# Introduction to Personal Financial Planning

# 1

## OVERVIEW OF PERSONAL FINANCIAL PLANNING

Imagine yourself trapped in a maze filled with twists and turns, blind alleys, and dead ends. Wouldn't exiting it be simpler if you had a map and compass to guide you? Your financial life can be a maze, and a personal financial plan is the map and compass that can help guide you through that maze.

Individuals use a variety of investment, risk management, and tax planning strategies to meet their financial goals. Those goals change over a person's lifetime, and a flexible financial plan can be modified as circumstances change.

### The Nature of Personal Financial Planning

**Personal financial planning** helps individuals and families reach goals that require money to achieve, such as having adequate retirement income or resources to cover college expenses. With good planning, most people find they can achieve their desired standard of living and meet their financial goals in a timely and orderly fashion.

**Personal financial planning**
The process by which individuals and families develop and implement a comprehensive plan for achieving their financial goals.

Many people conduct financial planning on an ad hoc basis. For example, parents may fail to put aside money for a child's college education until the child's final year in high school. A family may begin saving for the purchase of a home but then have to divert the savings to the expenses of daily living following a job loss. A father with young children could fail to plan adequately for the death of his spouse and have to suddenly adjust to unforeseen child care expenses. A sound financial plan can reduce or eliminate the financial stress of these situations.

Comprehensive personal financial planning focuses on allocating resources toward the achievement of financial goals in a systematic manner. Goals are first established and then prioritized. Once the set of priorities is determined, individuals can develop plans to meet those financial goals in the desired order.

Financial goals often create conflicts because individuals have limited resources to achieve their goals. Resources devoted to current consumption are resources that will not be available to fund future consumption. This year's dream vacation takes away funds that could be used to provide for retirement. However, some financial goals can be complementary to one another. Under current tax laws, certain forms of retirement savings can also be used for the purchase of a first home or for college expenses. That means that savings put aside in a retirement savings account may be available to meet other goals.

Financial planning is a continuous process, because goals and priorities change over time. An individual or family may meet one financial goal sooner than expected and then be able to divert resources toward other goals, or an individual or family may be unable to meet a goal and have to adjust priorities. For example, a family setting aside 20 percent of every paycheck in a retirement account may suddenly need to provide in-home care for elderly parents. That change in priorities would require diverting funds from future consumption to current consumption.

Throughout the financial planning process, individuals and families must remain aware of the effect of current tax policies on the financial plan. Changes in tax policies may require that priorities be rearranged or that financial plans be altered. Risk management planning is also an important element of financial planning, and risk management planning and tax planning affect investment strategies.

Successful financial planning is a process that integrates all of these diverse elements into a coherent and dynamic road map for achieving financial goals over an entire lifetime. See the exhibit "Hierarchy of Financial Planning Goals."

## Personal Financial Planning Goals

Before developing financial action plans, an individual or a family should establish personal financial goals. After establishing these goals, priorities for the goals are determined to guide decisions regarding the timing for achieving those goals as part of the overall comprehensive financial plan.

For example, suppose a family has two goals. First, it wants to fund the college education of two children. Second, it wants to save money to purchase a retirement home after the children complete college. The family will not purchase the retirement home before the children graduate from college. Therefore, establishing and building the college fund takes priority over establishing and building the fund for a retirement home. If the family cannot begin to fund both concurrently because of budget constraints, the comprehensive financial plan will first focus on the college fund and, once that goal is achieved, will shift focus to the retirement-home fund.

Financial goals and the priorities attached to those goals differ by person and by family and also change over time. For some people, improving their current standard of living is the most important financial goal. For others, saving for retirement is the primary financial goal. Improving their current standard of

## Hierarchy of Financial Planning Goals

Individuals use a variety of investment, tax planning, and risk management techniques to achieve a hierarchy of financial goals over the course of a lifetime.


[DA08104]

living might be an additional, but secondary, financial goal. However, most people have these basic financial goals throughout their lives:

- Provide for the basic essentials of living (food, clothing, and shelter). Basic living expenses must be met before other non-essential goals are addressed.
- Protect against loss of income or wealth caused by injury, illness, or death. Risk management techniques are essential to protect the individual or family from losing the gains they have already achieved.

After providing for these basic financial goals, other financial goals may include these:

- Paying off student loans or credit card debt
- Purchasing a home or making other major asset purchases
- Funding college expenses
- Building wealth
- Saving for retirement

Finally, individuals may establish goals related to the distribution of their assets after death. Estate planning goals may include providing for the future care of disabled dependents, passing wealth on to future generations, or providing funds to favored charities.

## Personal Financial Planning Life Cycle

**Personal financial planning life cycle**

The pattern of changing financial goals people set as they face new life circumstances.

Financial goals change over time following changes in earnings, marital status, economic conditions, and so on. The **personal financial planning life cycle** reflects the changes that occur over a person's lifetime. Throughout this life cycle, individuals have to continually refine their personal financial plan to meet these ever-changing financial goals. See the exhibit "Personal Financial Planning Life Cycle."

In childhood and adolescence, individuals are dependent on their parents or guardians for support. They typically have little or no income, and their expenses are subsumed within the overall household expenses. They have no need for tax planning, retirement planning, or risk management planning. Even after they go off to college, most adolescents' personal financial planning issues are taken care of by parents.

Planning becomes more complicated in the early twenties. Some individuals move directly from high school into careers and begin to accumulate savings to buy cars and houses. Others go to college before starting a full-time job. These individuals may have college loans to pay off in addition to saving for cars and houses. They are now typically responsible for their own auto insurance. They may have limited retirement savings through an employer sponsored plan. Recent law changes allow children up to age twenty-six to remain on their parents' health plan, but they may obtain their own health insurance either through their employer or an individual, private plan.

In their late twenties and thirties, many individuals marry and enjoy the benefits of two incomes with no children. As these couples begin to start families, their financial goals shift toward protecting themselves and their dependents from loss, while at the same time increasing their standard of living. They begin accumulating funds for their children's college education or other future needs such as buying a first home or moving up to a larger home. Risk management planning becomes more important at this stage of the life cycle when individuals or families have dependent children. Educational needs, life