Financial Planning for the Utterly CONFUSED

Sixth Edition

How to
(make sense of):

- Roths and 401ks
- Treasuries, CDs, and Mutual Funds
- Real Estate Investing

Joel Lerner

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No birth certificate is issued when a friendship is born. There is nothing tangible. There is just a feeling that your life is different and that your capacity to love and care has miraculously been enlarged without any effort on your part. It's like having a tiny apartment and somebody moves in with you, but instead of becoming cramped and crowded, the space expands, and you discover rooms you never knew you had until your friend moved in with you.

Preface

I am a retired professor, not a stockbroker, bank executive, or insurance salesperson. My specialty isn't fancy jargon, hucksterism, or statistics. Rather, it's explaining financial and economic matters to ordinary people in plain English. That's what *Financial Planning for the Utterly Confused* is all about, now in this new, sixth edition.

There used to be a time when most of us thought that investing was something only for the rich and that very few people could afford to take on any apparent risk. But of course, times have changed as we have become a nation of investors who realize that we cannot achieve financial freedom from social security (whether privatized or not) and company-based pension plans that are slowly being reduced in size and employer contributions. And just as we, as potential investors, have increased in number, so too have the various types of investment choices. At one time, the only choices were stocks or bonds, but now the possibilities are vast, including annuities, CDs, Ginnie Maes, index funds, money markets, mutual funds, Treasury obligations, zero coupons—the list goes on and on. As you are aware, everyone wants choice, but too many alternatives can be confusing. This book attempts not only to narrow down those choices and explain each financial instrument for the layperson, but also to show you how each instrument can be adapted to today's ever-changing economic environment. You won't find tips on high-flying stocks that promise to help you double your money overnight. As you already know, no one can make such promises with any certainly. What you will find here is an honest appraisal of the advantages, disadvantages, costs, and benefits of each type of financial instrument—an appraisal based on current tax laws and their effects upon you, the investor.

A glossary of common financial terms is provided (at the end of the book) to serve as a handy reference tool as you read the money-managing columns in your daily newspaper or your favorite magazine. It should help you penetrate some of the verbal fog generated by brokers, bankers, salespeople, and especially government agencies that enforce the many financial policies of the current administration.

My hope is that *Financial Planning for the Utterly Confused* will be a valuable tool for the millions of Americans who need help in managing their small to medium-sized investment plans. The information in this book can be the first building block in the creation of a secure and comfortable financial future that only you can initiate. There is a saying that sums up financial planning in 10 two-letter words:

If it is to be,
It is up to me.

Introduction

"Though no one can go back and make a brand new start, anyone can start from now and make a brand new end."

Do I Need to Read This Chapter?

- Do I know something about my finances—but not enough?
- Am I making the mistake of expecting others to do my work for me?
- Have I identified and prioritized my financial goals?
- Am I where I should be, given my age and family situation?
- Does risk scare me?
- Do I know the "hidden" factors that might be eating away at my nest egg right now?
- Am I keeping the right records?

The best investment you can make is in yourself. Financially you must have some knowledge about your own affairs because you cannot hand over everything to a financial adviser (see Chapter 27) or broker and expect that person to do it all. Each month you know doubt receive a monthly statement of your financial position, but do you really have any idea what those figures mean? If you will take the time to learn about money matters, you will receive a rich reward—dividends in understanding that in the long run will improve your financial position.

How Do You Begin a Financial Plan?

The first step in creating a financially secure plan is to identify your personal and family financial goals. Goals are based on what is most important to you. Short-term goals (up to a year) are what things you desire soon (say, household appliances), while long-term goals are items you want later on in life (a home, education for your children, sufficient retirement income). Take these short- and long-term goals and establish priorities, making sure you have an emergency fund as the first item. Then estimate the cost of each goal, and set a target date to reach it. See Table I.1.

Although every financial plan will be different, each should be meet certain criteria:

1. An emergency fund equal to 3 months of net income (after taxes)
2. Adequate insurance
3. Specific amounts for investments set aside on a regular basis

A rule of thumb states that you should have a retirement fund that is 20 times the amount of money you need to supplement social security and a pension. For example, if you want $30,000 a year beyond your pension and social security, you will need to save $600,000.

Interested in calculating your investment strategy? Here's the first step the experts advise. Apply the simple formula called the *rule of 72*. It will help you figure out how long it will take, or what interest rate you will need, to double your money.

For example, if you invested $10,000 at 6 percent, it would take you 12 years to have $20,000 (72 ÷ 6). You simply divide the number 72 by the interest. On the other hand, suppose you knew the length of time your money would be invested, but you wanted to know the rate of interest you would need to "double" at the end of time period. You would divide 72 by the number of years, which would result in the required interest. For example, if you were 56 years old and you wanted to retire at 65, 9 years from now, you would need 8 percent interest each year to double your money (72 ÷ 9). As a sidelight, if you were interested in tripling your money, use the number 115 instead of 72 and then continue with your calculation.

You are all aware of the changing life cycle. Your goals must be updated as your needs and circumstances change. In your young adult years, short-term

Table I.1 Interest Tables to Meet Your Goals

1. $10,000 Lump Sum

Rate of Earnings	5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
5%	$12,763	$16,289	$20,789	$26,533	$33,864	$43,219
6%	13,382	17,908	23,966	32,071	42,919	57,435
7%	14,026	19,672	27,590	38,697	54,274	76,123
8%	14,693	21,589	31,722	46,610	68,485	100,627
9%	15,386	23,674	36,425	56,044	86,231	132,677
10%	16,105	25,937	41,772	67,275	108,347	174,494
11%	16,851	28,394	47,846	80,623	135,855	228,923
12%	17,623	31,058	54,736	96,463	170,001	299,599

2. $100-per-Month Investment

Rate of Earnings	5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
5%	$6,801	$15,528	$26,729	$41,103	$59,551	$83,226
6%	6,977	16,388	29,082	46,204	69,299	100,452
7%	7,159	17,308	31,696	52,093	81,007	121,997
8%	7,348	18,295	34,604	58,902	95,103	149,035
9%	7,542	19,351	37,841	66,789	112,112	183,074
10%	7,744	20,484	41,447	75,937	132,683	226,049
11%	7,952	21,700	45,469	86,564	157,613	280,452
12%	8,167	23,004	49,958	98,926	187,885	349,496

3. Annual Investment Required to Reach $100,000

Rate of Earnings	5 Years	10 Years	15 Years	20 Years	25 Years	30 Years
5%	$17,236	$7,572	$4,414	$2,880	$1,966	$1,433
6%	16,736	7,157	4,053	2,565	1,720	1,193
7%	16,254	6,764	3,719	2,280	1,478	989
8%	15,783	6,392	3,410	2,024	1,267	817
9%	15,332	6,039	3,124	1,793	1,083	673
10%	14,890	5,704	2,861	1,587	924	552
11%	14,467	5,388	2,618	1,403	787	452
12%	14,005	5,088	2,395	1,239	669	369

Notes: Amounts are to nearest dollar.
Rates are compounded annually.
These are year-end values.

goals may include obtaining adequate insurance, establishing good credit, and generally just getting your adult life under way. During your middle years, the goals shift from immediate personal spending to education for children and retirement planning. In your later years, travel may become a primary goal. Also when planning for your future, age is a vital factor.

How Does Age Enter into Financial Planning

Here are some guidelines to use, depending on your present age:

Ages 20 to 40. When you are young, growth of financial resources should be a primary goal; a relatively high degree of risk is tolerable. *Suggestion:* Invest in a diversified portfolio of common stocks or in a mutual fund managed for growth of assets, not income. Speculation (real estate, coins, metals, etc.) is acceptable.

Ages 40 to 50. This is the period of time when the 20/20 rule goes into effect, working now for about 20 years and having 20 years more to go before retirement. Stocks are still an attractive choice, but now you need a more balanced approach. Begin to invest in fixed-rate instruments (bonds), and look into ones that are tax free (municipals) only if your present or near-future income is high enough to warrant it.

Ages 50 to 60. At this point, growth is less important and risk less acceptable. Move a portion of your investments out of stocks and into bonds in order to minimize risk and increase your current flow of income.

Age 60 and Over. By now, the majority of your funds should be in income-producing investments to provide safety and maximum current interest.

There is a rule of thumb that may be appropriate here. It is based on the concept that the percentage of your portfolio in bonds should approximate your age, the balance going into equalities or slight-risk vehicles. For example, at age 40 you would keep 40 percent in bonds and 60 percent in equities. At age 60 the reverse would be appropriate—60 percent bonds and 40 percent equities. Of course, this is a very general idea and may not be appropriate for everyone.

When planning investments for your age bracket, consider the following:

1. *Security of principal.* This refers to the preservation of your original capital. Treasury securities are guaranteed by the government, while stocks fluctuate greatly.

2. *Return*. This means the money you earn on your investment (interest, dividends, profit).
3. *Liquidity*. This pertains to the ease of converting your investment into cash.
4. *Convenience*. This refers to the time and energy you are willing to expend on your investment.
5. *Tax status*. Depending on your tax bracket, each investment will bear heavily on your personal situation. Municipal bonds are tax free while certificates of deposit (CDs) are fully taxable.
6. *Your personal circumstances*. Included under this category would be your income, your health, your individual circumstances, and your ability to tolerate risk.

How Should You Deal with Financial Risk in Planning for the Future?

The single most important factor in deciding on the best investments for you is the level of risk you can afford to take. Thus, the first step in formulating your investment plan is a careful self-examination. How much money do you have to invest? How great will your financial needs be for the foreseeable future? How much of your capital can you realistically afford to risk losing, and how great a degree of risk can you and your family handle psychologically? Each of these factors will have a bearing on the degree of risk you can tolerate in investment decisions. The trade-off is simple: to get larger rewards, you have to take greater risks.

You can achieve a balance by investing in a pyramid fashion. Begin with conservative (safe) investments at the foundation (Treasury obligations, insured money markets, CDs), and then gradually build up, accepting a bit more risk at each step. Stocks are a very common method of investing, but how much of a percentage should you invest? A rule of thumb you might use as a guide is to subtract your age from 100. However, this is only one estimate of many. At the very top, you may have high-risk investments (coins, gold, real estate), but because of the pyramid, the investments will be small compared with the rest of your holdings. Also, to minimize loss, you should have at least two different types of investments that perform differently during a specific period of time. For example, when interest rates are low, your portfolio of stocks usually gains while bonds do poorly. Diversify!

How Can You Overcome Obstacles to Your Financial Plan?

Regardless of how well you plan financially, certain obstacles will always arise. Four factors that could have a major impact on your investment objectives are as follows:

1. *Inflation*. When it comes to investing and inflation, what matters most isn't what you make, but what you keep. It is obvious that if you are to plan financially for your future, you must receive a return that is high enough to outpace any long-term effects of inflation. If, for example, you kept retirement money in a savings account paying 3.5 percent per year and over the same period of time the inflation rate averaged 5 percent per year, your investment world have less purchasing power at retirement than it did when it was started. Table I.2 is designed to illustrate the effect of the inflation rate on the cost of living for future years. Look down the "Years to Retirement" column to the number of years until you retire, and read across the rows to find the estimated inflation rates. Multiply your plan or budget by the inflation rate to adjust for future costs. For example, if you are planning to retire in 10 years and the inflation rate is 4 percent, multiply your cost of investment or budget by 1.480 in order to reflect inflation-adjusted costs. Ten years from now, it would cost you \$59,200 to buy the same items you could have bought today for \$40,000 (\$40,000 × 1.480 = \$59,200).
2. *Interest rate risk*. A change in interest rates will cause the value and price of fixed-rate instruments (bonds) to move in the opposite direction of interest rates. If interest rates go down, the value of bonds goes up; and, conversely, if interest rates go up, the value of bonds goes down. You have interest rate risk with all types of bonds. The longer the maturity of the bond, the greater the interest rate risk; so if you are concerned about this risk, stay short term.

   Here's a series of guidelines for handling risk. They should make you more "comfortable"—in both senses of the word.

   - Don't invest in any instrument in which you can lose more than you can potentially gain. This factor is sometimes referred to as *risk-reward balance*.
   - Diversify your holdings. Spread your investment dollars among a variety of instruments, thereby minimizing the risk potential.
   - When investments fail to perform up to your expectations (the period to hold them is based upon your objectives), sell them. "Cutting your losses"

Table I.2 Effect of Inflation Rate on Cost of Living in Future Years

Years to Retirement	3%	4%	5%	6%	7%	8%	9%	10%
1	1.030	1.040	1.050	1.060	1.070	1.080	1.090	1.100
2	1.061	1.082	1.103	1.124	1.145	1.166	1.188	1.210
3	1.093	1.125	1.158	1.191	1.225	1.260	1.285	1.331
4	1.126	1.170	1.216	1.262	1.311	1.360	1.412	1.464
5	1.159	1.217	1.276	1.338	1.403	1.469	1.539	1.611
6	1.194	1.265	1.340	1.419	1.501	1.587	1.677	1.772
7	1.230	1.316	1.407	1.504	1.606	1.714	1.828	1.949
8	1.267	1.369	1.477	1.594	1.718	1.851	1.993	2.144
9	1.305	1.423	1.551	1.689	1.838	1.999	2.172	2.358
10	1.344	1.480	1.629	1.791	1.967	2.159	2.367	2.594
11	1.384	1.539	1.710	1.898	2.105	2.332	2.580	2.853
12	1.426	1.601	1.796	2.012	2.252	2.518	2.813	3.138
13	1.469	1.665	1.886	2.133	2.410	2.720	3.066	3.452
14	1.513	1.732	1.980	2.261	2.579	3.937	3.342	3.797
15	1.558	1.801	2.079	2.397	2.759	3.172	3.642	4.177
16	1.605	1.873	2.183	2.540	2.952	3.426	3.970	4.595
17	1.653	1.948	2.292	2.693	3.159	3.700	4.328	5.054
18	1.702	2.026	2.407	2.854	3.380	3.996	4.717	5.560
19	1.754	2.107	2.527	3.026	3.617	4.316	5.142	6.116
20	1.806	2.191	2.653	3.207	3.870	4.661	5.604	6.727
25	2.094	2.666	3.386	4.292	5.427	6.848	8.623	10.835
30	2.427	3.243	4.322	5.743	7.612	10.063	13.268	17.449

is the only sure way to prevent minor setbacks from turning into financial nightmares. A rule of thumb is to sell an investment when its value declines by 10 percent of your original cost.

- Did you ever hear of a "stop order"? Most small market investors have not, and yet it can cut your losses automatically. When you purchase a stock, you give your broker instructions to sell that stock if it should decline by, say, 10 percent of its original purchase price. The moment the predetermined level is reached, your stock will be sold.
- Don't discount risk altogether. The rewards may justify taking a chance. Remember the turtle. It makes progress only when it sticks its neck out.

3. *Taxation.* Determining to what extent any tax-advantaged investment would help you is a serious consideration. You must therefore take into account your tax bracket, present income, future income, and investment holdings before you do financial planning. Also consider the value of assets that will be exempt from estate tax for future income, and investment holdings before you do financial planning. Also consider the value of assets that will be exempt from estate tax for future years. Presently assets that are exempt from estate tax will increase until 2010 when the estate tax will be 0, but all exempted amounts will return in 2011 at $1 million.

Year	Estate Tax Exemption	Top Estate Tax Rate
2007	$2 million	45%
2008	$2 million	45%
2009	$3.5 million	45%

Remember that there is no tax on a surviving spouse who receives any amount of inheritance.

4. *Procrastination.* This is an obstacle that depends solely on you. Don't imitate the person who says, "Someday I'm going to stop procrastinating." Regardless of how well a financial plan is structured, if you don't follow it through, it will be doomed before it begins.

Now that your goals have been defined and the areas of risks and rewards examined, the next step is getting all the "paper" together.

What Financial Records Should You Keep?

Start by developing a "road map" so that you or your heirs (in case of disability or death) will know where documents are. Records that should be kept available are:

1. Professional numbers: Telephone numbers of your lawyer, doctor, accountant, insurance company, business associates, and financial advisor or broker
2. Account numbers: Brokerage, bank, credit cards, insurance policies (and beneficiaries), and safe deposit box (keys and authorized deputies)
3. Business records: Tax returns, company books, payroll data, etc.
4. Personal records: An updated will and trust agreements

5. Health records: Living will, health care proxy, etc.
6. Retirement benefits: Social security, IRAs, 401(k)s, and the like
7. Burial arrangements: Cemetery plots, deeds
8. Any outstanding liabilities

This introduction to financial planning lays the foundation for all the topics in the forthcoming pages of this new edition. You owe it to yourself to read business periodicals (newspapers, magazines, annual reports), learn (seminars, courses), ask (brokers, financial planners), and make certain that you can apply the knowledge gained from the following chapters so that when opportunity does knock, you are not in the backyard looking for four-leaf clovers.

"The difficulty is not buying on time—it's paying on time."

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