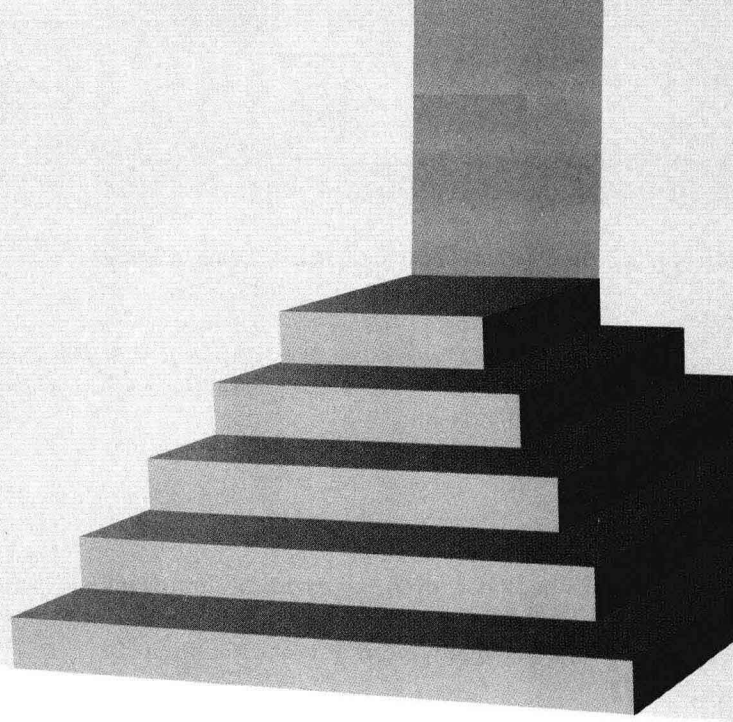


# PERSONAL FINANCE

ARMAN

FORGUE

# Personal Finance



SIXTH EDITION

E . T H O M A S   G A R M A N

*Virginia Polytechnic Institute and State University*

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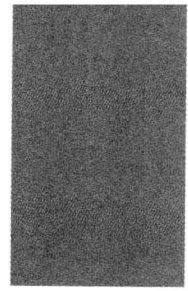
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# Preface



The twentieth century has brought individuals the benefits of many new savings, credit, insurance, and investment options. Now more than ever, making sound financial decisions is exceedingly complex, even when compared with just 15 or 20 years ago. A solid understanding of the concepts and principles of personal finance is vital. *Personal Finance*, Sixth Edition, provides a comprehensive examination of these principles and offers solid strategies for successful management and planning. This edition has been thoroughly revised to reflect the most recent changes in our economic environment and describes the most up-to-date options available for readers as we transition into the next century. The new Garman/Forgue *Personal Finance* Web site, for example, offers exercises and experiences that parallel the text and offer the industry's best opportunities for learning on the Internet.

For a person to achieve financial success, he or she must plan, analyze, and control financial resources. This involves developing the knowledge and skills necessary to take advantage of favorable financial opportunities, resolve personal financial problems, achieve self-satisfaction, and strive toward financial security. This book is not about “headlines” and “highlights.”

Competence and confidence are the two broad goals that underlay our efforts in writing *Personal Finance*. To develop competence in personal finance, the reader needs a text wide in scope. We have worked to make *Personal Finance* the most comprehensive and thorough textbook available. To help the reader become a lifelong skillful manager of personal finances, we take a how-to approach, explaining, for example, how to manage cash, determine personal credit limits, reduce income taxes, buy a car, calculate an affordable home mortgage loan, select an insurance agent, project life insurance needs, choose a life insurance policy, select a stockbroker, compare mutual fund investments, and project the anticipated return on an investment. We outline step-by-step procedures for the more complex financial activities, such as developing a total personal financial plan, planning and reconciling a 12-month budget, calculating personal income taxes, determining how much life insurance is needed, and figuring how much money will be needed for retirement.

To develop confidence in the area of personal finance, the reader needs to be led through, not simply to, the material. We aim to acquaint the reader with the subject matter logically and to offer no surprises. For students in personal finance with little background in finance, economics, or mathematics, our text offers clear explanations and instructions. Numerical examples are always explained parenthetically, and the benefits and costs of different personal finance decisions are examined closely. Key words and concepts—which are printed in boldface type—are clearly and completely defined when they first occur and often *again* in later chapters. Instructors who assign chapters out of sequence will find this feature particularly convenient.

More than 130 tables, charts, and illustrations support the text, including facsimiles of forms that are used in personal finance, such as checks and up-to-date income tax tables. Beginning- and end-of-chapter pedagogical materials are all designed to develop the reader's confidence in the area of personal finance.

As an aside, the Houghton Mifflin Company is pleased to report that *Personal Finance* is the required text for the first of a two-part examination process for the certification program, Accredited Financial Counselor, sponsored by the Association for Financial Counseling and Planning Education.\*

## Major Changes in the Sixth Edition

We have thoroughly enjoyed the challenge of updating and revising *Personal Finance*. It is popular with students because of the informal writing style and with instructors because it is so readable that students come to class prepared. We have again aimed to keep the narrative conversational and yet clear and concise. Responding to the comments and suggestions of both users and nonusers, we have added more topics, reorganized chapters for a better flow, highlighted important topics in special boxed features, updated and expanded use of Internet Web site exercises, and updated all tables and figures, as well as improved the overall pedagogy.

The new Personal Finance course links the Web site that accompanies this text and brings our package into full interface with the Internet. Developed in tandem with Courseworks Publishing, Inc., the Courselinks site provides both students and instructors with a wealth of supplemental materials to enhance learning and aid in course management. Included among the features of the Courselinks site are

- PowerPoint Chapter Outlines for instructor use as class notes.
- Regularly updated lists of supplemental Web sites for additional reading and enhancement of understanding the world of personal finance.
- Many of the applied mathematics problems from the text with links to the appropriate calculator or worksheet to be used to answer the problem.
- Each of the Exploring the World Wide Web exercises from the text with links to the appropriate external Web site for completing the exercise.
- Multiple-choice quizzes that are instantly graded to provide feedback to students on their mastery of personal finance concepts.
- Sites for students and instructors to share insights, questions, and information with fellow students and faculty.
- Many of the formulas and worksheets from the text plus present and future value calculators for doing all of the mathematical computations illustrated in the text.

\* For more information, contact Accredited Financial Counselor Program, The Association for Financial Counseling and Planning Education, 6099 Riverside Drive, Suite 100, Dublin, OH 43017; telephone (614) 798-4107; fax (614) 798-6560; e-mail: [request@afcpe.org](mailto:request@afcpe.org); Internet: [www.afcpe.org](http://www.afcpe.org).

## Topical Treatment

To keep pace with changes in the financial services industry and to provide a complete perspective on personal finance, we have added a number of current topics, such as

- The effect of work decisions on success in personal finance
- Flexible spending accounts that offer tax sheltering
- Hope scholarship and lifetime earning credits
- Maximization of the benefits from a tax-sheltered retirement account
- The relationship between financial planning and budgeting
- Smart card and stored-value cards
- How much to save
- Prioritization of wants
- New vehicle leasing regulations
- Evaluation of your decisions as a guide for future purchasing behavior
- Second mortgage loans
- Price-to-Sales ratio
- Inflation-indexed savings bonds
- The Roth IRA
- Cash-balance pension plans
- Strategies to legally avoid overpayment of income taxes
- Survivorship life insurance
- New alternative mortgage loans
- The proper forms of asset ownership (discussed in all appropriate chapters)
- Disability income insurance
- Bond premiums and discounts
- How a sideline business can reduce income taxes

We have also expanded coverage on more than 40 topics, including

- Financial tasks and challenges of divorced and remarried persons
- Advice on how to get out of debt
- Managing educational loan debts
- Resolving the dilemma of long-term health care
- Maintaining health care coverage when changing jobs
- Hidden hazards of decreasing premium life insurance
- The tax-planning principles of estate planning

## Organization

We have retained the successful format of the fifth edition, with some improvements:

- Chapter 1, “The Importance of Personal Finance,” has been strengthened by the addition of a new section on “How Work Decisions Affect Success in Personal Finance,” based on material that was formerly in a separate chapter on careers.
- The “Managing Taxes” and “Estate Planning” chapters have been revised to emphasize all the tax-planning principles of estate planning.

## Boxed Features

“Tax Considerations and Consequences,” a boxed feature in every chapter, focuses on the key tax aspects of the subject at hand. Other boxed features provide basic personal financial advice or knowledge. “How to . . .” boxes offer concrete information on how to carry out a specific financial task, whereas “Did You Know?” and “What if . . .” boxes relay interesting anecdotes and information intended to increase the reader’s overall knowledge.

There are more than 100 boxed inserts, including new ones on

- How to Search for Investments on the Internet
- Did You Know? Buying a Home Can Reduce Income Taxes Because Interest and Real Estate Taxes Are Tax-Deductible
- How to Calculate Taxable and Tax-Exempt Yields
- How to Keep Your Money Safe
- How to Discuss Personal Finances
- Did You Know? You Can Do Banking from Home
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- Did You Know? About Direct-Investment Plans and DRIPs
- Did You Know? How Most Investors Select Stocks
- Did You Know? That Zero-Coupon Bonds Pay No Annual Interest
- How to Get at Your Qualified Retirement Funds Early
- How to Use Advance Directives
- How to Investigate a Brokerage Firm and Its Sales Representatives

## Decision-Making Worksheets

New decision-making worksheets designed to help students solve personal finance problems by following a step-by-step procedure include

- Should You Buy or Rent (Based on Costs for the First Year)?
- Estimating Retirement Needs in Today’s Dollars

## Tables and Figures

We have updated all tables and figures and added several new ones, including

- Rule of 72
- Budgets and Financial Statements
- Classifying Annuities
- The Value of Tax-Sheltered Contributions

## Internet Addresses

Every chapter offers Internet addresses for businesses, nonprofit organizations, and government agencies useful to the student of personal finance. Web sites are indexed for convenience.

## End-of-Chapter Pedagogy

The end-of-chapter pedagogy has been revised to give more specific direction for a serious study of personal finance.

- Financial Math Questions are collectively designed to review *every* key math concept in personal finance.
- The new Exploring the World Wide Web of Personal Finance exercises let students and faculty apply chapter concepts using calculators and the vast resources of the Internet.
- Money Matters: Life-Cycle Cases can be used intermittently or in a logical series. We've included the popular Harry and Belinda Johnson case study of a young family from previous editions as well as a case study that follows the Hernandez family from midlife into retirement.

## Overview of the Sixth Edition

The contents have been arranged so that as each new topic is introduced, it is fully explained and its fundamentals are thoroughly examined before commencing further study. For example, Chapter 13, "Investment Fundamentals and Portfolio Management," precedes chapters on specific types of investments. In addition, not only does each chapter follow an overall logical sequence but each is also a complete entity. Thus, the chapters can be rearranged to follow any instructor's developmental sequence without losing students' comprehension.

Part 1 provides an introduction to financial planning. Chapter 1 discusses what will be gained from the study of personal finance, describes the goals of financial planning, and helps the reader understand the economic environment so he or she can succeed financially by forecasting the state of the economy and understanding how work decisions affect success in personal finance. In Chapter 2, we explain how to plan financially over one's lifetime, and we



review the types of financial records and statements that are pertinent to success in effective personal financial management, such as tax records and documents, balance sheets, and income and expense statements. In Chapter 3, we take the student through all phases of personal income taxation—especially how to legally avoid taxes—and we give advice on how to successfully win an audit with the IRS. “Managing Taxes” offers sufficient detail to enable a reader to adequately and accurately fill out an income tax form. Expanded coverage illustrates the 13 principles of effectively reducing tax liability.

Part 2, comprising six chapters, discusses the specifics of managing expenditures. Chapter 4 takes a cash-flow approach to the subject of budgeting. It provides basic information about money and then illustrates a complete financial plan before examining the specifics of budgeting and cash-flow management (goal setting, organizing, decision making, implementing, controlling, and evaluating). Chapter 5 examines the new concept of cash management, which involves making effective use of today’s changing financial services industry to earn maximum interest on all one’s money. Chapter 6 discusses credit use and credit cards, including new legal protections that are available, and Chapter 7 treats the subjects of the planned use of credit, non-credit-card borrowing, and what happens should one become overextended using credit. We cover automobiles and other major expenditures in Chapter 8, discussing several ways to save money when purchasing goods and services, detailing the several steps in the planned buying process, with emphasis on automobile purchases, and showing how to compare leasing with financing. Chapter 9 focuses on the housing expenditure, covering all aspects in the home-buying process, including new methods of financing, as well as renting (especially because renting is sometimes the wiser choice), and we provide information on both refinancing and selling a home.

Part 3 emphasizes income and asset protection. Chapter 10 thoroughly explains the concepts fundamental to understanding risk management, insurance, and how to purchase coverage. It emphasizes automobile and home-related property and liability coverage. Chapter 11 takes a new approach to health care planning that recognizes that most people’s health insurance is really a health care plan; thus we have strengthened coverage on health maintenance organizations, preferred provider organizations, and managed care systems. Chapter 12 covers all the key concepts in term and cash-value life insurance, including single-premium life insurance and universal life insurance.

Part 4 contains five separate chapters on investment fundamentals and portfolio management, stocks and bonds, mutual funds, buying and selling securities, and real estate and advanced portfolio management. Because the topic of investments is too complex to treat superficially, this chapter-by-chapter breakdown offers instructors more flexibility in deciding which topics to teach. Importantly, Chapter 13 is a comprehensive study of investment fundamentals for those instructors who have time to teach only one chapter from Part 4. In each chapter, we provide enough detail for the reader to decide which investment alternatives are most suitable. We also offer specific guidelines on when each investment should be sold.

Part 5 concludes the text with two valuable chapters on financial planning for the future. Chapter 18 examines how to develop and implement a plan for a secure retirement, and Chapter 19 reviews the tax-planning principles of estate planning, with coverage on wills and trusts.

Students will find the four appendixes in *Personal Finance* useful beyond the course. Appendix A has more than two dozen key illustrations on how to use the present and future value tables. Appendix B permits students to accurately estimate Social Security benefits: retirement, survivor's, and disability. Appendix C explores careers in personal financial planning and counseling. Appendix D offers a concise explanation on using a financial calculator for personal finance decision making. The Glossary defines all key terms listed at the end of each chapter.

## Supplements

These supplements are available with *Personal Finance*, Sixth Edition:

- *Instructor's Resource Manual with Test Bank*
- *Study Guide* (with three sets of sample test questions)
- A computerized *Test Bank*
- Over 70 *Color Transparencies*
- *PowerPoint Slides*
- Garman/Forge *Personal Finance* Web site

The *Instructor's Resource Manual with Test Bank*, written by Professor Linda Gorham of Northeastern University and Berklee College of Music, has six components: suggested course outlines to emphasize a general, insurance, or investments approach to personal finance; detailed outlines for each chapter; outside research projects and class assignments; and answers and solutions to all end-of-chapter questions and problems. The manual also includes a test bank of more than 2200 questions, with the correct answers identified as well as textbook pages on which the responses can be found. Nearly 130 transparency masters are included that illustrate almost all text tables and figures as well as many boxed features and formulas.

A completely revised *Study Guide*, written by the authors, requires students to define 20 important terms from each chapter and provides three sets of sample examinations for each chapter. Each exam consists of true-false, matching, multiple-choice, and completion questions, plus some applied math problems. Correct answers are provided at the back of the *Study Guide* chapters.

A computerized version of the *Test Bank* in the *Instructor's Manual with Test Bank* is also available to instructors. The new program is very user-friendly and permits editing of test questions.

*Color Transparencies* are available to adopters of 50 copies or more of *Personal Finance*. These transparencies—which include selected tables, figures, formulas, and boxed features from the text—illustrate the most commonly taught concepts in personal finance.

*PowerPoint Slides* are a new supplement for this edition. Dr. Susan Jenkins and Janiel Nelson of Idaho State University have created over 450 slides that outline the text and include a selection of the text art. These slides are a valuable asset for use in the classroom, both as presentations and as PowerPoint Chapter Outlines for instructor use as class notes.

The new Courselinks *Personal Finance* Web site includes downloadable PowerPoint slides, links to the sites required to work through the World Wide Web

exercises, links to additional web resources, self-testing quizzes that are instantly graded, and online access to formulas and worksheets. The new Garman/Forgue *Personal Finance* Web site enhances and extends the scope of the text.

## Acknowledgments

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