 of monthly expenditures that weren’t absolutely essential. These expenditures included things like cable (\$150), keeping the thermostat higher in winter and lower in summer (\$100), cell phones (\$150), the newspaper (\$10), additional contributions to the new car fund (\$100–\$400), etc. We talked about each possibility as a family, and then every person privately made a list of what he or she would cut to make up for the \$750 per month loss. I found I was out of step with the rest of the family in several matters. Everyone wanted to cut the newspaper, except me. No one wanted to cut the cell phones, except me. Once we got everyone’s input, we cut according to the recommendations: we stopped the newspaper, adjusted the thermostat, waited to get a new car, cut cable, etc. I believe this experience helped my children understand what you sometimes have to do to live within your means.

Urbana–Champaign. The researchers found that of those young adults with good financial skills, “Nearly all said their parents had gotten them into the habit of saving as young children, suggesting saving is a behavior that comes from experience, not knowledge.”²

A student in our BYU study recalled that her parents would buy things she *needed* for her, but they encouraged her to save her own money to purchase things she *wanted*.

As I grew older and started earning money by babysitting and mowing lawns, my parents encouraged me to be a little more financially independent. When I wanted to buy something that was not exactly a need, my parents would tell me they did not have the money in their budget to



allow for me to have the item, but that I could get money from my savings jar and purchase it myself. Later, when I wanted to go to Especially for Youth (EFY) over the summer, my parents and I compromised on the cost. They saw how important it was to me to go to EFY and that I did not have \$400 to pay for it all. They told me they would pay for the whole event and I could pay them back as I got the money, up to \$200. As a fourteen-year-old girl, I learned that I could rely on my parents for financial support if it was absolutely needed, but I was still responsible for myself.



Another student talked about how his parents taught him to save and sacrifice for what he and the family wanted:

I recall several times when my parents would discuss with us kids how the electricity bill or water bill was a little high and we needed to lower it. They made a goal to go to Disneyland and told us that if we helped cut down our spending costs, we would be able to go. My mom and dad often reminded us to turn off the lights when we left a room, put on a jacket before turning the thermostat up in the wintertime, and take shorter showers to save water.

Principle 3: Work Hard

Effective parents teach their children to work—both with and without pay. They foster a spirit of entrepreneurship by encour-

aging their children to earn money themselves outside the home.

It is important to teach your children the connection between work and money. Because of the behavior of some parents, some children come to believe that money automatically appears when they want something. You must teach your children to work for what they want. Begin while they are young. Marvin J. Ashton wrote,

One of the greatest favors parents can do for their children is to teach them to work. Much has been said over the years about children and monthly allowances, and opinions and recommendations vary greatly. I'm from the 'old school.' I believe that children should earn their money needs through service and appropriate chores.³

Rachel Cruze, daughter of financial celebrity Dave Ramsey, wrote, "I learned early on that work creates discipline, and when you have discipline in your life, you are a healthier person."⁴ Underscoring the importance of work, Dave Ramsey wrote, "You should view teaching your children to work in the same way you view teaching them to bathe and brush their teeth—as a necessary skill for life."⁵

It is important to teach your children to see the connection between work and money—that money is the reward for honest labor. Giving your children a weekly allowance may blur the connection between labor and financial reward. Rachel Cruze offers an interesting perspective on allowances: "When speaking of money, 'allowance' shouldn't even be in your children's vocabulary. Use the word 'commission,' and explain how money comes from work."⁶

Several participants in the BYU study mentioned practices that taught this principle. One of the students described how hard work taught her the value of money:

One of the most valuable lessons that my parents taught me was the importance of hard work. When I was little, they gave me opportunities to earn small sums of

money from doing some of the tougher chores around the house. We had our regular chores that we did, but Mom assigned small amounts (like \$0.50 or \$1) to extra chores such as washing the cars, washing out the trash cans, and deep cleaning the oven or fridge. Working from the time I was young really helped me to value my hard-earned money. I am much less likely to spend on things that I don't really need because I have worked hard for what I have.

Another of the BYU study participants recalled how his mother taught him to plan and save for purchases:

My mom took advantage of the time when I obsessed over Pokémon cards to teach me about saving. Each week I would fold laundry for \$0.25 a basket until I had enough money to buy my beloved Pokémon cards. Together, we worked out how much money the cards cost, how many quarters it took to pay that much, and how many weeks it took to save that much. For months, I folded four baskets of laundry each week for four weeks, so that by the end of the month, I could claim the cards I worked and saved for.

It is great to give children the opportunity to earn money within the home. However, fostering ways to help them earn “green” dollars by working outside of the home can be very beneficial. Here is what happened in one family:

Well, I started mowing the lawn with my



dad when I was four. I had a lawn mowing business when I was eight, and I've had a job ever since. . . . So my brother and I actually started it. We just printed off about 200 fliers and took them around the neighborhood and put them around on people's doors. Then the next week we had twelve lawns to mow.

While it is important to give children the opportunity to do some chores for money, it is essential for children to learn to do their part without pay. Here is how one student put it: “They gave us chores. We didn't get paid for chores. So they taught us to really be motivated to work rather than just for the pay.”

Principle 4: Live Within Your Means

Effective parents teach their children to be frugal, live within their means, and avoid debt.

Teach your children to live joyfully within their means. Children must come to understand that money is finite and that when it's gone, it's gone. If a child wants something but doesn't have the money for it, the parent should not buy it. Children should have to work and save and sacrifice until they have sufficient to buy what they want. Participants in our study reported many ways their parents taught this. One student describes how being given a certain amount of money for school supplies can help children learn to live within their means:



Every summer, about two weeks before a new school term started, my mom would take my siblings and me to Walmart. Before we started shopping, she would give each of us \$40. We were told we could spend this money on school supplies, clothes, or whatever else we needed for school but were cautioned that we would have to be careful about how we spent it because we would not be given more. I still have a clear memory of staring up at a new SpongeBob backpack the year before starting second grade, weighing in my mind whether or not I could reuse school supplies from the previous year so I would have enough money to purchase the backpack. It was through experiences like this that my parents taught me about how to use money.

Another person in the study told of her mom's powerful example of living within her means:

[Because] my mom was so frugal growing up, I was very aware of how much stuff cost. Like I would never get a soda or drink when we would go out to eat, which was hardly ever. We'd just get water. I was just very aware of how much stuff cost just because I could see that my mom did that. So even though I never knew where my dad's paycheck went, I knew that "Oh, cable costs money." Having internet costs money or another phone line. I was just very aware at a very young age because my parents told us "Oh, this costs money."

This study also revealed that parents were



creative in showing how to live within your means. One student remembered the following:

I learned that you really don't need to spend a lot for nice things. You just need to be creative sometimes! We spent so much time painting things, refinishing furniture, creating furniture and toys for our Barbies and pets, and finding free stuff.

Principle 5: Use a Family



Budget

Effective parents set, live within, and share their household budget with their children.

Many parents are reticent about sharing too much about the family budget with their children. However, Robert D. Hales taught, "We help our children learn to be provident providers by establishing a family budget. We should regularly review our family income, savings, and spending plan in family council meetings."⁷ Perhaps it is good to share more rather than less. One student remembered a creative way that her parents included the children in the family budgeting discussion:

One time in particular, our parents decided to teach us about finances by putting my younger sister and me in charge of planning out how we were going to spend the family's money for next month. We were the parents for the night. They

brought out an envelope of money and then let us go to town. As my sister and I started planning out all of the fun we would have—toys we would buy, treats we would splurge on, etc.—my parents asked if we wanted to keep living in our home, if we wanted our lights to stay on, if we wanted heat and food to eat, cars to drive, and so on. It quickly became apparent that we didn't have quite as much money as we had hoped to spend on any and every wish we had! We learned a valuable lesson about planning how to spend money in the future, in addition to learning that “real life” costs money.

When children are older, parents can teach them more adult-like budgeting skills. One student remembered how her dad taught these skills:

Later in my life, I asked my dad to teach me the basic principles of budgeting. So one day, we sat down at the kitchen table, took out a piece of paper, and wrote out a fake budget plan. He started with the initial gross income, then taught to always first pay the Lord (tithing) and yourself (savings). Next, he asked me to list off some other categories important in a budget. After I gave suggestions and he added more, our list consisted of things like rent, utilities, groceries, clothes, entertainment, miscellaneous, etc. He explained to me the importance of the entertainment and miscellaneous categories, so as not to leave them out. Finally, he stressed the importance of actually living within the budget.



Principle 6: Provide Real-World Financial Experience

Effective parents provide real-world experiences with money and financial institutions.

It is important that parents teach children to deal with real financial institutions outside of the home. Rachel Cruze states, “Keeping up with a checking account as a teenager can teach them so many lessons. They’ll learn how to interact with a bank, check their account online, actually reconcile their account, write checks (yes, they still need to know how to do this), and take responsibility for their money in a more adult manner.”⁸

Rachel Cruze’s statement was supported by interviews in our BYU study. One student reported the following experience:

They [my parents] also taught me the principle of saving by establishing a bank account for me when I was twelve years old. My parents helped me understand that all the money I wanted to save, I could put in this bank account and then I could use for education later on. Because of this lesson, I was able to put my money in a savings account in the bank and let it compound interest. By the time I went on my mission, I had saved enough to pay for half of my mission.

Another student described a similar experience:

My dad took me to the bank, and we set up two certificates of deposit, and I remember him trying to explain to me what it was.

Parents need to help children learn to be responsible with debit cards and credit cards. Children see people pulling out pieces of plastic from their wallets at the store and getting whatever they want. Children need to know what debit and credit cards are and how to use them. Here is how one student reported being taught about debit and credit cards:

My parents taught me about credit cards and how to watch your balance on them

Bill Cosby teaching

budgeting:

[https://www.](https://www.youtube.com/watch?persist_safety_mode=1&safety_mode=true&v=L7soJdOhKZM)

[youtube.com/](https://www.youtube.com/watch?persist_safety_mode=1&safety_mode=true&v=L7soJdOhKZM)

[watch?persist_safety_](https://www.youtube.com/watch?persist_safety_mode=1&safety_mode=true&v=L7soJdOhKZM)

[mode=1&safety_](https://www.youtube.com/watch?persist_safety_mode=1&safety_mode=true&v=L7soJdOhKZM)

[mode=true&v=](https://www.youtube.com/watch?persist_safety_mode=1&safety_mode=true&v=L7soJdOhKZM)

[L7soJdOhKZM](https://www.youtube.com/watch?persist_safety_mode=1&safety_mode=true&v=L7soJdOhKZM)





by getting me a debit card when I was eighteen. Starting with my debit card helped me develop skills to better manage a credit card. My parents would explain to me about their credit card when we went to different stores. Because they explicitly told me how they use their credit card and how they manage their balance, I feel confident in my ability to have a credit card and never get in credit card debt.

By using financial transactions in the home, you can teach your children what will happen when they conduct a real transaction with a real bank. For example, one BYU par-



ticipant reported the following experience:

My parents taught me that whenever they loaned me money, they also expected me to pay them back. Sometimes they would write down on a piece of paper the exact

amount I owed them and had me sign the paper saying I would pay them back. The little things they did to help me understand what a loan from the bank would be like (by facilitating that experience in the home) really helped me have experience.

Several students expressed appreciation that their parents had taught them how to make real investments with real financial institutions in their teenage years. One student described the following experience about investing:

Once I was in high school, he [my dad] also involved me in the process of investing money. When he had a meeting with his financial manager, he would invite me to join them for a couple of minutes to discuss my finances. I remember my dad telling me he thought it would be a good idea to take \$1,000 of my savings and invest it. Then the three of us discussed some options, and my dad and I ended up making a decision together. This taught me that saving is not the only thing to do with your money. It also taught me that it's important to consult with people who are wiser than you and to look at a lot of options before making a decision.

Principle 7: Give Freely of Your Resources

Effective parents teach their children to freely give to institutions and people in need.

Teach your children to serve by being an example of anonymous service. May we

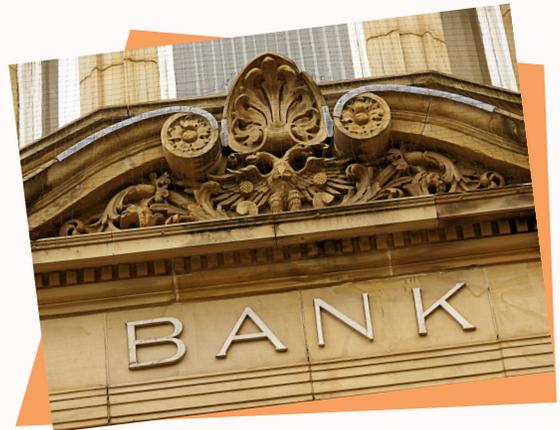


The Hill-Mulford Family Bank

By E. Jeffrey Hill

There are many ways parents can teach children that money matters and how to live joyfully within their means. One practice my family adapted from Richard and Linda Eyre was to establish a family bank.⁹ We call it the Hill-Mulford Family Bank. Until they graduate from high school, our children may invest their money in and borrow money from this family bank. Money invested earns 10 percent interest per month, compounded monthly. Money borrowed costs 10 percent interest, compounded monthly. This arrangement quickly teaches children that it is wise to save money and allow it to earn interest and that it is unwise to borrow money and pay interest. But there was a problem: the children learned this lesson so well that we had to limit the balance to avoid bankruptcy. We calculated that, due to the miracle of compound interest, our eight-year-old who invested five dollars per month in the Hill-Mulford Family Bank would have more than four million dollars by the time high school graduation came along. We decided to limit savings and loans to \$100. At that point, the money is withdrawn and can be taken in cash or deposited into a real bank.

After beginning to teach a family finance class at BYU and learning so much about the retirement value of a 401(k), we decided to make another Hill-Mulford financial offering. We call it the Hill-Mulford Family 401(k). It has many of the same characteristics as an employer-sponsored traditional 401(k). In the workplace, contributions to a 401(k) are matched by the employer for retirement, earn a return, and cannot be withdrawn early without a substantial penalty. Our family 401(k) is designed to help our children save for education. As parents, we match our children's contributions until they graduate from high school. We guarantee a return of 1 percent per month on the family 401(k) balance (in line with what a return would be on a diversified, primarily-stock based mutual fund). The children can only withdraw the money in the family 401(k) for expenses associated with missions or higher education. The maximum balance in the family 401(k) is \$10,000. In order to make sure we fund the family 401(k) with real money, we keep a separate investment account in the outside financial world that has at least the balance of the combined family 401(k) balances. We are hopeful that our children's experience with the family 401(k) will help them learn to fully utilize the employer-sponsored 401(k) when they begin working full-time, as well as provide a savings plan for future higher education expenses.



all be like this student's father and teach our children through example!

I know that my dad is very good at saving money. And he was always just very, very generous. If someone ever needed something, he would never say anything. I would learn that my dad was generous through other people.

for it to rub off. This is particularly important when it comes to money. Unfortunately, many couples choose not to share financial information with their children, a decision that is not particularly healthy. We encourage you to instead model your financial decisions and teach your children by example, like the parents in the following stories shared by our participants.

Principle 8: Example is the Best Teacher

Effective parents model the application of sound financial principles. Example is the best teacher.

Be the kind of person you want your children to become, and then be around enough

A Hill of Generosity

Tammy is an excellent example to our children of being generous. At Christmas, she seems to have a knack for knowing who among our friends could use a little extra help. She talks with the kids about how we might assist, and together we decide on the plan. Sometimes it's a gift, most often it's cash, but it's always anonymous. We think of creative ways to get the money to the families safely and anonymously. —Dr. Hill

One participant observed wise financial decisions while living at home: “I watched my parents talk about financial decisions together, shop at thrift stores, buy the generic brand cereal, share hamburgers and fries instead of buying each of us happy meals, and rarely buy new clothes for themselves.”



Another participant learned about the importance of saving from a family discussion: “I still remember the day when my parents paid off our house. They explained to my siblings and me what that meant and how they did it. My parents told us that they had diligently saved, and they encouraged us to do the same when we have our house.”

A third participant shared how his parents were examples of wise investing: “I think [my dad] and my mom, the first thing they do in the morning is read scriptures, and the second thing they do is look at stocks, and then they go eat breakfast. I guess him being wise in his investment kind of shows me the importance of investing. . . . I feel like the sooner you invest, the better off you’re going to be.”

Lasting Impressions

Parents can make a big impression upon their children when they share successes related to getting out of debt. I still have fond memories of my dad calling me over as he wrote the checks for the monthly bills. I remember him writing the mortgage check and then writing a second check. He asked me, “Jeff, do you know why I am writing another check to the bank for our house?” I didn’t have a clue. He told me, “I’m doing it so we can pay back the bank faster so we don’t have to owe anybody anything.” I still remember that experience more than fifty years later. —Dr. Hill

Summary

Parents who talk openly with their children about the family’s finances; who teach their children to save their money, work hard, and live within their means; who use a family budget, provide real-world experience, and give freely; and who teach by example, will likely raise children who will grow up to be financially-empowered emerging adults. This is an essential task. The stakes are high.

Here are some closing words by Dave Ramsey:

The psalmist said, “Like arrows in the hand of a warrior, so are the children of one’s youth” (Psalm 127:4). This is a great word picture to remind us that our children are to be released into the world. If they are strong and true, they will fly straight just like an arrow that is properly formed. It is gratifying to pull back a bow, let an arrow fly, and watch it strike the bull’s-eye. Unfortunately, in our soft and wimpy culture, we are not releasing arrows; we are releasing boomerangs. We throw them out, and they come right back.¹⁰



May all of you take seriously your responsibility to teach practical financial skills to your children so that they can successfully navigate their financial futures.

Other Resources

➔ Money as you grow: <http://www.consumerfinance.gov/money-as-you-grow/>

Notes

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Glossary

401(k)

A defined-contribution (DC) retirement plan offered to employees in which a specified amount of money is taken from both the employer and the employee on a regular basis and invested.

Adjustments (for-AGI)

"Above-the-line" IRS-allowed reductions to your gross income that are used to calculate adjusted gross income.

After-tax return

The return on an investment after the impact of federal, state, and local taxes has been taken into account.

Actively managed funds

Funds that are managed by professional investors who constantly "buy low" and "sell high."

Adjustable rate mortgage (ARM)

A loan which allows the interest rate to rise or fall with changes in mortgage interest rates.

Adjusted Gross Income (AGI)

The first step of calculating your federal income tax, determined by subtracting your adjustments to income from your gross income.

Amortization

The amount and frequency of equal payments that will gradually repay a loan (including principal and interest) over the length of the loan.

Annuity

The disbursement of money on a periodic basis—a series of equal payments which are made at a specific time.

Asset classes

A group of financial assets with similar risk and return characteristics.

Assets

The monetary value of what your family owns that could be turned into cash.

Automobile insurance

Insurance against damage to your vehicle, damage to another vehicles, bodily injury, or damage to property resulting from an accident involving a vehicle.

Automobile loans

Short-term loans that are secured by the automobile the loan is paying for.

Balance

The total amount owed on a credit card at a specific time.

Balloon mortgages

Mortgages where all remaining principal is due a certain number of years into the contract.

Benchmarks

Passively managed portfolios of financial assets that indicate how well your financial assets are performing by comparison.

Beneficiary

The recipient of life insurance who benefits in the event of the death of the insured.

Blend stocks

Stocks that include components of both value and growth stocks.

Bond

A loan with a set interest rate purchased from a government or company.

Bond mutual funds

Diversified funds in which you buy a share in thousands of different bonds in a changing portfolio.

Budget

A spending plan in which family income is allocated to specific categories of expenditures.

Bunching

A tax strategy where you itemize deductions every other year by strategically timing the payment of your deductions.

Capacity

Your ability to repay the debt from your family's income.

Capital

The worth of all your assets.

Capitalization

What you could buy the company for if you bought all of its stock.

Cash inflow

Family income.

Cash management

How to effectively manage your family's monetary assets.

Cash outflow

Family expenditures.

Cash value

The total account value that is available to the life insurance policy owner while he or she is alive.

CD

Certificate of Deposit. Pay a fixed interest rate for keeping your funds in the account for a fixed period of time.

Character

The amount of integrity you demonstrate.

Co-insurance/Co-payment

The portion of expenses beyond the deductible that the insured person pays, up to an annual maximum.

Collateral

An asset that can be pledged against a loan.

Collision coverage

Auto insurance that pays for damage to your car when it is involved in an accident, regardless of who is at fault.

Compounding periods (N)

The frequency with which interest is applied to an investment.

Compound interest

Interest earned on interest.

Comprehensive coverage

Auto insurance that protects from risks other than vehicle collision.

Conditions

The economic state of the nation or community at the time of a loan request.

Consumer loans

An amount of money lent to an individual for personal, family, or household purposes.

Convertible loans

Loans in which the interest-rate structure can change.

Coordination of benefits

Multiple insurers coordinating insurance claims medical payments so as to avoid double paying.

Corporate bonds

Bonds issued by corporations.

Coupon bonds

Bond purchaser receives regular interest payments until maturity date.

Credit

A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future, generally with interest; the term also refers to the borrowing capacity of an individual or company.

Credit bureaus

Private companies that collect and report your financial information from creditors, public records, and various institutions.

Credit card

A form of open credit that allows you to borrow money up to a specific limit with no collateral, with the expectation that you will pay back the money at a specific interest rate and with specific terms.

Credit evaluation

The process of turning the information in your credit report into a three-digit number to determine whether or not you deserve to be given credit.

Credit-holic

Someone who is addicted to credit and whose financial life is out of control.

Credit limit

The available credit given to a specific account holder.

Credit reports

Files of information that credit bureaus compile about specific individuals.

Credit score

A three-digit number that is used by banks, insurance companies, and other financial institutions to determine how likely it is that you will be creditworthy and pay your debts on time.

Current market value

The price at which your family's asset could be sold in the present market environment.

Debt

Something owed to someone else.

Debt-elimination calendar

A debt-elimination strategy in which you plan out all debt repayments, paying all minimum payments but focusing mostly on one until it is paid off, then using the amount of money previously paid toward that debt to pay off the next most important debt.

Deductible

A specified amount that you must pay to cover an expense that could qualify for your insurance coverage before your insurance begins paying for eligible expenses.

Deductions (from-AGI)

IRS-allowed reductions to your adjusted gross income that are used to calculate taxable income.

Defined-benefit plan (DB)

A type of retirement plan in which all contributions are made by the employer and the benefit is guaranteed for life and based on the number of years of service and the final salary.

Defined-contribution plan (DC)

A type of retirement plan in which contributions are made by both the employer and the employee, but the investments are chosen by the employee; the contribution amount is specified by a formula, but the benefit amount varies according to payment amounts, the market, and the management of the employee.

Depreciate

To lose value over time

Disability insurance

Insurance that provides payments to insured individuals in the event that regular income is interrupted by illness or an accident.

Dividends

Money paid to shareholders on a regular basis.

Emergency Fund

Liquid financial resources to meet unexpected and immediate

needs; this should total at least 3–6 months of living expenses.

Equity

Hypothetical amount of money you would have left if you sold your home and paid off your mortgage today.

Estate

The money, property, and other assets owned by a person at the time of their death.

Estate taxes

A tax charged on the value of a person's estate upon his or her death if the estate is sufficiently large.

Excise taxes

A tax levied against certain specific products or services (such as fuel, liquors, and cigarettes) on a per unit basis.

Exclusions

Specific conditions or items that are not covered by the standard insurance policy.

Face value (bonds)

Value of the bond when redeemed on the maturity date.

Face value (insurance)

The basic benefit the life insurance company will pay the beneficiaries upon the death of the insured.

Family loans

Borrowing and lending between family members.

FDIC

Federal Deposit Insurance Corporation. The government agency which insures deposits at most commercial banks for up to \$250,000 per depositor. Joint depositors are insured for up to \$500,000.

FICO score

The most common type of credit score.

Financial Reserve

Cash or other liquid assets held to cover 3–6 months of emergency expenses.

Fixed expenses

Expenditures that your family has little direct control over and that do not often change from month to month.

Fixed-rate loans

Loans that maintain the same interest rate for the duration of the loan.

Fixed rate mortgage

A loan which has a constant (or fixed) interest rate throughout the life of the contract. Monthly PI (principal and interest) remains fixed the duration of the loan.

Future value (FV)

The monetary value of an investment at some point in the future.

Geometric return

The compound interest rate of an investment.

Global funds

Funds that contain a mixture of US and foreign holdings.

Grace period (credit cards and loans)

The period of time between a payment due and penalties, interest, or cancellation.

Grace period (insurance)

The period of time between the payment due date and the cancelation of your insurance.

Graduated payment mortgages (GPM)

Mortgages with lower initial payments that increase over time.

Growth stocks

Companies whose earnings are expected to grow very rapidly.

Guaranteed renewable

An option that gives an individual the right to continue insurance at the end of each premium period

HALT principle

Avoid making purchases or financial decisions when you are
Hungry
Angry
Lonely
Tired

Health insurance

Insurance for expenses relating to health and medical procedures.

Health savings account (HSA)

An account that is created by an employer on behalf of an employee to save money toward medical expenses.

Home equity loan

A loan which uses the equity in your house to secure your loan (to be avoided!).

Homeowners insurance

Insurance that covers a personal residence combined with other personal protections for the owner(s).

Income and expense statement

A record of your family's past cash inflows and outflows over a specified period of time.

Income taxes

A tax levied directly against the earnings of workers; this tax is one of the main sources of government funds.

Individual Retirement Account (IRA)

A tax-advantaged retirement plan that is managed by the individual who owns the plan. Maximum contributions are \$5500 per years until age 50. Money may not be withdrawn without penalty until age 59 ½.

Inflation

Decrease in the purchasing power of money.

Inflation protected securities

Securities whose yield is linked to the rate of inflation as measured by a specific inflation index.

Inheritance taxes

A tax on money and property received by heirs.

Installment loans

Loans that are repaid at regular intervals.

Insurance

A contract in which an individual receives financial protection or reimbursement against losses from an insurance company.

Interest

Remuneration for investing or loaning money.

Interest rate (I)

The rate you will receive for investing at a specified compounding period for a specified period of time (generally expressed in percent per year).

Intermediate-term bonds

Bonds with a maturity of about four to seven years.

International stocks

Stocks of companies based entirely outside the US or throughout the world.

Investment

A current commitment of your money in the expectation of reaping future returns.

Investment Plan

A detailed road map of your investment risk and return, investment strategy, constraints, and reporting and evaluation methodology.

Itemized deduction

The sum of the possible deductions from AGI that you qualify for.

Junk bonds

Bonds with high yields issued by companies in distress.

Large-cap stocks

Stocks from companies with a capitalization of more than \$10 billion.

Lease

Long-term renting with a number of conditions.
Notes

Liabilities

Synonymous with debt, calculated by adding up the outstanding balances on any current and long-term family debts.

Liability coverage

Auto insurance that pays for losses related to bodily injury, property damage, lawsuits, and defense costs.

Life insurance

Insurance against the financial loss resulting from the death of the insured.

Liquidity

The immediate accessibility of money.

Loan contract

A document which describes what the lender requires of your family once you are granted the loan.

Long-term bonds

Bonds with a maturity of about seven or more years.

Long-term care (LTC) insurance

Insurance that covers the costs of nursing home facilities and long-term home health care.

Lump sum

One payment at a specific time.

Mad money

A certain amount of funds allocated to each spouse, for which they are not responsible to the other spouse.

Marginal tax rate

The rate at which the next dollar earned is taxed.

Maturity date

Date at which a bond is redeemed at face value.

Maximum annual co-payment

The most you can pay towards co-insurance in any given year.

Maximum annual out-of-pocket cost

The most you can pay towards medical care in any given year (annual deductible + maximum co-payment).

Medical payment coverage

Auto insurance that pays for accident-related medical costs and funeral expenses incurred by you or your family members within three years of an accident.

Mid-cap stocks

Stocks from companies with a capitalization of \$2 billion to \$10 billion.

Miscellaneous

One of your budgets most important, but often neglected, categories; a generous catch-all category for those unexpected expenses which find the holes in your budget.

MMA

Money Market Account. This 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.

Monetary assets

Financial resources that are legal tender (cash) or can be converted to legal tender very quickly.

Mortgage

A loan in which the home serves as loan collateral.

Municipal bonds

Tax-free bonds issued by state and local governments.

NCUA

National Credit Union Administration. Government agency which insures deposits at credit unions for up to \$250,000 per depositor or \$500,000 for joint depositors.

Net worth statement

A snapshot of your family's total assets minus your total liabilities on a particular day.

Nominal return

The return on an investment before the impacts of inflation and taxes are taken into account.

Non-cancelable

A type of policy in which your premium cannot be raised nor your policy canceled prior to age sixty-five

Opportunity cost

The potential loss or gain that occurs when one financial option is chosen over another.

Ownership

The right to possess or own something.

Passively managed funds

Funds that are managed by professional investors who invest

money using a “buy and hold” strategy.

Payday loans

Short-term loans of one or two weeks which are secured with a postdated check.

Payment (PMT)

A periodic amount invested or received during the life of the investment (e.g., monthly payment, annual disbursement, dividend, etc.).

Payroll taxes

Taxes levied against the earnings of workers to fund the Social Security and Medicare systems. These taxes amount to 7.65% of employee wages and salaries.

Personal property taxes

A state and local tax against certain personal assets.

Plastic surgery

Cutting up a credit card, making it unusable, but still keeping the account open.

Point

Equal to one percent of the mortgage loan value, points are paid to the lender in exchange for a lower interest rate.

Policy owner

The individual or business that pays for and owns the insurance policy.

Portfolio

All of your various investments.

Premium

A specified amount paid regularly (usually monthly or annually) to an insurance company in exchange for coverage.

Present value (PV)

Current value of money.

Principal

The original amount of money borrowed or invested (generally synonymous with present value).

Property taxes

A tax levied against the assessed value of land and buildings.

Purchasing power

The value of monetary funds based on the amount of goods

or services that one unit of money can buy.

Real return

The rate of return on an investment after the impacts of taxes and inflation are taken into account.

Refinance

To finance a home again with a new loan and a new interest rate, must pay off old loan and closing costs.

Roth IRA/401(k)

A type of retirement plan in which contributions are taxed before they are put into the account and money is not taxed when it is withdrawn.

Sales taxes

A percentage tax applied to the purchase price of taxable goods.

Secured loans

Loans which use one of your assets as collateral to guarantee that the lending institution will get the amount of the loan back even if you fail to make payments.

Short-term bonds

Bonds that mature in less than about four years.

Single-payment loans

A type of short-term lending repaid in one lump sum that may be used to temporarily finance a purchase until permanent, long-term financing can be arranged.

Small-cap stocks

Stocks from companies with a capitalization of less than \$2 billion.

SMART principle

Family goals should be
Specific
Measurable
Attainable
Relevant
Time-bound

Speculation

The practice of engaging in risky financial transactions, often promising greater than market-rate return, in an attempt to profit from fluctuations in the market.

Standard deduction

The dollar amount set by the government that any tax filer may use as a reduction to AGI; the amount differs depending on filing status.

Stock Exchange

A market in which securities (bonds, shares, and notes) are bought and sold.

Stock mutual funds

Funds that pool investor money to purchase many different stocks in groups or types of companies.

Student loans

Loans which are often used to pay for higher education and have federally subsidized interest rates.

Taxable income

The second step of calculating your federal income tax, determined by subtracting your deductions from your AGI.

Tax credits

Dollar-for-dollar reductions from your tax liability.

Tax-deferred accounts

Accounts which allow you to invest without first paying taxes on the principal; you then pay taxes on both the principal and the earnings when you withdraw money at retirement.

Tax due/Tax refund

The final step of calculating your federal income tax, determined by subtracting tax credits from your tax liability.

Tax-exempt accounts

Accounts which require you to pay taxes on the principal before you invest it, but you do not have to pay any taxes on the capital gains or future earnings.

Tax Freedom Day

The day of the year on which you have earned enough money to pay for all of your taxes for that year.

Tax liability

The third step of calculating your federal income tax, determined by multiplying your taxable

income by government-set tax rate(s).

Term life insurance

A policy in which the face value is paid to the beneficiaries when the insured dies.

Time value of money (TVM)

How the value of money changes over time due to inflation and interest.

Timing the market

The attempt to obtain greater than market-rate returns by buying when the market is low and selling when the market is high.

Traditional IRA/401(k)

A type of retirement plan in which contributions are not taxed and constitute an income adjustment when they are put into the account and money is taxed when it is withdrawn.

Truth in Lending Act

A law which requires that all lenders provide the consumer

with certain information before they sign the credit contract.

Uninsured/Underinsured motorist coverage

Auto insurance that covers your costs if you are injured in a hit-and-run accident, or injured by an uninsured motorist or a motorist whose insurance is insufficient to pay for your expenses.

Unsecured loans

Loans which do not require collateral and are generally offered only to borrowers with excellent credit histories.

US Treasury Bonds

Bonds backed by full faith and credit of the United States.

Value stocks

Companies that are inexpensive in terms of the underlying fundamentals of the market.

Variable expenses

Expenditures that your family controls and that may vary from month to month.

Variable-rate loans

Loans which have an interest rate that is adjusted at different intervals over the life of the loan.

Waiting periods

A stated length of time that must elapse before certain types of coverage are available to the insured

Waiver of premium

An option that pays your premium for you in the case of disability, thus keeping your policy in force

Whole life insurance

A policy in which the premiums are divided between death protection and safe, relatively low return investments.

Zero-coupon bonds

Bonds purchased at less than face value then sold at face value at the maturity date with no interim interest payments.