Lesson 1

OVERVIEW OF A FINANCIAL PLAN

Chapter 1 slides modified by Nadine Parla and Penny Ellison

You can have everything you want. All you need is a plan. And how do we spell plan? B-U-D-G-E-T!”

- Gail Vaz-Oxlade, TV host and author Debt-Free Forever: Take Control of Your Money and Your Life

CHAPTER OBJECTIVES

- Explain how you could benefit from personal financial planning
- Identify the key components of a financial plan
- Outline the steps involved in developing a financial plan

DEFINITIONS

Personal Finance

The process of planning your spending, financing, and investing activities, while taking into account uncontrollable events such as death or disability, in order to optimize your financial situation over time.

DEFINITIONS

Personal Financial Plan

A plan that specifies your financial goals, describes the spending, financing, and investing activities that are intended to achieve those goals over time, and uses the risk management strategies that are required to protect against uncontrollable events such as death or disability.

BENEFITS OF UNDERSTANDING PERSONAL FINANCE

- Make Your Own Financial Decisions
  - Know there is an opportunity cost to your decisions
  - Opportunity cost is what you give up as a result of a decision

- Judge the Advice of Financial Advisers
  - Be informed
  - Evaluate potential financial advisers using questions created by the Financial Planning Standards Council (FPSC)

COMPONENTS OF

A FINANCIAL PLAN (5)

1. Budgeting and tax planning
2. Financing your purchases
3. Protecting your assets and income (insurance)
4. Investing your money
5. Planning your retirement and estate

COMPONENTS OF A FINANCIAL PLAN (5)

TEXTBOOK CORRECTIONS

Page	Page 4*	Page 9	Page 9	Page 10
		Exhibit 1.5	Exhibit 1.6	Exhibit 1.7
Component 1	Budgeting and tax planning	Tools for Financial Planning	Managing your income	Financial Planning Tools
Component 2	Financing your purchases	Managing Your Financial Resources	Managing your financial resources	Financial Management
Component 3	Protecting your assets and income (insurance)	Protecting Your Wealth	Protecting your assets and income	Protecting Your Assets and Income (insurance)
Component 4	Investing your money	Personal Investing	Investing	Investing
Component 5	Planning your retirement and estate	Retirement and Estate Planning	Your retirement and estate	Retirement and Estate Planning

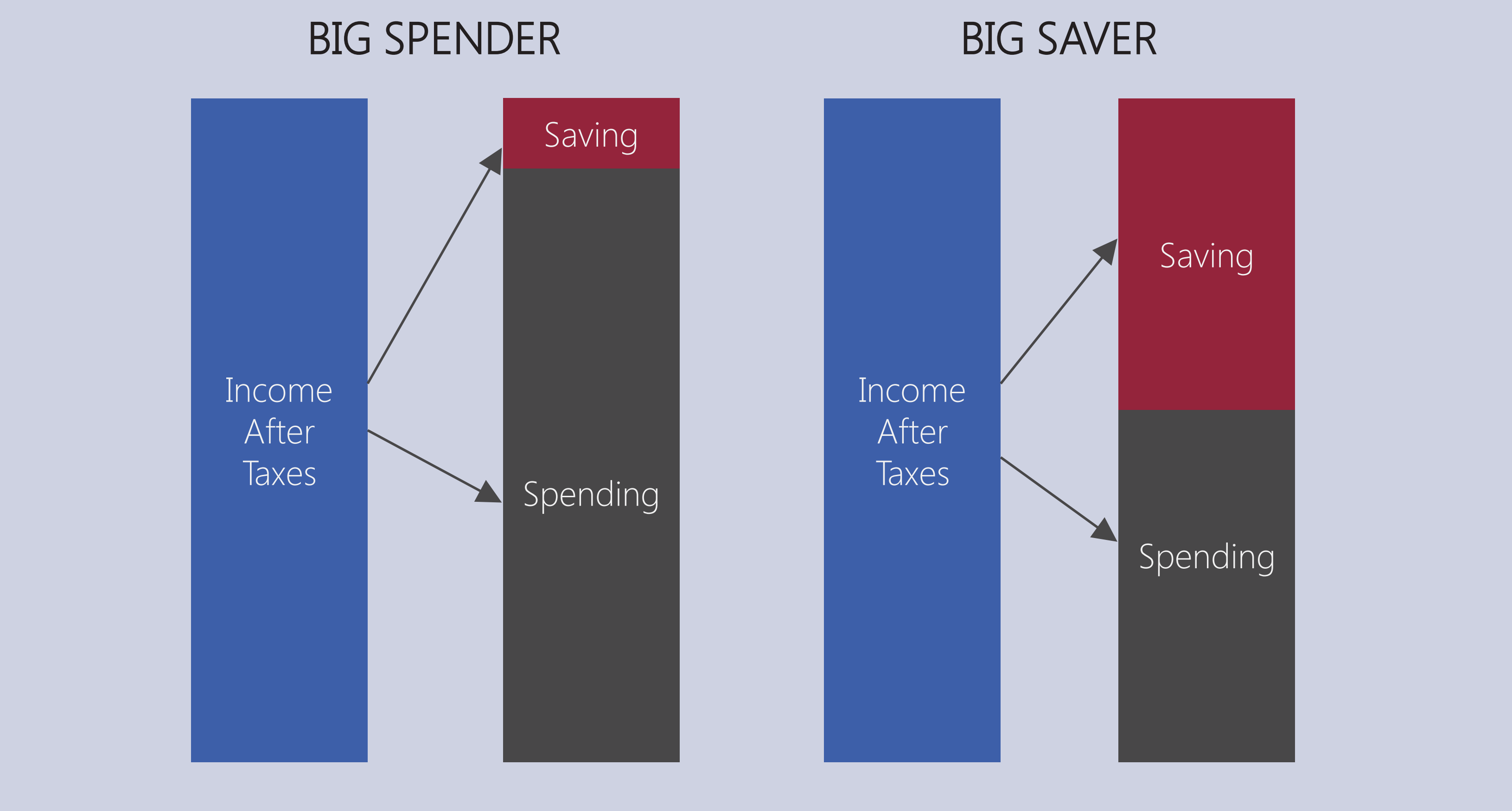
*Textbook uses several names to identify the 5 key components – for consistency, refer to the first column for this course

BUDGETING AND TAX PLANNING

- **Budgeting:** the process of forecasting future income, expenses and savings goals
- Requires you to decide whether to spend or save
- Helps you estimate how much of your income will be required to cover monthly expenses so that you can set a reasonable and practical goal
  - **Big spenders:** focus on spending (with little or no money for savings)
  - **Big savers:** save and consider spending only after allocating a portion toward saving

BUDGETING AND TAX PLANNING

EXHIBIT 1.1 HOW A BUDGET PLAN AFFECTS SAVINGS



BUDGETING AND TAX PLANNING

Budgeting:

- Evaluate your current financial position
  - **Assets**: what you own
  - **Liabilities**: what you owe (your debt)
  - **Net worth**: the value of what you own minus the value of what you owe
- Budget is influenced by your income and your life stage

BUDGETING AND TAX PLANNING: LIFE STAGES

Exhibit 1.2 Typical Planning Life Stages						
	Pre-Career	Early Earning	Mid Earning	Prime Earning	Retirement	Post-Retirment
Age Group	0 to 22	23 to 30	31 to 44	45 to 59	60 to 74	75+
Consider Your current Financial Position	Establish good money management habits Establish a credit rating	Follow the pay yourself-first principle Manage your debt, don't let your debt manage you Balance your savings goals Have an adequate amount of property, health, and life insurance Consider a mutual fund, inside or outside an RRSP	Consider RESPs Have an adequate amount of property, health, and life insurance Continue with your RRSPs Have a will and power of attorney Investigate and understand your pension plan at work	How much do you need to save? Are all debts paid? Children's education fund? Marriage? Job security? Elder care?	What can you expect from government programs? RRSP/Lira maturity options? Review workplace pension benefits Account for all of your assets Retirement income distribution patters What happens if a spouse dies?	RRSP/LIRA maturity options? Wealth management: how, who, where? Estate planning
Milestones	Graduation	First job new job/raise	Marriage First house First baby	Empty nest Parental care Ten years to retirement	Retirement Empty nest Travel Parental care	

Source: Adapted from http://www.bmonesbittburns.com/personalinvest/InvestorLearning/FinancialPlanning/Lifestages/default.asp (accessed June 27, 2007). Reprinted with permission of BMO Nesbitt Burns

BUDGETING AND TAX PLANNING

- Tax Planning: many financial decisions are affected by tax laws and by understanding how your alternative financial choices affect taxes, you can make financial decisions that have the most favourable effect on your after-tax cash flows.
  - Entertainment/purchases etc.: Most do not realize how taxes permeate our daily lives as we pay taxes on almost anything and everything we do.
  - Income: Canadians pay a lot of income tax and our tax system is complex, but given that personal income taxes are probably the biggest single expense you will incur over your lifetime, it is a good idea to understand how the system works and how to legally control the level of your tax bill.

FINANCING YOUR PURCHASES

(Plan to Manage Your Financial Resources)

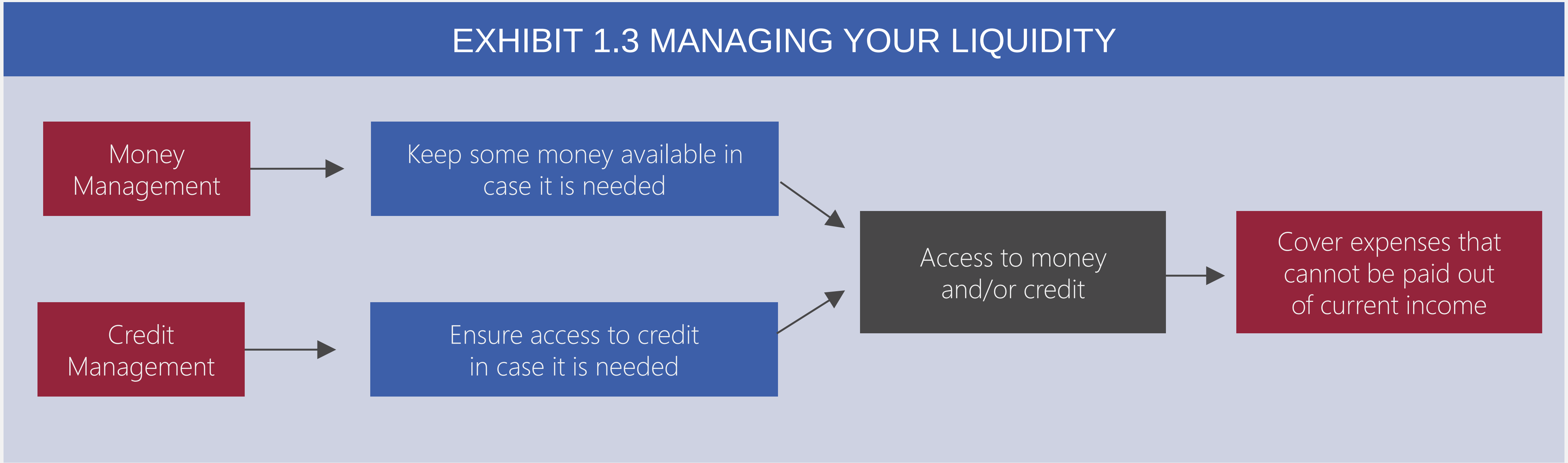
- Liquidity: access to ready cash, including savings and credit, to cover short-term cash needs or unexpected expenses (i.e. emergencies)
- Money management: decisions regarding how much money to retain in liquid form and how to allocate the funds among short-term investment instruments

FINANCING YOUR PURCHASES

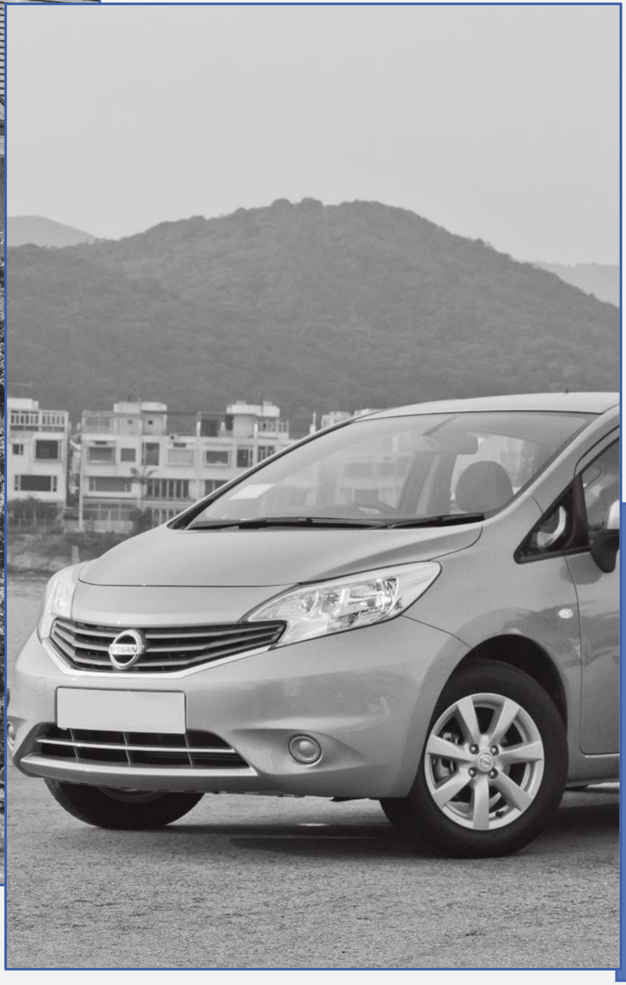
(Plan to Manage Your Financial Resources)

- **Emergency fund**: a portion of savings that you have allocated to short-term needs such as unexpected expenses in order to maintain adequate liquidity
- **Credit management**: decisions regarding how much credit to obtain to support your spending and which sources of credit to use

BUDGETING AND TAX PLANNING



FINANCING YOUR PURCHASES (PLAN TO MANAGE YOUR FINANCIAL RESOURCES)



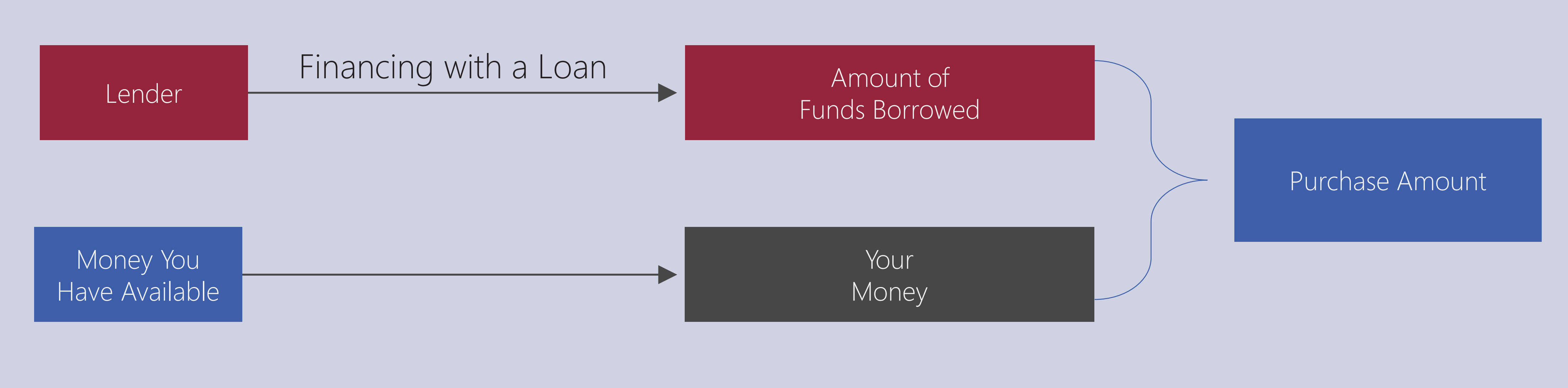
Loans often needed for large expenditures

- Tuition, car, house
- Managing loans

- How much can you afford to borrow?
- Determining maturity of the loan
- Selecting a loan with a competitive interest rate

FINANCING YOUR PURCHASES
(PLAN TO MANAGE YOUR FINANCIAL RESOURCES)

EXHIBIT 1.4 FINANCING PROCESS



PROTECTING YOUR ASSETS AND INCOME

Risk: Exposure to events (or perils) that can cause a financial loss

Risk management: decision about whether and how to protect against risk

Insurance planning: determining the types and amount of insurance needed to protect your assets

- Insure risks that would result in either a significant loss of income for a long period of time or an unplanned use of your financial resources

INVESTING YOUR MONEY

- Any funds you have beyond what you need to maintain liquidity should be invested with the primary objective of earning a return
  - Stocks, bonds, mutual funds, real estate
- All investments have some level of risk
  - **Investment risk**: uncertainty surrounding the potential return on an investment and its future potential value
  - **Risk tolerance**: your ability to accept a potential loss

PLANNING YOUR…

RETIREMENT

Retirement planning: determining how much money should be set aside each year for retirement and how those funds should be invested

ESTATE

Estate planning: determining how your wealth will be distributed before and/or after your death (effective estate planning protects your wealth against unnecessary taxes, and ensures that your wealth is distributed in a timely and orderly manner)

EXAMPLES OF DECISIONS MADE IN EACH COMPONENT OF A FINANCIAL PLAN

EXHIBIT 1.6 Examples of Decisions Made in Each Component of a Financial Plan

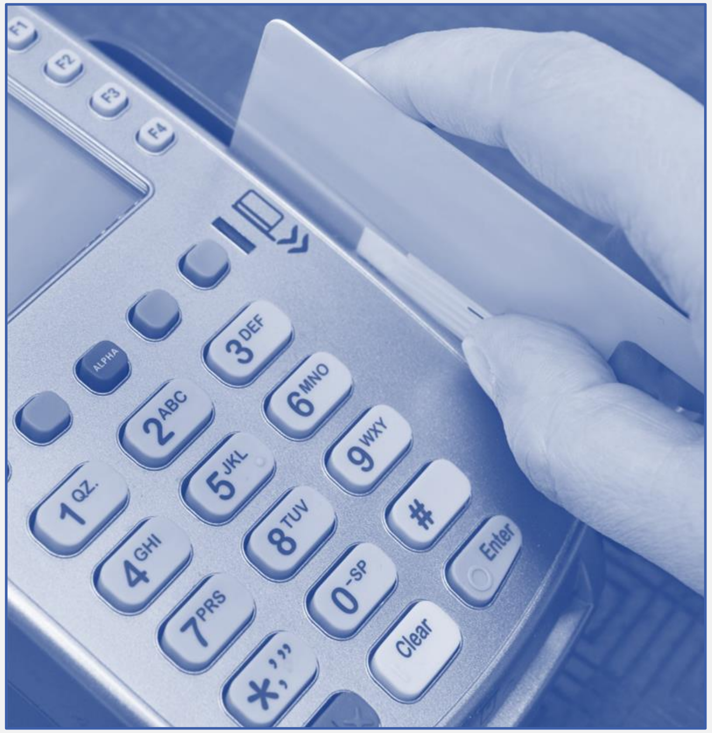
A Plan for:	Types of Decisions
1. Budgeting and tax planning	What expenses should you anticipate?
	How much money should you attempt to save each month?
	How much money must you save each month towards a specific purchase?
	What debt payments must you make each month?
2. Financing your purchases	How much money should you maintain in your bank account?
	Should you use credit cards as a means of borrowing money?
	How much money can you borrow to purchase a car?
	Should you borrow money to purchase a car or should you lease a car?
	How much money can you borrow to purchase a home?
	What type of mortgage loan should you obtain to finance the purchase of a house?

A Plan for:	Types of Decisions
3. Protecting your assets and income (insurance)	What type of insurance do you need?
	How much insurance do you need?
4. Investing your money	How much money should you allocate toward investments?
	What types of investments should you consider?
	How much risk can you tolerate when investing your money?
5. Planning your retirement and estate	How much money will you need for retirement?
	How much money must you save each year so that you can retire in a specific year?
	How will you allocate your estate among your heirs?

How the 5 Component's

RELATE TO YOUR CASH FLOWS

- Income is cash that you receive
- Expenses are cash that you spend



- Budgeting balances income and spending
- Financial management focuses on depositing funds to establish an emergency fund or obtaining credit for large purchases

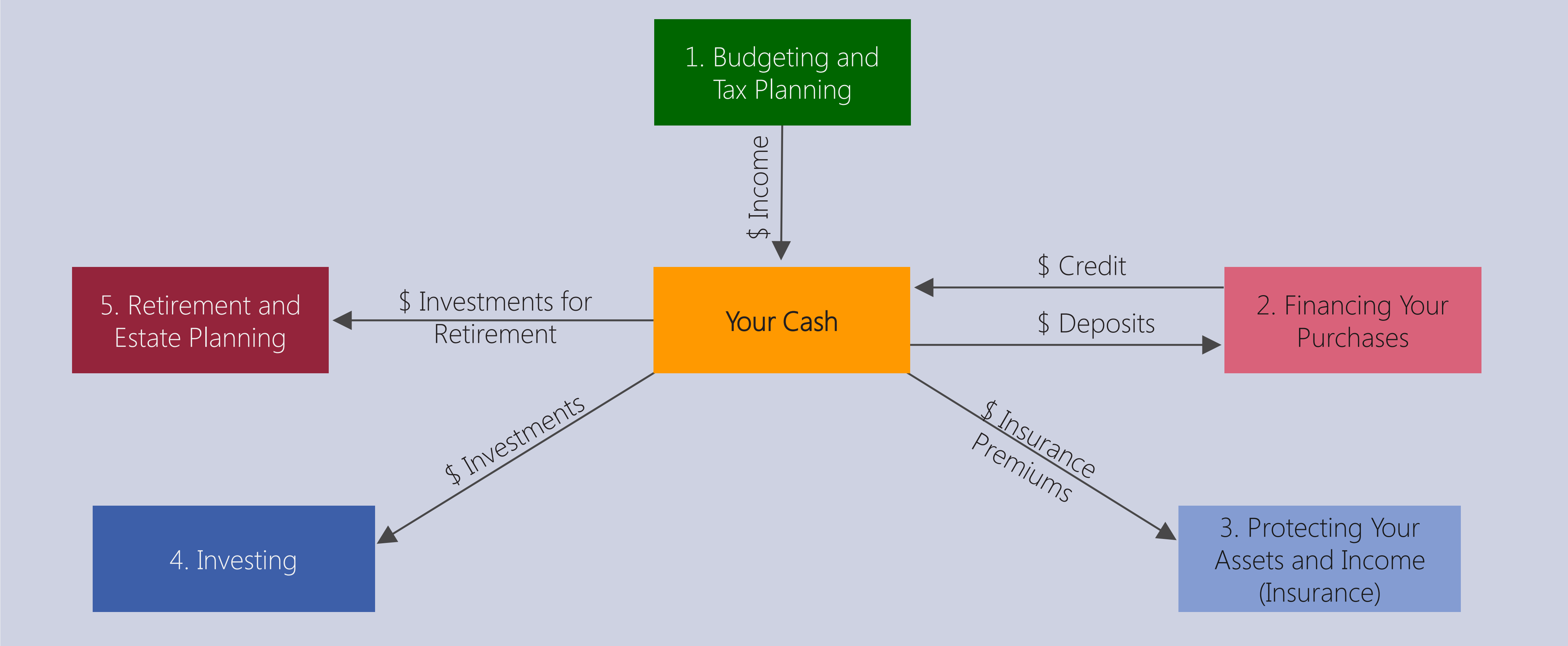
- Protecting your assets and income focuses on determining your insurance needs and costs
- Investing uses cash to build wealth
- Retirement planning focuses on building wealth in your retirement account
- Estate planning is used to determine how you will distribute your assets before and/or after your death

How the 5 Component’s

RELATE TO YOUR CASH FLOWS

HOW COMPONENTS RELATE TO CASH

EXHIBIT 1.7 HOW FINANCIAL PLANNING AFFECTS YOUR CASH FLOWS



How Psychology

AFFECTS YOUR FINANCIAL PLAN

- What motivates your spending behaviour?
  - Achieving immediate satisfaction?
  - Peer pressure?
  - A strong desire to avoid debt?

- Focus on the Future
- Assess Your Own Spending Behaviour

DEVELOPING THE FINANCIAL PLAN

1. Establish your financial goals
   - Ensure they are SMART (i.e. specific, measurable, actionable, realistic, and timely)
2. Consider your current financial position
3. Identify and evaluate alternative plans that could help you achieve your goals
4. Select and implement the best plan to achieve your goals
5. Evaluate your financial plan
6. Revise your financial plan

DEVELOPING THE FINANCIAL PLAN

- Step 1. Establish your financial goals (SMART goals)
  - Specify your goals (i.e. down payment on a house, pay down your debt)
  - Measure your goals
  - Act on your goals (include specific action steps)
  - Realistic goals (stronger likelihood of reaching goals)
  - Timing of goals
    - **Short term** (within one year) – i.e. purchase a car in 6 months
    - **Medium term** (between 1–5 years) – i.e. pay off a school loan in the next three years
    - **Long term** (five years+) – i.e. save enough money for retirement

DEVELOPING THE FINANCIAL PLAN

- Step 2. Consider your current financial position
  - How your future financial position is tied to your current level of debt
    - Individuals with lower levels of debt will make different decisions than someone who has mounting debt
  - How your future financial position is tied to your age and wealth
    - A 20 year-old with less assets will have a different financial plan than a 65 year-old with many assets

DEVELOPING THE FINANCIAL PLAN

- Step 3. Identify and evaluate alternative plans that could help you achieve your goals
  - Plans could be conservative or aggressive

DEVELOPING THE FINANCIAL PLAN

- Step 4. Select and implement the best plan for achieving your goals
  - Individuals in the same financial position with the same goals may select different plans
    - Saving a specific amount every month vs. making some risky investments
  - The Internet* has valuable financial planning information

*Focus on ethics regarding personal financial advice (get best advice appropriate to your needs but be wary of unethical behavior or of incompetent advice). Always be alert, ask questions, carefully consider advice.

DEVELOPING THE FINANCIAL PLAN

- Step 5. Evaluate your financial plan
  - Keep plan in an accessible place and monitor your progress
  - Review your plan annually (update based on life stages, milestones, etc.)
- Step 6. Revise your financial plan
  - Change plan as financial condition and financial goals change
  - Revise based on specific events or changes in your means and priorities

SUMMARY OF STEPS USED TO DEVELOP A FINANCIAL PLAN

EXHIBIT 1.8 Summary of Steps Used to Develop a Financial Plan
1. Establish your financial goals.
▪ What are your short-term financial goals? ▪ What are your medium-term financial goals? ▪ What are your long-term financial goals?
2. Consider your current financial position.
▪ How much money do you have in savings? ▪ What is the value of your investments? ▪ What is your net worth?
3. Identify and evaluate alternative plans that could achieve your goals.
▪ Given your goals and existing financial position described in the previous steps, how can you obtain the necessary funds to achieve your financial goals? ▪ Will you need to reduce your spending to save more money each month? ▪ Will you need to make investments that generate a higher rate of return?
4. Select and implement the best plan for achieving your goals.
▪ What are the advantages and disadvantages of each alternative plan that could be used to achieve your goals?
5. Evaluate your financial plan.
▪ Is your financial plan working properly? That is, will it enable you to achieve your financial goals?
6. Revise your financial plan.
▪ Have your financial goals changed? ▪ Should parts of the financial plan be revised in order to increase the chance of achieving your financial goals? (If so, identify the parts that should be changed, and determine how they should be revised.)

YOU HAVE REACHED THE END OF THIS SECTION