



## Kiplinger Financial Services' COMMON CENTS MATTERS

February, 2004

### WHAT EVERYONE NEEDS TO KNOW ABOUT FINANCIAL PLANNING (PART 2 OF 3)

*What Everyone Needs To Know About Financial Planning, Part 1 of 3* discussed what financial planning is and the top 10 mistakes people make related to financial planning. In Part 2 of 3 we will take a look at getting started with your planning, determine how you are doing financially and how to start accumulating assets to meet your financial goals.

#### **WHERE DO I BEGIN?**

Your financial plan should begin with where you are today -- your personal net worth. Your net worth is simply the total of all your financial assets (cash, stocks, bonds, mutual funds, IRA's, employer retirement accounts, home and furnishings, etc.) less the total of all your liabilities (home mortgage, home equity loans, student loans, auto loans credit card debt, etc.).

#### **IS THERE A WAY TO DETERMINE HOW WELL I AM DOING FINANCIALLY?**

Yes, Thomas Stanley in his book the Millionaire Next Door provides the following formula for determining how well people are doing accumulating wealth:

Your annual pre-tax income \$	
Multiplied by your age	x _____
Subtotal	_____ (a)
Subtotal (a) divided by 10	\$ _____ (b)

Compare the total on line (b) to your calculated net worth reduced by any inheritances you may have received to evaluate how well you are doing at accumulating wealth.

#### **HOW TO BUILD WEALTH THROUGHOUT YOUR LIFETIME.**

The earlier you begin planning your financial future, the better off you will be. Not only will you benefit from more years of compound interest and returns, but you will also benefit from fewer financial mistakes over the years. The right financial advisor will help you plan for every cycle of your life and probably will recommend something like this:

##### **Ages 16-30 – building the foundation**

- During this period of your life you should begin saving and accumulate a cash reserve equal to 3-6 months of expenses.
- You should train for a career, which could include college.
- You should determine your long-term financial goals.
- You should open an IRA to begin taking advantage of tax deferred savings.
- You should determine your life and disability insurance needs.
- You should protect your belongings with automobile and homeowners insurance.
- You should retain a small amount in liquid investments for short-term goals and invest the balance in medium to high-risk investments to obtain maximum growth.

##### **Ages 31-45 – your assets are beginning to grow**

- If you haven't already done so, you need to open an IRA or start a retirement plan.
- You need to invest for capital growth (stocks and/or equity mutual funds).
- You need to write your will and evaluate your estate needs.

## WHAT EVERYONE NEEDS TO KNOW ABOUT FINANCIAL PLANNING (PART 2 OF 3) CONTINUED

- You need to explore retirement goals.
- If you have children, you need to evaluate insurance needs for a growing family, name a guardian, and plan for their education needs.

### **Ages 46-60 – your peak earning years**

- Your children are out of the house, or soon to be out.
- Your investment allocation may begin to shift gradually from growth to income.
- You should diversify your investments.
- You should update your estate plan.
- You should get more serious about your retirement planning.
- You should reevaluate your life, disability, and homeowners insurances.
- You should consider deferred compensation plans with your employer.

### **Ages 61-70 – serious about retirement**

- You should reevaluate your budget to meet retirement needs.
- Determine what you are going to do for the rest of your life after you are retired.
- You should investigate part-time employment or volunteer work.
- Consider plans for transitioning the family business.
- Convert group life insurance, if applicable.
- You should increase the allocation portion of your income producing investments.
- Insure that long-term care needs are met.
- Evaluate health care options.
- You should reduce your taxable estate.
- Update your estate planning documents.
- Consider charitable giving plans.
- Consider gifting plans for your family.

As early as possible during the above life cycle you should calculate how much income you will need during retirement. Then you will need to do some calculations based on assumed rates of earnings and inflation to determine how much you need to set aside each month to meet your goal. In reality, very few people have a clue as to what this

number is for them. Those that do can spend what is left over, without guilt, knowing that their future needs are taken care of.

### **ANOTHER KEY TO BUILDING WEALTH THROUGHOUT YOUR LIFETIME IS COMPOUNDING.**

Compounding is the interest or the return generated on both your money invested and the interest earned in previous times. It is in essence; interest earning interest and profits making more profits. Instead of removing the earnings on your investments, you leave them in and add them to your initial investment allowing your money to grow more exponentially. Here are three very simple rules for compounding.

1. Reinvest your dividends.
2. Develop an automatic investment strategy through a payroll deduction or periodic withdrawal from your checking account. (Pay yourself first..)
3. Make time work for you. Understand the “Rule of 72”. An 8% investment will double in 9 years. ( $8 \times 9 = 72$ ). To double your investment in 10 years you need a 7.2% return. ( $10 \times 7.2 = 72$ ).

### **WEALTHY PEOPLE SHARE FOUR THINGS IN HOW THEY LOOK AT MONEY.**

1. They have a plan and they follow it.
2. They are vocationally aligned – they love what they do.
3. They are not trapped by social status – they do not try to keep up with the Jones’.
4. They are frugal – they live below their means.

In *What Everyone Needs To Know About Financial Planning, Part 3 of 3*, we will discuss making the decision to hire a financial planner, what to look for in a planner, how a trusted advisor is paid and things that a financial advisor should know about you.