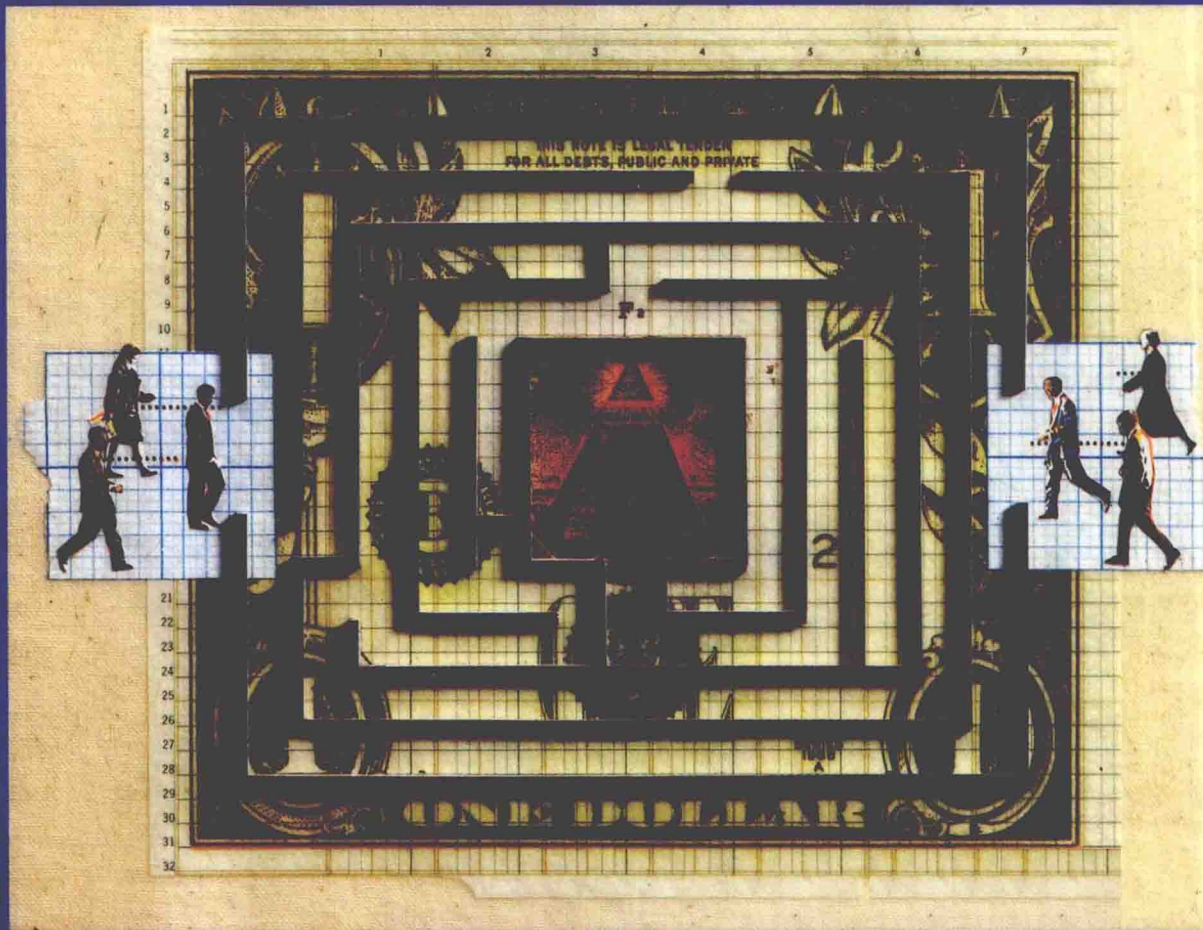


FIFTH EDITION

STRATEGY FOR PERSONAL FINANCE

LARRY R. LANG



FIFTH EDITION
**STRATEGY FOR
PERSONAL FINANCE**

LARRY R. LANG

University of Wisconsin Oshkosh

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To Pamela, Catherina, Laurence, Wilma, Ross, and Mary

STRATEGY FOR PERSONAL FINANCE

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Larry R. Lang is a professor of finance at the University of Wisconsin Oshkosh. He received both his bachelor's degree and his Ph.D. from Michigan State University. Before beginning his university teaching career, he was a practicing Certified Public Accountant with a large national accounting firm. This is the fifth textbook that he has written. He is currently active in research in the personal finance area. His work has been presented at professional meetings and has appeared in national publications. He has conducted numerous financial planning seminars in both the public and private sectors. Professor Lang is active in numerous professional associations. He lives with his wife and two children in Oshkosh, Wisconsin.

TO THE STUDENT

Welcome to the study of personal financial planning; you have decided to pursue a rewarding, challenging and exciting discipline. The principal objective throughout *Strategy for Personal Finance* is to prepare you to be a lifelong personal finance manager.

Each of the book's 19 chapters is specifically tailored to develop and improve your skills as a financial decision maker. Once you have developed and honed those skills, you will be in a much better position to achieve your personal financial goals.

Financial decision-making skills can help you get the greatest benefit from the money you have. Even topnotch planners find available funds are limited, however. Many people earning a high five-digit or comfortable six-digit salary still find they do not have enough money to meet their goals. But money management skills, intelligently applied, can help you make each scarce dollar work harder.

Your financial planning skills can also help you avoid the major pitfalls and abuses that challenge consumers. Your study can benefit you in a very measurable dollar-and-cents way throughout your career. You will learn how to develop a financial plan that adapts to the changing needs of your life-cycle of financial planning. Throughout *Strategy for Personal Finance*, we develop decision models that identify the costs and benefits of each financial product or service alternative. The book also examines the qualitative considerations that complement and supplement the dollars-and-cents dimensions of a decision.

Extensive numerical examples and decision situations are used to illustrate the steps and processes of financial decision making. You will have many opportunities during your studies to practice and refine your planning skills.

The financial planning field is a dynamic one where new products and services are regularly introduced and existing ones modified. That does not antique the models, guidelines, and suggestions given in the text. Though you may have to modify them to account for new developments, they will continue to be valid.

IT IS YOUR DECISION

The objective of the text is to help you develop the personal financial planning skills you need to meet your individual objectives, needs, and goals. The book doesn't propose a standard financial plan that says, go do this and your personal finances will be well planned. People are so diverse, have so many different needs and circumstances, and have such unique aspirations that a single "boilerplate" plan will never work. Instead, you need to use the various financial decision models to tailor a financial plan for your unique goals, needs, and available resources. The objective of the text is to teach you how to develop just such an individual plan.

PRACTICING YOUR DECISION-MAKING SKILLS

Practice is the best way to develop and improve your financial decision-making skills. With that in mind, numerical examples and sample decision situations are used throughout *Strategy for Personal Finance* so you can apply what you have learned. Each chapter contains extensive examples which show how to analyze the costs and benefits associated with different financial products and services. When the example is less involved, the steps are illustrated through one or two annotated equations; for more involved, lengthy examples, the associated costs and benefits are developed in a detailed worksheet. Both are integrated into the chapter material, along with a discussion of related points and issues.

You will have additional opportunities to practice your new skills on the questions, problems, and case studies at the end of each chapter. These exercises will test your understanding and retention of needed concepts. Case studies create situations that call on your analytical and reasoning skills for solutions.

New to this edition of the text are a series of appendixes that demonstrate how a financial calculator can assist you in making your financial decisions. Step-by-step instructions are provided for three widely used financial calculators. Each appendix ends with a series of problems you can use to practice your calculator skills.

SPECIAL FEATURES OF THIS BOOK

You should find the following features of the book highly useful in your study of personal finance:

First

Each chapter covers a broad range of different personal finance topics. An informed financial planner understands a wide array of financial topics ranging from those which require almost daily decisions (individual dollar amounts may be small, but they add up to a significant total) to those which are encountered far less frequently (the dollar amount is large so the consequences of a poor choice can be *very* costly).

Second

A list of the important concepts opens each chapter. Read them to get a general guide to the topics covered and the order of presentation before you begin the chapter.

Third

Descriptive information has been limited to what is needed to provide you with background in each area.

Fourth

Each chapter provides extensive numerical examples to illustrate the decision models and compare the respective costs and benefits. Actual computations are illustrated through equations and worksheets. You should take time to review these so you thoroughly understand each concept.

Fifth

Whenever a new term or concept is first introduced, it is explained and set off in **boldface** type. Those ideas are listed at the end of the chapter as key terms; use them to test whether you have mastered the chapter's major points.

Sixth

Practice helps you develop and refine your money management skills. The discussion questions, problems, and case study at the end of each chapter will strengthen your understanding of the chapter's qualitative and quantitative financial concepts.

Seventh

Selected chapters include an appendix that discusses how a financial calculator can assist in utilizing each decision model. Step-by-step instructions are provided for three widely used calculators: the Hewlett-Packard HP-10B, the Sharp EL-733, and the Texas Instruments BA-II PLUS. Each appendix ends with problems for you to practice your calculator skills.

Eighth

For those with access to a personal computer, there is the SPF financial planning program that contains the major financial decision models from the text. A computer disk logo (at left) indicates those end-of-chapter problems and case studies that can readily be solved using the SPF program. Examples of applications include budgeting, estimating income taxes, automobile purchases, housing decisions, investment planning, and retirement planning. The SPF program is available from your instructor; McGraw-Hill, Inc. provides copies of the SPF program to the instructor.

Ninth

A detailed student workbook is available for the text to provide further opportunities for practicing money management skills. It includes a crossword puzzle, discussion questions, problems, a case study, and a series of sample test questions for each chapter. Many of the problems and case studies use the SPF personal computer program to assist in their solution. Selected solutions are provided at the end of the workbook to confirm your progress.

START YOUR MONEY MANAGEMENT CAREER NOW

Now is a good time to begin your money management training. The financial and personal rewards that come from being an astute manager have never been bigger. Skilled money managers regard the introduction of new products and services and the revision of existing ones as opportunities to improve their existing financial plan. Because the personal finance field is evolving rapidly, your money management training will need to be a lifelong pursuit.

Expend a reasonable amount of effort and you can develop the skills a good personal finance manager needs. Of course, you need the motivation to begin your money management career. To paraphrase one well-known financial planner, Venita VanCaspel: The reason many people's finances are in such dire condition in later years is not that they "planned to fail, but that they failed to plan." But the very fact that you have enrolled in this course suggests you decided not to be part of that "unplanned" group. All that remains is for you to turn to page 1, Chapter 1 and begin. You will find personal finance to be interesting, stimulating, and best of all, financially rewarding. Good luck in your money management career.

Larry R. Lang

TO THE INSTRUCTOR

Since the fourth edition of *Strategy for Personal Finance* was published five years ago, the elements of personal financial planning have changed significantly.

One example is the substantial changes that have occurred in the area of consumer credit options. With their continued full tax deductibility of finance charges, home equity loans and lines of credit have become a more prominent source of consumer credit. Meanwhile, publicity surrounding the cost of traditional consumer credit sources may have sensitized individuals to the importance and rewards of searching out lower-cost credit sources.

With continued modest levels of inflation, interest rates in the financial markets have returned to more traditional relationships. Current real rates of return on short-term, highly liquid investments are positive but they are limited. This is consistent with historical norms where nominal returns were only slightly higher than inflation. This drop in rates has forced investors to reexamine whether the potentially higher returns on less liquid investments justify their higher risks.

If the rapid growth in professionally managed investments such as mutual funds and variable annuities is any guide, investor interest appears to continue unabated. Individuals seem more willing to diversify beyond more traditional domestic investments. This expansion of investment alternatives has increased the challenge of proper selection and monitoring.

This is not meant as a detailed list of changes over the last five years. Rather, it provides a perspective on the rapid change within the field. Managing one's personal finances, always a challenge, is now an even greater challenge. A new edition of *Strategy for Personal Finance* was essential so these developments could be incorporated.

LIFELONG FINANCIAL MANAGEMENT

The fifth edition of *Strategy for Personal Finance* continues our objective of preparing students to be lifelong personal finance managers. As the

range of alternatives expands, good management becomes increasingly important. A three-step approach to presenting financial concepts is used:

- Discuss why a particular finance topic is important to a student.
- Show the student how to develop a financial decision model that considers both the costs and benefits associated with choosing a particular financial product or service.
- Show students how they can use the decision model they develop to help them make sound personal financial decisions.

This edition includes new financial decision models for assessing recently introduced financial products and services. The extensive discussion questions, problems, and case studies of the previous editions have been completely updated. As before, they provide students the opportunity to practice their financial management skills. New to this edition are a series of end-of-chapter appendixes that illustrate how a financial calculator can assist with personal financial decisions.

CHANGES IN THE FIFTH EDITION

- 1 There are appendixes at the end of selected chapters that illustrate how a financial calculator can be used to assist in personal financial planning decisions.
- 2 The discussion of personal computer software for financial planning and tax preparation has been expanded and is now fully integrated within the appropriate chapter or appendix.
- 3 The material on federal income taxes (Chapter 5) continued to be revised for changes in tax regulations right up through mid-1992. This edition continues its earlier focus on helping students learn the structure and workings of the tax system. With that background they can incorporate future changes and revisions that will continue to characterize this rapidly changing area.
- 4 Coverage of second mortgages and home equity loans (Chapter 7) has been expanded to reflect the increased popularity of this credit source due to its fully deductible finance charge.
- 5 The material on qualifying for credit includes greater coverage of the process lenders use to decide which borrowers qualify for credit. It includes steps consumers can use to check and correct their credit file at credit reporting agencies.
- 6 The decision model for comparing housing options (Chapter 9) has been refined, improving its presentation and making it easier to use. The discussion of financing options for this important purchase has been completely updated to reflect recent changes and trends.
- 7 Evaluation of the financial strength and viability of insurance companies receives increased emphasis in the four chapters on insurance; this coincides with the publicity surrounding the financial difficulties of some firms in this industry.

- 8** Coverage of health insurance and competing options has been expanded to reflect the challenges confronting consumers in their search for adequate coverage in this important decision area.
- 9** Students are now introduced to material on the efficiency of financial markets in Chapter 14's discussion of investment fundamentals. Coverage of efficient financial markets continues to be integrated in subsequent chapters on specific investment options.
- 10** The discussion of diversification has been shifted to the introductory investment material in Chapter 14. It has also been expanded to include the increasingly important area of international investing. Later chapters on specific investment options continue to stress the potential gains from adequate diversification.
- 11** Chapter 16's coverage of common stocks has been completely revised with increased emphasis on the decision models for selecting common stocks. The chapter expands its coverage of the ongoing management of a common stock portfolio.
- 12** The coverage of professionally managed investment options in Chapter 17 has been broadened to include closed-end mutual funds. In addition to updating the material on mutual funds and variable annuities, the decision model for selecting from among competing options has been refined and strengthened to assist students in this important decision.
- 13** An appendix has been added to Chapter 18 that illustrates how the expected inflation rate and the projected rate of return can be integrated into retirement planning. The presentation uses the same time value of money concepts to which students were introduced in earlier chapters.

PEDAGOGICAL FEATURES

Suitable Courses

This book is designed for use in:

- 1** Undergraduate personal finance courses at both 4-year and 2-year colleges and universities.
- 2** Introductory courses in personal financial planning which may be followed by an advanced financial planning course.
- 3** Undergraduate consumer economics courses at 2-year and 4-year colleges and universities.
- 4** Family management courses at 2-year and 4-year colleges and universities.
- 5** Personal finance courses offered in continuing education or adult education programs.

Overall Organization

The 19 chapters are divided into five major sections. The first section provides background and basic introductory materials to prepare and equip students for their role as lifelong financial decision makers. The

second section discusses the key points in managing their income. The third analyzes the benefits and costs of large consumer purchases. Insurance coverage is the central thrust of the fourth section. The fifth discusses building for the future; it includes coverage of currently available investment alternatives. *Strategy for Personal Finance* closes with chapters on retirement planning.

Completing the Chapters

While the material has been organized in what we consider a logical sequence, chapters can be rearranged to suit a particular instructor's preference. Each chapter is self-contained, so one can generally cover most chapters out of sequence. This also means an instructor can drop one or more chapters if desired. Instructors who want to emphasize a particular topic or topics will find the book is flexible; time spent emphasizing particular topics in more detail can be recovered by eliminating others if necessary.

Instructors who plan to utilize a financial calculator will likely want to cover Appendix 1B since it contains introductory material on calculator basics. Subsequent appendixes can be covered as desired. Each appendix contains sufficient introductory calculator material so that it is not essential that students cover all prior appendixes. Problems at the end of the appendixes are in order of increasing difficulty so instructors can match the coverage to their preference.

Given the broad topical coverage and the extensive end-of-chapter materials, the text should provide sufficient material to fill the available time in single-semester or one-quarter courses.

Organization of Individual Chapters

Each time a new term or concept is introduced in a chapter, it is immediately explained; the term is shown in **boldface** type. Each chapter uses numerical examples extensively to illustrate benefits and costs for different options. When the example is simple, an equation summarizes the computation. On longer, more involved examples, the steps and computations are summarized in a worksheet. In addition, charts, graphs, tables, and cartoons are used throughout the text to illustrate important points and issues. Previous editions have convinced us that good visual displays improve the readability and teachability of the material.

MATERIALS IN EACH CHAPTER

Learning Objectives and Chapter Summaries

Each chapter begins with a short list that outlines the major points the student should learn from that chapter. At the end of the chapter a summary in outline form reemphasizes the chapter's major points. There is also a list of key words and phrases that were introduced in the chapter.

End-of-Chapter Materials

The fifth edition continues and expands on the extensive end-of-chapter materials introduced in previous editions. Typically, 10 to 20 discussion questions cover the major qualitative points from the chapter. Next, 5 to 8 problems review the major quantitative concepts. Each problem begins with a brief topic line to highlight the concept it covers. Users who want to emphasize selected topics will find that useful. A computer symbol (at left) is used to identify those problems that can be solved using the SPF financial planning disk. Last, a case study provides students with a simulated situation; here, they can analyze a more complex set of data and develop a solution. The same symbol identifies those cases that lend themselves to the SPF planning disk.

Student Workbook

The student workbook that accompanies *Strategy for Personal Finance* has been extensively revised. The workbook includes specially marked problems and case studies on which the computer-assisted SPF financial planning component can be used.

Features of the workbook include:

- A large format so the majority of work can be done in the workbook.
- A crossword based on each chapter's key words and phrases.
- Discussion questions that review a chapter's qualitative points and issues.
- Problems of varying difficulty. Some are intended to be worked by hand while others can be supplemented with the SPF computer disk.
- Multiple-choice and true-false test items that are similar to the ones in the test bank.
- Solutions to the crossword puzzle, selected problems, and all sample test items.

Since the workbook materials are different from those in the text, the workbook can either supplement the materials in the text or substitute for them. The workbook's self-correcting sections make it suitable for a number of different classroom situations, and the amount of class time spent using the workbook can be readily tailored to the time available. The text is accompanied by a full ancillary program with items designed to complement both your teaching efforts and your students' learning process. If you would like information on any supplemental materials, please contact your local McGraw-Hill sales representative.

Larry R. Lang

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Larry R. Lang

CONTENTS IN BRIEF

	To the Student	xix
	To the Instructor	xxiii
	Acknowledgments	xxix
PART ONE	INTRODUCTION	3
	1 Personal Financial Planning: Your Starting Point	4
APPENDIX 1A	Review of Selected Personal Financial Planning Software	29
APPENDIX 1B	Using a Financial Calculator to Develop Your Personal Financial Plan	30
	2 Financial and Personal Records	41
PART TWO	DEVELOPING AND MANAGING YOUR INCOME	69
	3 Developing Financial Goals and Integrating Them into Your Budget	70
APPENDIX 3A	Using a Financial Calculator to Develop Your Financial Goals	99
	4 Payment Services: Using Them Effectively	109
	5 How to “Manage” Your Income Taxes	136
APPENDIX 5A	Income Tax Reference Books and Tax Preparation Software	176
	6 Credit: How to Get It and How to Use It	182
APPENDIX 6A	Using a Financial Calculator to Evaluate Credit Offers	220
	7 Sources of Consumer Credit	227