

sixth edition

# *Personal Financial Planning*



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# *Personal Financial Planning*

*s i x t h   e d i t i o n*

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End-of-Chapter Feature, “*Getting a Handle on Your Financial Future*,”  
contributed by Robert W. McLeod, CFP, CFA, *University of Alabama*  
and Saliba, Reinhart, McLeod & Company

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## ABOUT THE AUTHORS

**Lawrence J. Gitman** is a professor of finance at San Diego State University. He received his bachelor's degree from Purdue University, his M.B.A. from the University of Dayton, and his Ph.D. from the University of Cincinnati. Professor Gitman is a prolific textbook author and has over thirty-five articles appearing in *Financial Management*, the *Financial Review*, the *Journal of Financial Planning*, the *Journal of Risk and Insurance*, the *Journal of Financial Research*, *Financial Practice and Education*, the *Journal of Financial Education*, and other publications. His major textbooks include *Principles of Managerial Finance*, Sixth Edition, *Basic Managerial Finance*, Third Edition, *The World of Business*, which is coauthored with Carl McDaniel, and *Fundamentals of Investing*, Fifth Edition, which is coauthored with Michael D. Joehnk. Gitman and Joehnk also wrote *Investment Fundamentals: A Guide to Becoming a Knowledgeable Investor*, which was selected as one of 1988's ten best personal finance books by *Money* magazine.

An active member of numerous professional organizations, Professor Gitman is past president of the Academy of Financial Services, the Midwest Finance Association, and the FMA National Honor Society. In addition, he is a Certified Financial Planner (CFP). Gitman also serves as a member of the Board of Directors, F & C International Corporation (NASDAQ-FCIN), Cincinnati, Ohio. He lives with his wife and two children in La Jolla, California, where he is an avid bicyclist.

**Michael D. Joehnk** is a professor of finance at Arizona State University. He received his bachelor's and Ph.D. degrees from the University of Arizona and his M.B.A. from Arizona State University. A Chartered Financial Analyst (CFA), he has served as a member of the Candidate Curriculum Committee and the Council of Examiners of the Institute of Chartered Financial Analysts. He has also served as a Director of the Phoenix Society of Financial Analysts, a vice-president of the Financial Management Association, and secretary-treasurer of the Western Finance Association.

Professor Joehnk is active in research and is the author (or coauthor) of some 50 articles, five books, and numerous monographs. His articles have appeared in *Financial Management*, the *Journal of Finance*, the *Journal of Bank Research*, the *Journal of Portfolio Management*, the *Journal of Consumer Affairs*, the *Journal of Financial and Quantitative Analysis*, the *AJII Journal*, the *Journal of Financial Research*, the *Bell Journal of Economics*, the *Daily Bond Buyer*, *Financial Planner*, and other publications. In addition to coauthoring several books with Lawrence J. Gitman, Professor Joehnk is the author of a highly successful paperback trade book, *Investing for Safety's Sake*; he was the editor of *Institutional Asset Allocation*, which was sponsored by the Institute of Chartered Financial Analysts and is published by Dow Jones-Irwin. He also is a contributor to the *Handbook for Fixed Income Securities*. In addition, he has held a variety of editorial positions and is currently serving as Executive Co-Editor of the *Journal of Financial Research*. He and his wife live in Scottsdale, Arizona, where they enjoy collecting Southwestern art.

## P R E F A C E

The financial services revolution continues to usher in exciting changes in the institutions, instruments, and techniques of personal financial planning. The widespread use of personal computers, along with tax and regulatory reforms, major changes in financial institutions, new methods of borrowing, expanded insurance products, and new investment vehicles have dramatically changed the field of personal finance. It has evolved into a well-structured, fully integrated discipline that we now call personal financial planning.

The sixth edition of this book reflects feedback from past users as well as nonusers, practicing financial planners, students, and our own research. It provides helpful new approaches, expanded coverage in selected areas, and special pedagogical features while retaining the basic organizational structure, topical coverage, superior readability and useful instructional aids that marked the success of the first five editions. As with the preceding edition, this one continues to emphasize comprehensive personal financial planning. The most notable addition in this regard has been the introduction of end-of-chapter financial advisory sections, captioned "Getting a Handle on Your Financial Future." These discussions include checklists and provide specific suggestions for use by students in applying the material presented in the chapter to their personal financial circumstances.

### MAJOR CHANGES IN THE SIXTH EDITION

The sixth edition has been thoroughly updated to reflect the cutting edge of contemporary personal financial planning. The most notable changes will be described first as general changes and then as specific chapter-by-chapter changes.

#### GENERAL CHANGES

- A greater emphasis is given throughout the text to *real-life* financial planning and decision making.

- New to the end of each chapter is "Getting a Handle on Your Financial Future." These sections, prepared by a practicing financial planner, provide advice and checklists that give students—both those just starting out and those who are "thirtysomething"—help in immediately applying the concepts presented in the chapter.
- Both new and expanded discussions of the interpersonal and emotional issues involved in each stage of the financial planning process are included in order to strengthen the behavioral dimension of the text.
- By taking an action-oriented perspective, the text continues to emphasize and illustrate personal financial decision-making *procedures*. This emphasis continues to be enhanced by the inclusion of the updated and revised *Mark and Ana Williams continuous case*, which provides personal and financial information about a real-life family in order to allow students to develop a specific comprehensive financial plan.
- To facilitate the decision-making process, the book's *worksheets* have been greatly expanded as well as refined, and are now produced in a standardized format. Each provides a step-by-step framework for making a particular financial decision.
- The *computer-based problem-solver disk*, described inside the back cover of this book, has been completely rewritten and refined by Professor James B. Pettijohn, a recognized expert in the development of financial software. *FP/PC: Financial Planning on the Personal Computer* is a fully interactive teaching device that affords students a practical look at the role of the computer in the personal financial planning process.

#### SPECIFIC CHAPTER-BY-CHAPTER CHANGES

- A discussion of interpersonal and emotional dimensions of the personal financial planning process was added to Chapter 1. The discussion of the economy was expanded to include monetary and fiscal policy, gross domestic product (GDP), and the consumer price index (CPI). Career coverage

was expanded to give attention to gender and race, making career decisions, and career strategies for the 1990s. In addition, the revised *Mark and Ana Williams continuous case* is introduced at this point, along with relevant personal and financial data.

- In Chapter 2, the format of the balance sheet now lists assets in order of relative liquidity and classifies liabilities as current or long-term. Recommended procedures for preparing balance sheets and income statements have also been added.
- The discussion of financial goals in Chapter 3 includes a new section on the special planning concerns of managing two incomes and adapting to changes in marital status. Also included is a major discussion and demonstration of time value of money concepts—both future value and present value for both lump sums and annuities.
- Chapter 4 contains a complete up-to-date discussion of recent interpretations and technical refinements in the tax law. In addition, coverage of filing status has been expanded and relocated and the preparation of Form 1040EZ is discussed and demonstrated.
- The discussion of the new financial marketplace in Chapter 5 now includes a section on the banking industry crisis—both the S&L crisis and the problems in commercial banking. In addition, the discussion of checking accounts now describes ways to arrange overdraft protection.
- Ways to cover the down payment and closing costs when the buyers' savings are inadequate are now covered in Chapter 6, along with the procedure for estimating the size of mortgage one can afford. In addition, behavioral factors to consider when making either rent-or-buy or homebuying decisions are now discussed. Also included are discussions of using a mortgage broker, prequalifying for a mortgage loan, choosing an adjustable-rate mortgage index, monitoring mortgage payments, and the motives and analytical procedures (including a new worksheet) for deciding whether to refinance a mortgage. The expanded discussion of buying an automobile now includes detailed purchase consideration information, more on price negotiation, and specifics on closing the deal.
- Chapter 7 continues to emphasize the positive aspects of what it takes to build a strong credit history; in addition, the material on credit bureaus, credit bureau reports, and bankruptcy has been greatly expanded, and coverage of *secured credit cards* and *credit card fraud* has been added. Also new to this chapter is a discussion of how to find the credit card that is right for you.
- Chapter 8 contains a whole new section on *student loans*—the various types of federally-sponsored educational loan programs (including Stafford and Perkins loans) are fully discussed in terms of student qualifications, loan limits, application procedures, and repayment terms. Also new to this chapter is a box on home equity installment loans. In addition, the Buy-on-Time-or-Pay-Cash worksheet has been revised to reflect the latest tax treatment of interest expense on consumer loans.
- Chapter 9 has been carefully reworked to reflect the latest standards in the fields of risk management and life insurance. Several new types of insurance products are discussed, including *low-load* whole life policies, *joint life insurance*, *survivorship (last to die) insurance*, and *living benefits*. Also, in light of some of the financial difficulties that the life insurance industry has experienced, the material on life insurance ratings has been greatly expanded.
- Chapter 10 has been reorganized to focus on four major categories of health insurance—medical expense, long-term care, special coverages, and disability income—and the specific policy provisions and costs of each is discussed individually. In addition, cost containment provisions in medical expense insurance plans and expanded detailed discussions of both long-term care and disability income insurance policies are now included.
- The discussion of coinsurance in Chapter 11 has been revised in several places in order to make this potentially confusing concept more understandable, and material has been added on inflation protection riders.
- A number of changes have been made to Chapter 12 on investing in stocks and bonds, including a whole new section on the growing trend toward *market globalization* and different ways of investing in foreign securities. Also added was some discussion on how to go about selecting stocks for investment purposes. In the area of bonds, a new box was added on buying U.S. Treasury Securities at the auctions; also added is material on



U.S. Treasury zero-coupon bonds and mortgage-backed securities.

- In Chapter 13, the coverage of the various securities markets and market indexes has been updated and expanded, and new material has been added on *pink sheet stocks* and market regulations.
- The most obvious change to Chapter 14 is that commodities and options are now presented and discussed as *derivative securities*, in keeping with the way they are actually treated and viewed in the market. But there are other changes as well, including a new section on how mutual funds are organized and run; in addition, the discussion of mutual funds has been expanded to include *socially responsible* funds and *international* funds.
- The discussion of retirement planning in Chapter 15 has been expanded and updated, as necessary. One of the most noteworthy additions to this chapter is the new material on the three biggest pitfalls to sound retirement planning; material has also been added to this chapter on insurance company ratings as they apply to annuity products and *guaranteed investment contracts* (or GICs for short).
- The impact of recent tax legislation on estate planning and the effects of the latest legislative developments on trusts and estates are covered in Chapter 16. In addition, the discussion of the common features of wills and the sample clauses were revised and clarified. The discussion of co-ownership that focuses on ways people can take title to property was revised to include community property.

## ORGANIZATION OF THE BOOK

*Personal Financial Planning* addresses all of the major personal financial planning problems that individuals and families encounter. It presents a model of the major elements of effective money management. All of the latest financial planning tools and techniques are discussed. Most of the widely used examples involve young people so that the student reader may more easily identify with each situation.

This comprehensive text is written in a low-key, personal style and uses state-of-the-art pedagogy to present the key concepts and procedures used in sound financial planning and effective money management. The roles of various financial decisions in the overall personal financial planning process are clearly delineated.

The book is divided into six parts. Part One presents the basic principles of personal financial planning and then covers personal financial statements, cash budgets, and taxes. Part Two concerns the management of assets, including cash and savings instruments, housing, and other major assets. Part Three covers debt management, including the various types of open account borrowing and consumer loans. Part Four deals with insurance planning and considers life insurance, health care plans, and property and liability insurance. Part Five concerns investments, including stocks, bonds, mutual funds, real estate, and other investment vehicles, and how to make transactions in securities markets. Part Six is devoted to retirement and estate planning. All these parts are tied together via the *Mark and Ana Williams continuous case*, which begins at the end of Chapter 1 with an extensive inventory of personal and financial data. Additional elements of the Williamses' financial plans are then introduced at the ends of Parts One through Five, and Chapters 15 and 16 so that the students can deal with the unfolding elements of a complete financial plan.

## PEDAGOGY

Each chapter opens with an element called *Financial Facts or Fantasies*, a series of six true-false questions concerning the material covered, for which answers and brief explanations are appropriately placed throughout the chapter. In addition, each major section of the chapter begins with a critical thinking question designed to stimulate interest in the material that follows by challenging the student to relate it to his or her personal life. Each chapter contains two boxes set off from the text material and containing brief discussions of relevant personal financial planning material that serve to

enrich the topical coverage. Numerous exhibits, each containing descriptive captions, are used throughout to more fully illustrate key points in the text.

Many chapters contain discussions and illustrations of how the personal computer can be used in various phases of financial planning and, where appropriate, brief descriptions of some of the more popular computer software are included. A running glossary provides brief definitions of key terms. End-of-chapter material includes roughly 20 review questions and problems that students can use to test their grasp of the material. Two case problems highlighting the important analytical topics and concepts are also supplied.

Following the case is a listing of about ten information sources, including general information articles from popular personal finance publications such as *Kiplinger's Personal Finance Magazine*, *Money*, and *Consumers Digest*, and a separate listing of relevant government documents and other publications.

The final item in each chapter is the new financial advisory section, "Getting a Handle on Your Financial Future." And, of course, as noted before, each part of the book ends with the Williamses continuous case.

## ANCILLARY MATERIALS

Recognizing the importance of outstanding support materials to the instructor and the student, we have continued to improve and expand our ancillary package.

### Worksheets

A file folder containing *blank worksheets* identical to those presented and used in the text is included free of charge with each new copy of the book. Each worksheet provides a logical format for dealing with some aspect of personal financial planning such as preparation of a cash budget, home affordability analysis, or automobile lease versus purchase analysis.

### Instructor's Manual and Test Bank

A comprehensive *Instructor's Manual and Test Bank* has been prepared to assist the teacher. For each chapter, the manual includes

- An outline
- Discussion of major topics
- A list of key concepts
- Solutions to all end-of-chapter questions, problems, and cases
- *Outside projects* that can be assigned to students so that they can apply major concepts and techniques presented in the chapter (instructions for outside projects are printed on separate sheets to make duplication for classroom distribution a simple task)
- Solutions to all questions on the text continuous case
- Two additional integrative cases, each with a detailed solution. One of the cases deals with a young couple, and the other addresses the financial concerns faced by single parents.
- A complete test bank that has been revised, updated, and expanded by Carlene Creviston of Ball State University includes true-false and multiple-choice questions, as well as four to six short problems for nearly every chapter.

### Computerized Test Bank

A computerized version of the printed test bank is available on either a 5¼" or 3½" IBM-compatible diskette. It comes in either the regular computerized test bank format or in a WordPerfect file that can be easily edited.

### Workbook

Carlene Creviston of Ball State University has updated the *Workbook* to assist students in mastering the information and techniques presented in the text and to serve as a resource manual as they develop personal financial plans. Specific components for each chapter include

- A thorough outline of concepts discussed
- Completion exercises that stress vocabulary
- Comprehensive case problems (with solutions) that demonstrate the application of chapter concepts

Most chapters include both problem-solving exercises (with solutions) and comprehensive cases.

### Personal Financial Planning Disk

The computer-based problem-solver—*FP/PC: Financial Planning on the Personal Computer*—was revised for this edition of the book by its author, Professor James B. Pettijohn of Southwest Missouri State University. The disk performs like any of the widely used commercially available software packages and is completely interactive; best of all, being very user-friendly, it streamlines the recordkeeping and problem-solving activities presented in the text. A computer logo is used in the margin to identify sections of the book to which the disk is applicable. End-of-chapter problems and cases that can be solved with the disk are keyed with the same logo. Some worksheets used in the text are formatted on the disk to provide assistance in applying some of the more complex procedures, ranging from financial statement and budget preparation to tax estimation, investment management, and retirement planning. The software has been extensively tested to ensure its accuracy and ease of use. *FP/PC* is made available to users of *Personal Financial Planning*, Sixth Edition. The software will operate on IBM PC's or true compatible machines with at least 512K of memory and is available in both 5¼ and 3½ inch diskette sizes.

### ACKNOWLEDGMENTS

In addition to the many individuals who made significant contributions to this book by their expertise, classroom experience, guidance, general advice, and reassurance, we also appreciate the students and faculty who used the book and provided valuable feedback on it, confirming our conviction that a truly teachable personal financial planning text could be developed.

Of course, we are indebted to all the academicians and practitioners who have created the body of knowledge contained in this text. We particularly wish to thank several people who gave the most sig-

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