



EIGHTH
EDITION

PERSONAL FINANCIAL PLANNING

■ Harold A. Wolf



PERSONAL FINANCIAL PLANNING

Eighth Edition

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ALLYN & BACON

Boston London Sydney Toronto

To my parents and to Jeanette, Mark, Sue, Votan, and Henrietta

Series editor: Cary Tengler

Cover administrator: Linda Dickinson

Editorial-production service: Bywater Production Services



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The first three editions of this book were authored by Maurice A. Unger and Harold A. Wolf.

The first seven editions were published under the title *Personal Finance*.

Library of Congress Cataloging-in-Publication Data

Wolf, Harold Arthur, 1923—

Personal financial planning / Harold A. Wolf.—8th ed.

p. cm.

Rev. ed. of: *Personal finance*. 7th ed. c1984.

Includes bibliographies and index.

ISBN 0-205-11727-9

1. Finance, Personal. I. Wolf, Harold Arthur, 1923— Personal finance. II. Title.
HG179.W573 1989
332.024—dc19

88-26716
CIP

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1 93 92 91 90 89 88

Personal financial planning

Preface

This, the eighth and silver anniversary edition of *Personal Financial Planning*, represents a significant and substantial revision in response to the increasing complexity and rapid changes taking place in today's economic and financial environment. Personal financial planning was complex enough in 1964 when the first edition was published; it is infinitely more so today.

Taxes are now more complex, and so too is the economy and the financial environment. Prices and interest rates are now more volatile. While interest rates are low presently, relative to a few years ago, they could rise again. The same is true of inflation. Inflation, while semidormant, could reignite, which would tend to increase interest rates. In short, there is more uncertainty in the financial community and, indeed, the entire economy.

In 1964, when this book was first published, the Consumer Price Index (CPI) stood at 92.9 (the base year of 1967 being 100); in December 1987 it stood at 345.7. The total amount of inflation during this book's life so far has been 272.12 percent. It should be noted that in early 1988 the Bureau of Labor Statistics, which calculates the CPI, changed the base year. It is now the average of prices over 1982 to 1984 that equals 100. Hence the year-end 1987 figure of 345.7 was converted in early 1988 to 115.7. This is somewhat misleading. However, if we adjust the 1964 figure of 92.9 downward to reflect this, which is what the government did to the early 1988 figure, it becomes 31.1. Hence prices have risen from 1964 to January of 1988 from 31.1 to 115.7, 272.12 percent.

In 1964 when this book was first published, inflation was 1.7 percent. In 1987 it was 4.4 percent. In early 1988 it is running at about 3.8 percent.

It is obvious that whatever one's individual life style and goals are, a better understanding of the principles of personal finance is absolutely vital today. The goal of this book remains the same: to provide the reader with the information necessary for understanding these principles and to help the reader develop better skill in making financial decisions that will bring the most personal satisfaction.

**MAJOR
CHANGES IN THE
EIGHTH EDITION**

The organizational format and the content of this edition have been substantially changed. After securing the comments and suggestions from many users of the book over the years, the following changes were made.

General changes

All statistics were, of course, updated. More figures, tables, and exercises were added to enable readers to more readily apply certain financial planning principles to their own particular cases.

One chapter (Consumer spending) was eliminated because the way financial planning has evolved it is no longer relevant.

A new chapter, Automobiles and major household appliances, was added because these items are a big part of budgeting, and hence, financial planning.

*Specific chapter
changes*

Chapter 1 has been rewritten to reflect the new financial planning philosophy rather than the traditional personal finance. Personal finance was the forerunner of financial planning, but financial planning is a more sophisticated integration of personal finance into one planning model.

Chapter 2 deals with recordkeeping and also presents the tools of financial planning. More analysis is presented here than in the seventh edition. The discussion of keeping records and of personal statements has been strengthened and now stands alone as a separate chapter.

Chapter 3 is on personal budgeting. This chapter has been strengthened by adding material to enable the reader to obtain tighter control of his or her budget. Bankruptcy is included in this chapter to dramatize the cost of failing to budget. Career planning is a form of long-run budgeting, and, hence, is also included in this chapter.

Chapter 4 concerns depository institutions that are regulated by law. The new laws are integrated into the discussion in this chapter.

Chapter 5 is about using consumer credit. Nearly everyone uses consumer credit, and when they do, they must pay interest. The discussion on interest has been simplified and clarified over that in the earlier editions.

In Chapter 6 the subject is consumer protection laws. These laws and consumer protection agencies have not changed a great deal during the last few years. However, there have been some changes due to administrative action as well as court action. These changes have been integrated into this chapter.

Chapter 7 is a new chapter that discusses the purchase of automobiles and other "big ticket" consumer durable items. When you are planning to spend "big bucks" on these items, some planning and shopping around will save you money. This chapter discusses ways to do this. It also compares buying a car for cash, financing it, or leasing it.

Chapter 8 is on the personal income tax. The Federal Revenue Code was completely overhauled in 1986. These changes are analyzed and explained in detail. The chapter is designed to enable the reader to plan more effectively and to minimize his or her taxes.

Chapter 9 is on housing and home ownership. New material is included on mortgage financing including the new biweekly mortgage. The relative advantages of renting versus owning are discussed.

Chapter 10 introduces insurance of all kinds. Insurance is a way of managing the risks and hazards we all face in life. The principles of life, medical, and property and liability insurance are introduced in this new edition in a way that fits them into an overall financial planning model.

Chapter 11, on life insurance, too, is a part of the overall financial planning framework. The new edition simplifies the analysis that may be used to decide when to buy life insurance and what kind and how much to buy. The various types of policies are also analyzed in some detail, and the discussion of settlement option has been spelled out in greater detail than it was in past editions.

In Chapter 12, on health insurance, the growing use of the coinsurance cap has been included. Catastrophe insurance needs are also included in this edition, as is the growing use of individual practice associations (IPA) as modified forms of health maintenance organizations. How much health insurance to buy is discussed in greater detail, and a checklist has been added to evaluate the quality of the reader's health insurance plan.

Chapter 13 has been completely reorganized and rewritten to reflect the changes that have occurred in property and liability insurance in recent years. The homeowner's policy is now discussed in accordance with the actual format of the policy itself. For example, Section I coverage is discussed first, then Section II. The same is true of automobile insurance; the discussion begins with the declaration page, then the insuring agreement, the exclusions, and then the various parts covered.

Chapter 14 is titled Savings and Investing through Savings Institutions. Now that the law which formerly set the maximum rate of interest that could be paid on savings deposits has been repealed, the entire chapter has been rewritten to reflect this. The new structure of savings deposits and interest rates that thrift institutions offer is analyzed. There is also some new material on the escheat laws. The section on interest rates and how they are calculated has been rewritten and strengthened. There is also some new material on *real* (after an adjustment for inflation) interest rates, as well as on after-tax *real* interest rates.

Chapter 15 is The Fundamentals of Direct Security Investments. This chapter has not changed greatly. However, the material on interest rate risk has been strengthened as has the material on risk and expected rate of return.

In Chapter 16, Investing in Securities: Stocks and Bonds, the coverage of certain types of corporate bonds not issued very often is summarized and reduced. New material has been added on junk bonds and mortgage-backed bonds.

For Chapter 17, The Investor and the Securities Market, the material on over-the-counter stock has been rewritten to reflect the changes that have occurred there.

Chapter 18, Investment Companies and Other Investment Vehicles,

has been changed substantially. Some material on government agency (mortgage-backed) mutual funds has been added. Some new material on hidden costs (12b-1 fees) of acquiring mutual funds has also been added as has some material on Lipper Services on mutual funds. A warning has been added regarding investments in real estate because such investments are riskier today than they were a few years ago. The new tax law governing depreciation of real estate investments has been added as has some material on how real estate investments may provide leverage for the investor. The material on collectibles has been reduced and summarized because investments in this area are less popular and more risky today than they were in the past.

Chapter 19 on retirement planning has been completely rewritten because the new 1986 tax law changed many things. There have also been some changes in Social Security that are incorporated into the eighth edition.

Many people are now no longer eligible for a tax-deductible individual retirement account (IRA). Who is and is not eligible is spelled out in clear, precise language. Many people are eligible for a *reduced* IRA, and an easy-to-use checklist is provided to permit the reader to determine quickly the amount of his or her deductible IRA contributions. Tables and graphs were also added to show the IRA (and Keogh Plan) build-up compared to regular taxable savings deposit build-up.

The 401k salary reduction plan limits were also changed as were those of tax-sheltered annuities—403b plans. All these changes are spelled out.

The chapter also discusses the nondeductible IRA plans that have recently been established for the first time.

Chapter 20 deals with estate planning. The law was changed in this area too. The Clifford Trust was eliminated as a vehicle for transferring income from a high-tax to a low-tax member of the family.

The techniques for establishing a college trust fund for a child in such a manner that the income is taxed at the child's lower rate has been changed. This can still be done, however, and Chapter 20 explains how.

The law on gift and estate taxes has also been changed. These changes are explained, and the chapter includes an actual estate tax calculation with a step-by-step explanation.

There is now also a new estate planning tool called the Q-Tip trust. Chapter 20 shows how it works.

Other specific changes

The glossary of financial terms has been greatly expanded and can be found at the end of the book.

A list of useful addresses has also been added following the glossary. All of the companies and associations listed in this section are mentioned either in the text or in the Suggested Readings sections at the ends of chapters where what is available is often listed.

The goal of this revision is to provide the most up-to-date discussion of personal finance topics possible, given the changes in today's world. The data, statistics, and details concerning inflation, prices, interest rates, and innumerable other matters are the latest available.

The goal of this revision

New questions and cases have been added to the end of each chapter, and the list of suggested readings has been thoroughly revised, expanded, and updated. A student study guide is available.

All individuals are consumers. As such, they are almost constantly engaged in spending money for all kinds of things; spending on food takes place almost daily, while expenditures on big items like a car or household furniture occurs less frequently.

People also constantly engage in borrowing money; using credit cards; investing savings; paying taxes; buying houses and life, home, and auto insurance; and many other activities that may involve some financial pitfalls. I hope this book will help the reader avoid some of these pitfalls.

As people grow older, their income and patterns of expenditures change. Many young couples just starting out are heavy consumers and light savers. Not only are their incomes lower, but they are (or soon will be) buying housing and household furniture. With the coming of children, consumption will remain high. However, as income rises, savings hopefully will grow. Later, after a house full of furniture is acquired, and the children are through college, savings should rise further as the heavy consuming years are left behind.

This changing pattern of expenditure may be thought of as the family financial cycle. This cycle includes earning income, borrowing, making many different types of expenditures, acquiring consumer assets, making plans for retirement, and planning an estate. In the process of going through the financial cycle many complex situations may arise.

The book now is divided into five parts with twenty chapters. However, almost any chapter can be read out of sequence, and the topics can be studied in any order.

Part I covers the principles of financial planning and the financial and economic environment within which planning must take place. It also covers recordkeeping, personal financial statements, and the personal budget. These items are the heart and the foundation of financial planning.

Part II deals with managing your income; it is designed to give you more consumption per consumer dollar. It covers your liquid assets such as your checking account. It also discusses financing "big ticket" items (Chapter 5) and the various federal consumer protection laws. The "big ticket" items themselves are analyzed in Chapter 7. The final two chapters in Part II deal with personal income taxes and home-ownership. Taxes are a type of expenditure in the sense that they drain away income. The chapter on home-ownership is important because buying a home is the largest single expenditure that most people will make.

ORGANIZATION AND PEDAGOGICAL APPROACH

Part III deals with insurance planning and risk management. It covers all types of insurance: life, health care, and property and liability insurance.

Part IV is designed to help you with your investments. It first introduces and analyzes investments in depository (thrift) institutions. It then covers investments in bonds, stocks, mutual funds, rental real estate, and a number of other, more exotic, investments.

Part V is devoted to retirement and estate planning. These are tax planning because the two are inexorably intertwined. The two chapters in Part V integrate these two areas.

Each chapter begins with the highlights of what is to come in that chapter. I have added more subtitles to this eighth edition at the suggestion of many of my colleagues. As noted above, each chapter could stand alone, and some professors have changed the sequence in which they cover the material. The chapters are written in plain, simple, but precise, English, and in a way that any reader will feel at home with and will be able to comprehend without previous training or background in economics, finance, accounting, or any other business discipline.

INSTRUCTOR'S MANUAL AND TEST BANK

A comprehensive instructor's manual, together with a test bank, is available. It includes a possible course outline for a one-semester and a one-quarter course. For each individual chapter the manual has each of the following:

1. An outline
2. Discussion of the chapter's Summary Review Questions
3. Solutions to the chapter's Cases
4. A test bank of both multiple choice and true-false questions

The Allyn and Bacon Financial Toolkit is also available. This collection of programs allows students to solve problems beyond the capability of financial calculators. (IBM only).

STUDENT WORKBOOK AND STUDY GUIDE

A study guide is available to aid your students. Joseph C. Samprone, Jr. of Georgia College has written an excellent study guide. It is designed to help your students in their study of personal financial planning and make their work in the course more meaningful.

Professor Samprone has organized his guide around each chapter, and for each chapter he has presented the following material:

1. A summary and highlights of the chapter
2. Key terms introduced and used in the chapter (Learning the meaning of these key words is a useful exercise in mastering the chapter. The page in the book where these words are first used is also noted in the guide. This is a useful time saver if a review is in order.)
3. True-false test questions that cover the material in the chapter
4. Multiple choice test questions for each chapter
5. Matching test questions

There is also a key to all of the self-study test questions in the guide. Students may therefore test themselves by answering the questions, then grade themselves. This is a good way for students to prepare for actual exams.

In the preparation of any project of this nature there are many who need to be thanked for having so graciously given of their time and encouragement.

Particular credit is due Professor Lee Richardson, Martin Marietta Eminent Scholar in Marketing at the University of Baltimore who made many valuable contributions throughout the manuscript. I also wish to single out for special recognition Professor Patricia Tengel of Carnegie Mellon University and Jerry Jorgensen of the University of Utah for their valuable aid. Bette Grubbs of the Social Security District Office, Austin, Texas, was helpful in the ever-changing field of Social Security. Dick Dexter, agent for Penn Mutual, and Morgan Brenner of the Educational Training Department at the Penn Mutual home office were advisors for the chapters on insurance. Grant J. Wells of Ball State University must be cited for graciously giving his time and energy in thoroughly critiquing the manuscript.

The following individuals have made a real contribution with their thoughtful comments on various portions of the manuscript: Sam Andrews, University of Southern Maine; Sheldon Balbirer, School of Business, University of North Carolina, Greensboro; Robert Berry, Department of Business, Mt. San Antonio College; Margaret A. Charters, Director of Consumer Studies, Syracuse University; Ginny Dickinson, Oregon State University; Sue A. Greninger and Vickie Hampton, University of Texas at Austin; K. P. Hill, School of Business, Wichita State University; Ralph Marini, St. Joseph's University; Cynthia Needles, Iowa State University; Sue Peterson, Northern Illinois University; and Esther Williams, Idaho State University.

In writing a book covering such a wide range of related but somewhat different areas, it was necessary to consult various experts on the firing line in the business and financial community. They are too numerous for all of them to be mentioned here, but I do wish to specifically cite the following: Mike Bigley, Southwest Regional Manager of the Farmers Insurance Group; Bill Thurman, President of Gracy Title Company, Austin Texas; Lynn M. Wyrick, American Automobile Association; Ysabel M. Burns and Thomas Durkin, American Financial Services Association; Robert N. Chiappetta, American Council of Life Insurance; George P. Masot, United States Treasury, Bond Division; Dr. William L. Anthes, President, College of Financial Planning, Denver, Colorado; Scott L. Spitzer, American Stock Exchange; Dick Perkins, E. F. Hutton and Co.; John Wolfe, John Onken, John Eccles, William Armer, and Patricia O'Neil, all of City National Bank of Austin, Texas; Linda Arnold, Dow Jones and Company, Inc; Jack Robinson, Director, Department of Research and Economics, National Association of Mutual Savings Banks; Howard Cosgrove, Credit Union National

ACKNOWLEDGMENTS

Association, Inc.; Barbara Wheeler, New York Stock Exchange; Suzanne K. Stemnock, American Council of Life Insurance; Harry J. Guinivan, Investment Company Institute; Fred C. Cohn, President and Editor, Johnson's Charts, Inc.; Judy Dunn, Stewart Title Co.; David K. Fortt, Executive Vice President, Vernon Publishing Services, Inc.; Thomas J. Wolff, C.L.U., Vernon, Connecticut; Stephen Sanborn, Vice President, Standard and Poor's Corporation; Ellen Duttweiler, the New York Stock Exchange; Kathleen Q. Lantero, Wiesenberger Investment Companies Services, Division of Warren, Gorham and Lamont, Inc.; Charles S. Blaylock, President, Commercial National Mortgage Corporation; E. Burton Eubanks, President, University Federal Credit Union of Austin, Texas; Michael Delaney, Investment Company Institute; Feon L. Dorsey, Argus Research Corporation; Laurie G. Cain, The Travelers Insurance Co.; Pam Freydenfeldt, Gracy Title Co.; Joleen Jasinski, Standard and Poor's Corporation; Ken L. Kooock, owner of Green Pastures, the finest restaurant in Austin, Texas; Harold N. Schneider, Vice President, Farmers Insurance Group.

In addition, I wish to acknowledge the many students who have made valuable criticisms while using the book, and some additional colleagues at colleges throughout the country and who have shared with me their experiences with the book in the classroom. While the full list of those to whom I am in debt is too lengthy to be spelled out here, a number of them must be mentioned: Albie Rasmussen of Kansas State University; Martha Muncrief of N. L. Industries; Linda Hiniker of West Virginia University; Carol C. Fedrke of the University of Iowa; Leonard P. Vidger of San Francisco State University; Ronald B. Pruet of the University of Mississippi; Elizabeth Dolan of the University of New Hampshire; Sharon Garrison of North Texas State University; J. L. Hafstrom of the University of Illinois; Eugene Kosy of Central Washington University; David W. Weber of the University of Montana, Daniel L. Schneid of Central Michigan University, Carl H. Pollach, Jr., of the School of Business Administration, Portland, Oregon; J. Richard Becker of Indiana State University; and James E. Wert of the University of Arizona.

I wish to give particular thanks and acknowledgment to the reviewers of this eighth edition, Lillian H. Mohr, Florida State University; Myron S. Pharo, Pennsylvania State University; William S. Phillips, Memphis State University; Anne Bailey, Miami University; and Mary C. Stensrud, College of St. Catherine. They were most helpful.

I also wish to thank my editor at Allyn & Bacon, Cary Tengler, for his tireless effort to bring this, the eighth edition, to fruition, and to Rowena Dores of Allyn & Bacon and Judith Gimple and Laura Glenn of Bywater Production Services go my thanks for their editorial and production efforts as well.

Last, but not least, I give credit to my typists who have labored over the manuscript. Judy Brown, Andrea Cunningham, Joan Dana, Sharen Lackey, Kathleen Middleton, Leona Sparks, and Mary Wingo deserve special recognition.

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