



## Kiplinger Financial Services' COMMON CENTS MATTERS

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### WHAT EVERYONE NEEDS TO KNOW ABOUT FINANCIAL PLANNING (PART 1 OF 3)

#### **WHAT IS FINANCIAL PLANNING?**

Financial planning provides direction and meaning to your financial decisions. It provides a disciplined approach to saving and spending. It allows you to understand how each financial decision you make affects other areas of your finances. For example, deciding how much money you want provide for your children's college education will impact how much money you will have for retirement.

Navigating competently through the life transitions of employment, marriage, home ownership, parenting, eldercare, divorce, retirement, and ultimately death require the knowledge acquired through the financial planning process. The financial planning process has several parts. Each part is designed to lead you toward the development of realistic financial goals, and to provide you with the tools to measure your progress toward reaching those goals. The process involves assembling financial information, setting goals, looking at your current financial situation, and building a realistic plan to meet your goals. The planning process is not a one-time event; it is a life-long process of acquiring knowledge, making decisions, revising goals and monitoring progress.

#### **THE TOP 10 MISTAKES PEOPLE MAKE RELATED TO FINANCIAL PLANNING**

- 1. Not starting early enough** – Someone investing \$1,000 a year beginning at age 25 in an IRA earning 7% annually will have \$199,635 at age 65. However, if she waits until age 35 to begin investing she will have only \$94,461 at age 65, 53% less, even though the principle invested was only \$10,000 less.
- 2. No vision or written plan** – Any successful business leader will tell you that one of the keys to business success is to have a clear vision of what you want that business to look like long term. The vision is accompanied with shorter-term goals and objectives and related benchmarks that must be accomplished with daily activities that must take place. True wealth building happens the same way.
- 3. Not allocating cash and investment resources appropriately** – The premise of asset allocation is that over time you will allocate your dollars to different investment mixes with varying degrees of sensitivity of risk. Some investments will be low risk while others will be medium and/or high risk. The portion of your portfolio allocated to any one class or risk category changes based on your age, your goals and your current reality. Generally, your risk factors are higher when you are building wealth and decrease as you begin to rely on your portfolio for security.
- 4. Not managing high interest rate debt appropriately** – This kind of debt occurs most often when the holder of a credit card makes purchases that they cannot pay off within thirty days (or they do not have the attitude they need to pay them off within thirty days.) Once the credit card debt is not paid in full, the habit is formed and soon millions of people find themselves struggling every month to meet their bills. For example, assume your credit card balance is \$2,750 with an interest rate of 18.38%. If you are making constant

minimum payments of \$55 (2% of the beginning balance) on the card, it will take you 8 years to pay off the card resulting in interest paid of \$2,503. However, by making some life style changes and doubling your payment to \$110 (4% of the beginning balance) that same credit card balance will be paid off in 2 years and 8 months with interest paid of \$744. If you pay 8% of the balance each month (\$220 per month) the card will be paid off in 1 year and 2 months and the interest paid will be only \$326.

5. **Trying to time the market** – There is a difference between being a risk taker and being a gambler when building wealth. Chasing hot stocks and funds, following the masses, and trying to anticipate buys and sales are gambling. According to David Bach (**Smart Couples Finish Rich**) if you invested a hypothetical \$10,000 in the S&P 500 on March 31, 1995, by March 31, 2000, your \$10,000 would have grown to \$32,718, an average annual total return of 26.75%. But suppose during that five-year period there were times when you decided to get out of the market and, as a result, you missed the market's 10 best single-day performances. In that case, your return would have fallen to 17.42% and your investment would have grown to only \$22,316.
6. **Not building cash reserves** – One of the first goals anyone should have in pursuit of wealth is to build cash reserves. This is a basic component of a financial plan. You should have at least 6 months of reserve that will cover 100% of your monthly expenses. If you have any emergencies that surface like car repairs, medical emergencies, or job lay-offs these funds can be liquidated quickly to cover your expenses without having to use credit cards, cash advances, or the liquidation of other investments at an in opportune time. Your cash reserve should be kept in a savings account, money market account, CD or somewhere where it is easily accessible.

7. **Improper estate planning** – Proper estate planning will secure the wealth you are building. Many of the mistakes made include not having a durable Power of Attorney for health care, which gives a member of the family the right to make health care decisions for you if you cannot. It may be appropriate for you to have an irrevocable living trust that controls your assets while you are alive and states what happens to them when you die. Other omissions such as not having a will that states where you want your assets to go after your death or not having a bypass provision in your trust that allows you to exclude up to \$1.5 million of assets from your estate (assuming you are married) can erode your wealth.
8. **Short-term thinking** – Many people fail in their pursuit of building wealth because they do not think long-term. They are chasing high yields and looking for quick returns never fully understanding that the higher the yield, the riskier the investment. They have fallen in the habit of churning their portfolio, buying and selling off, and in the end, the result is a lower return. The best advice is to balance those returns with an asset allocation model and let the investment work for you over the long haul.
9. **Lack of knowledge of financial planning principles** – Many people do not understand the impact of their money decisions on their lives. Many people learn the hard way...by making expensive mistakes. One of the best sources for improving your knowledge is reading an old classic '**The Richest Man in Babylon**' by George Clason.
10. **Improper life-style management** – Lack of respect for money and oneself leads to self-gratification through the accumulation of "things". Generally, these material possessions will not become income-producing assets or appreciate in value. The temporary fulfillment lasts only days or weeks, but the long-term financial impact can be awesome.