Personal Finance

John B. Penson, Jr.
Donald R. Levi · Clair J. Nixon

Personal Finance

John B. Penson, Jr.
Texas A&M University

Donald R. Levi
Wichita State University

Clair J. Nixon
Texas A&M University

Prentice-Hall, Inc., Englewood Cliffs, New Jersey 07632

Library of Congress Cataloging in Publication Data

Penson, John B.
Personal finance.

Includes index.
1. Finance, Personal. I. Levi, Donald R., (date).
II. Nixon, Clair J. III. Title.
HG179.P364 332.024 81-15341
ISBN 0-13-657320-7 AACR2

Cover photograph by Stan Wakefield.

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

ISBN 0-13-657320-7

PRENTICE-HALL INTERNATIONAL, INC., *London*
PRENTICE-HALL OF AUSTRALIA PTY. LIMITED, *Sydney*
PRENTICE-HALL OF CANADA, LTD., *Toronto*
PRENTICE-HALL OF INDIA PRIVATE LIMITED, *New Delhi*
PRENTICE-HALL OF JAPAN, INC., *Tokyo*
PRENTICE-HALL OF SOUTHEAST ASIA PTE. LTD., *Singapore*
WHITEHALL BOOKS LIMITED, *Wellington, New Zealand*

Preface

Do you know how to assess your current financial position? Can you project which months you will have a cash surplus and which months you will experience a cash deficit? Are you familiar with the various income tax management strategies (such as income averaging) you can use to minimize your annual income tax liability? What factors should you consider when buying consumer goods and services or making investments? Can you determine whether a particular investment is right for you? And what factors should you be aware of when planning your retirement income and transferring your estate?

The purpose of this book is to introduce you to the key concepts of personal finance, including how to evaluate your personal expenditures in light of your current savings objectives, what types and how much insurance you need, what factors to consider when evaluating investment opportunities, and how to plan for retirement income and disposing of your estate.

Part One of this book asks you to assess your short-term and long-term financial goals, and discusses the factors that can impede your rate of progress in achieving these goals.

Part Two focuses on the various factors to consider when making personal consumption expenditures. The topics addressed here include the care and feeding of personal financial statements (Chapter 2), how to calculate your annual income tax liabilities and ways in which they can be minimized (Chapter 3), and selected topics pertaining to the purchase and financing of consumer goods and services as well as of your personal residence (Chapters 4, 5, and 6). Case examples will be used to underscore key concepts so that you will fully understand their meaning.

Part Three examines decisions related to your insurance program, and Part Four discusses selected topics in managing your portfolio of investments. Topics covered include identifying investment alternatives, buying stocks and bonds, evaluating investment companies, and determining the combination of investments that best suits your attitude toward the tradeoff between risk and returns.

The final part of this book focuses on planning for retirement and disposing of your estate, including such key areas as identifying several potential sources of retirement income and social security benefits you may be entitled to, estimating the value of your estate, and exploring ways to minimize the costs of transferring your estate.

Each chapter uses examples liberally where possible as well as copies of financial contracts, tax forms, investment performance statistics, and other documents that will give you a thorough appreciation of the topics covered. Occasional cartoons are used both to add a touch of humor *and* to emphasize a point. Each chapter will conclude with concepts for review, problems where applicable, and suggested readings. The concepts for review include one or more questions designed to underscore key concepts covered in the chapter. The problems contain some additional quantitative questions where applicable to further strengthen your grasp of the concepts addressed in the chapter. Additional assignments and answers to all the questions are supplied in the Study Guide for the interested reader. The suggested readings list other books and articles for those interested in pursuing these concepts in greater depth. A glossary of terms used is also found at the end of the book.

Intended primarily for first- or second-year students at colleges that offer a course in personal finance or personal money management, this book uses terminology that is both appropriate for and easily understood by its target audience.

We would like to express our appreciation to the anonymous reviewers who helped shape specific chapters in this book. We would also like to thank our colleagues and students for their insights and suggestions. Finally, we wish to thank Donna Heagberg for typing the initial draft of this book.

John B. Penson, Jr.
Donald R. Levi
Clair J. Nixon

Personal Finance

Contents

PART ONE

Introduction

1

Defining Your Financial Goals

A football team can usually win its game if the coach develops a sound game plan and the team executes this plan to perfection. In developing the game plan, the football coach must consider various offensive and defensive strategies as well as the resources available to him. His ultimate choice of which strategies to follow will be constrained by these resources—the talent of his players—and by his coaching philosophy. Finally, while the coach's ultimate goal is to win the game, he knows this goal can be achieved only through a series of short-term plans designed to score touchdowns.

The analogy of the football coach and the planning he must undertake underscores the theme of this chapter: reaching either long-term goals for your estate and retirement years or intermediate goals (like buying a home) requires the development of a series of short-term plans that are affected by such decisions as how much of your after-tax income you wish to save and the nature of the investments you desire to make with these funds. As our winning football coach would doubtless agree, you can maximize your chances of reaching your longer-term financial goals by carefully planning and executing a series of annual financial game plans consistent with these goals.

This chapter will discuss the factors you should consider when developing your short-term financial goals and help you see how to ensure that these goals are consistent with your long-term financial goals.

SHORT-TERM GOALS

What is a **short-term financial goal**? One example might be a commitment on your part to save 25 percent of your current annual after-tax income. Or it might have to do with the level of income you feel you should be earning at this point in your professional career. Perhaps you intend to be a millionaire by the time you are thirty-five years old. In fact, your short-term financial goals will probably include income and savings targets as well as other goals.

A variety of factors can affect your ability to achieve short-term financial goals. We shall divide our discussion of these factors into two groups: (1) those factors affecting your cash sources of funds, and (2) those factors affecting your cash uses of funds.

Factors Affecting Sources of Funds

Cash **sources of funds** that might be available to you in a given year include the following:

- ☐ Income:
  - Wages and salaries
  - Self-employment income
  - Dividends and interest income
  - Rental income
  - Royalty income
  - Realized capital gains
  - Other cash sources of income
- ☐ Borrowed funds
- ☐ Other cash sources of funds

Most of these categories should be self-explanatory. The category "Other cash sources of income" can include payments received from the government (such as welfare payments, unemployment compensation, or social security payments).

The Wall Street Journal Cartoon Portfolio, 1979

"My ultimate goal? Retirement."

And the category "Other cash sources of funds" can include such items as cash gifts and inheritances, proceeds from the sale of an asset you owned (excluding capital gains), or insurance benefits.

Your education and choice of career both have a direct effect on your ability to attain your financial goals. So do your selection of investments and your use of borrowed funds to finance cash uses of funds.

Effects of education. A definite relationship exists between the level of education you achieve and the level of your annual after-tax income. While there are always exceptions to this statement, the average annual income of heads of households with eight years of elementary education was recently shown to be 34 percent *less* than what you could have earned with four years of high school education, and 58 percent *less* than what you could have earned with four or more years of college education. This suggests, of course, that the average annual income of heads of households with four or more years of college education was 44 percent *higher* than the income earned by those with only four years of high school education.[1]

Effects of choice of career. Information supplied by the U.S. Census Bureau shows that your choice of career will also be likely to have a major effect on your level of annual income over time.[2] Using the average annual income of primary and secondary school teachers as our base, we see the average annual income achieved by *other* full-time workers was:

Physicians and surgeons	+274%
Farmers	−38%
Typists and clerical workers	−45%
Blue collar workers	+9%
Retail sales personnel	−17%
Engineers, technical	+42%
Laborers, general	−34%
Business management	+44%

Finally, if you are thinking of becoming an officer in the U.S. Armed Services, try to be a general or an admiral. Their annual compensation is 65 percent greater than that earned by a colonel or captain, and 175 percent greater than that received by a second lieutenant or ensign.[3]

Effects of consumption expenditures. One of the decisions you face during the course of a year is what proportion of your after-tax income you should use to finance the purchase of durable and nondurable consumer goods and services. For

[1] See U.S. Department of Commerce, Bureau of Census, *Current Population Reports*, series P-60, no. 110 (Washington, D.C.: U.S. Government Printing Office, 1978).
[2] See U.S. Department of Commerce, Bureau of the Census, *Current Population Reports*, series P-60, no. 110 (Washington, D.C.: U.S. Government Printing Office, 1976).
[3] Source: U.S. Deparment of Defense.

example, if you decided to use 90 percent of your after-tax income to finance these **consumption expenditures**, you should realize that your wealth will grow at a much slower rate than if you had managed to consume only 80 percent of your disposable income. Your consumption rate will depend upon your attitude toward postponing consumption *now* to finance investments that will increase your future ability to finance consumption expenditures. More will be said about this decision in Chapter 5.

Effects of selection of investments. While the level of your annual savings is important, the *type* of investments you make with your savings is also very important. The rate of growth of your net worth over time is likely to be much greater if you invest your annual savings in an inflation-resistant investment (that is, its rate of return equals or exceeds the rate of inflation) than it would if you invest these funds in a passbook savings account yielding an annual rate of return lower than the inflation rate. Even among inflation-resistant investments, your preference for assets emphasizing the safety of your equity will no doubt increase your net worth more slowly than if you emphasized growth. As shown in later chapters, the composition of your investment portfolio will be influenced in part by your attitude toward the tradeoff between risk and returns. If you are a risk taker, for example, you are more likely to be concerned with an investment's growth potential than the security it provides. But if you are risk averse (that is, you require a higher rate of return on an asset that exposes you to a higher level of risk), the safety of an investment may mean as much or more to you than the growth potential it provides. The evaluation of alternative investment opportunities will be assessed in Chapter 13.

Effects of borrowing. What is your attitude toward borrowing funds to buy household furniture and appliances? To buy real estate? To make other investments? Your answers to these questions and your ability to use your credit where it will do the most good will also have an effect on the growth of your net worth over time. For example, if you choose to use your borrowing power to finance current consumption expenditures that do not generate an *income-earning* asset, your net worth will grow much more slowly than if you used your borrowing power to finance the purchase of income-earning assets like real estate that also appreciate in value over time. The recent increase in household borrowing is illustrated in Figure 1.1.

In summary, a variety of factors can affect how soon you will reach your financial goals, to which different individuals will assign different weights. For example, the satisfaction of teaching young people may prompt some people to become elementary school teachers even though they know the financial rewards of doing so are not as great as they are in other fields. Your age will also affect your short-term financial goals. When you are young, you may be more inclined to take risks when making investments than you will be as you approach retirement.

Other factors. Other factors, of course, can affect the growth of your cash sources of funds over time. These include the growing popularity of the two-career family, where both the husband and wife are employed outside the home, and your

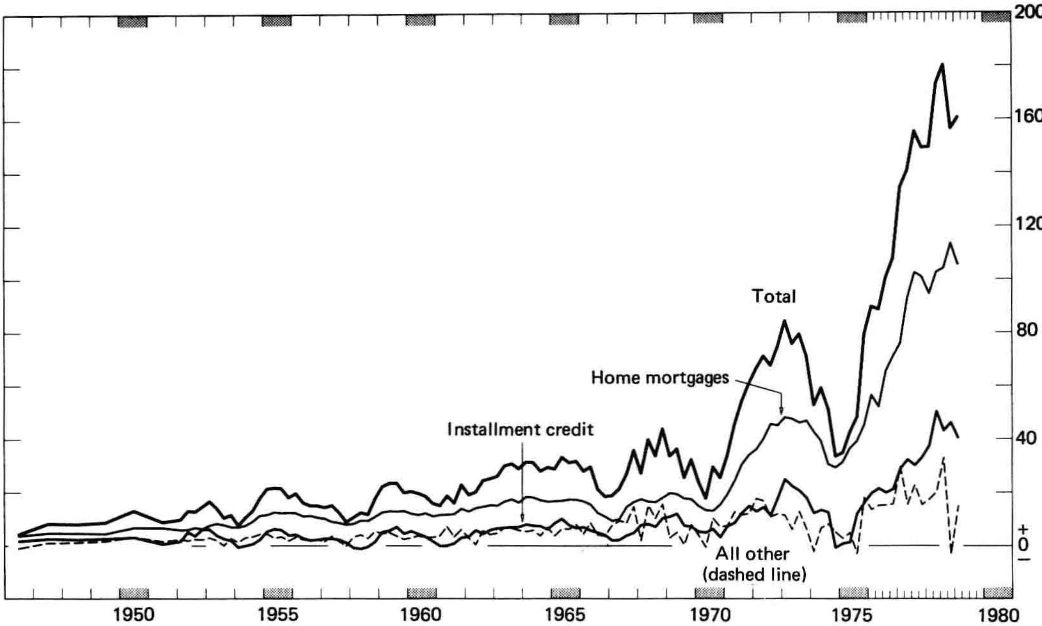

Figure 1.1 Household borrowing, 1946–1951, seasonally adjusted annual rates, quarterly 1952–1980. Source: Board of Governors of the Federal Reserve System, *1979 Historical Chart Book.*

taking a second job to help make ends meet. They also include the benefits of your insurance program when an insured event occurs.

Factors Affecting Uses of Funds

The cash **uses of funds** you might experience in a given year include the following:

- ☐ Consumption:
  - Food
  - Clothing
  - Personal care
  - Appliances
  - Household appliances
- ☐ Housing costs
- ☐ Transportation
- ☐ Medical costs
- ☐ Insurance premiums
- ☐ Loan payments
- ☐ Contributions
- ☐ Tax payments
- ☐ Investments
- ☐ Other cash purchases and payments