Financial Planning Fundamentals
An Overview of the Financial Planning Process
The Ground to Cover

- Setting goals
- Budgeting
- Emergency fund
- Insurance
- Using credit
- Investing
- Tax planning
- Saving for college
- Retirement planning
- Estate planning
Setting Your Goals
How SMART Are Your Goals?

• **Specific**
• **Measurable**
• **Attainable**
• **Relevant**
• **Timely**

Write down and prioritize your goals.
Budgeting

Income
1. Paycheck
2. Rental income
3. Government benefits
4. Interest
5. Investment income

- Expenses
  1. Fixed expenses
  2. Discretionary expenses

= Deficit
An Emergency Fund

An emergency fund is the foundation for any successful financial plan. Where you keep your emergency fund is important.
Risk Management with Insurance

Common types of insurance that help protect you and your assets from different risks:

- Health insurance
- Auto insurance
- Life insurance
- Property insurance
- Liability insurance
- Disability insurance
- Long-term care insurance
Using Credit

“Remember that credit is money”

Benjamin Franklin

- The three Cs of credit
  - Capacity
  - Character
  - Collateral

- How creditors determine your creditworthiness
  - Credit application
  - Credit report
  - Credit score
Debt

- Using credit creates debt
- Types of debt
  - Secured
  - Unsecured
- Important considerations
  - Amount
  - Term
  - Rate
Investment Fundamentals

What Is Investing?

Speculating?

Saving?

Investing--A carefully planned and prepared approach to managing and accumulating money.
Investment Fundamentals--

The Effect of Inflation

Purchasing Power of $200,000 at 3% Annual Inflation
Investment Fundamentals--

The Effect of Compounding

Growth of Annual $5,000 Investments

$5,000 invested annually at the end of each year
• 6% annual growth rate
• All earnings reinvested

This is a hypothetical example and is not intended to reflect the actual performance of any specific investment.

Investment fees and expenses, and taxes are not reflected. If they were, the results would have been lower.

“Rule of 72”

72 ÷ Rate of Return = Years Needed to Double in Value
Investment Fundamentals--

Sooner Is Better

- Don’t put off investing
- The sooner you start, the longer your investments have to grow
- Playing “catch-up” later can be difficult and expensive

$3,000 annual investment at 6% annual growth, assuming reinvestment of all earnings and no tax

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Investment Fundamentals--
Identifying Goals and Time Horizons

- Investment goals
  - Retirement
  - Education
  - Special purchase
  - Financial security

- Short-term goals vs. long-term goals

- In general, the longer your investment horizon, the more risks you can afford to take
Investment Fundamentals -- Risk Tolerance

- Ability of investment plan to absorb loss
- Personal tolerance for risk
  - Aggressive
  - Moderate
  - Conservative
Investment Fundamentals --

Relationship Between Risk & Return

Risk - Return Tradeoff

- Stability
- Growth
- Income

Potential Return

Risk

Options & futures
Common stock
Preferred stock
Corporate bonds
Government bonds
CDs
Treasury bills
Common stock
Preferred stock
Corporate bonds
Government bonds
CDs
Treasury bills
Investment Options--

Types of Investments

- Cash alternatives
- Bonds
- Stocks
- Other investments
- Funds

401(k) plans and IRAs are not investments--they are tax-advantaged vehicles that hold individual investments.
Investment Options--*Cash Alternatives*

- Low risk, short-term, relatively liquid
- Examples of cash alternatives include:
  - Certificates of deposit (CDs)
  - Money market deposit accounts
  - Money market mutual funds
  - U.S. Treasury bills (T-bills)
Investment Options--Cash Alternatives

**Advantages**
- Predictable earnings
- Highly liquid
- Little risk to principal

**Disadvantages**
- Relatively low returns
- May not keep up with inflation
Investment Options--*Bonds*

- Loans to a government or corporation
- Interest typically paid at regular intervals
- Can be traded like other securities
- Value fluctuates

Diagram:
- **Potential Return**
- **Risk**

- Bonds
- Cash alternatives
Investment Options--*Bonds*

Types of bonds include:

- U.S. government securities
- Agency/GSE bonds
- Municipal bonds
- Corporate bonds
Investment Options--*Bonds*

**Advantages**
- Steady and predictable stream of income
- Income typically higher than cash alternatives
- Relatively lower-risk (compared to options such as stock)
- Low correlation to stock market

**Disadvantages**
- Risk of default
- Value of bond will fluctuate with interest rates
- Lower risk means lower potential returns (than stock, for example)
Investment Options--*Stocks*

- Shares of stock represent an ownership position in a business
- Percentage of ownership determines your share of profit / loss
- Earnings may be distributed as dividends
- Shares of stock can be sold for gain or loss
Investment Options--*Stocks*

- Common vs. preferred
- Categories:
  - Small cap
  - Midcap
  - Large cap
- Stock terminology:
  - Growth stock
  - Value stock
  - Income stock
  - Blue chip stock
  - American Depositary Receipts (ADRs)
Investment Options---*Stocks*

**Advantages**
- Historically, have provided highest long-term total returns
- Ownership rights
- Can provide income through dividends as well as capital appreciation
- Easy to buy and sell

**Disadvantages**
- Poor company performance affects dividends / value of shares
- Subject to market volatility
- Greater risk to principal
- May not be appropriate for short term
Investment Options--*Other Investments*

- Real estate
- Stock options
- Futures and commodities
- Collectibles
Investment Options---Mutual Funds

- Your money is pooled with that of other investors
- Fund invests dollars according to stated investment strategy
- You own a portion of the securities held by the fund (instant diversification)
Investment Options--Mutual Funds

Before investing, investors should carefully consider a fund’s investment objectives, risks, and charges and expenses. These can be found in the prospectus available from the fund, which should be read carefully before investing.
Investment Options - *Mutual Funds*

- Three major investment categories:
  - Money market funds
  - Bond funds
  - Stock funds
- Mutual funds fall all along the risk-return spectrum (e.g., balanced funds, international funds)
- Active vs. passive management
## Investment Options--*Mutual Funds*

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diversification</td>
<td>Value of shares can fluctuate daily</td>
</tr>
<tr>
<td>Professional management</td>
<td>Portion of fund dollars may be tied up in cash for liquidity needs</td>
</tr>
<tr>
<td>Small investment amounts</td>
<td>Potential tax inefficiency</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Mutual fund fees and expenses</td>
</tr>
</tbody>
</table>
Investment Options -- Exchange-Traded Funds (ETFs)

- Most ETFs are based on an index
- Passive management may lower fund costs
- Can be traded throughout the day, bought on margin, and shorted, like stocks
- May provide tax efficiencies
Investment Options --
Exchange-Traded Funds (ETFs)

Before investing, investors should carefully consider a fund’s investment objectives, risks, and charges and expenses. These can be found in the prospectus available from the fund, which should be read carefully before investing.
Investment Methods--Dollar Cost Averaging

- Invest same dollar amount at regular intervals over time
- You buy more shares when price is low, fewer shares when price is high
- Average cost of shares will be lower than average market price per share during your investment time period

Five Hypothetical Investments

<table>
<thead>
<tr>
<th>Month</th>
<th>Shares</th>
<th>Market Price</th>
<th>Cost per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan</td>
<td>10</td>
<td>$30</td>
<td>$3.00</td>
</tr>
<tr>
<td>Feb</td>
<td>15</td>
<td>$10</td>
<td>$0.67</td>
</tr>
<tr>
<td>Mar</td>
<td>20</td>
<td>$20</td>
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<tr>
<td>Apr</td>
<td>12</td>
<td>$15</td>
<td>$1.25</td>
</tr>
<tr>
<td>May</td>
<td>30</td>
<td>$25</td>
<td>$0.83</td>
</tr>
</tbody>
</table>

Average market price per share

\[
\frac{30 + 10 + 20 + 15 + 25}{5} = \$20
\]

Investor’s average cost per share

\[
\frac{1,500}{87} = \$17.24
\]

This is a hypothetical example and does not reflect the performance of any specific investment. Dollar cost averaging can’t guarantee you a profit or protect you against a loss if the market is declining.
Asset Allocation -- *Considerations*

**Factors:**
- Diversification
- Risk tolerance
- Time frames
- Personal financial situation
- Liquidity needs
Asset Allocation -- Sample Allocation Model

A conservative asset allocation model will tend to focus on preserving principal.

Conservative

- Bonds 50%
- Stocks 25%
- Cash Alternatives 25%

These asset allocation suggestions should be used as a guide only and are not intended as financial advice. They should not be relied upon. Past performance is not a guarantee of future results.
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A moderate asset allocation model will tend to balance predictable income with potential growth.
Asset Allocation --
Sample Allocation Model

An aggressive asset allocation model will tend to focus primarily on potential growth.

These asset allocation suggestions should be used as a guide only and are not intended as financial advice. They should not be relied upon. Past performance is not a guarantee of future results.
Income Tax Considerations

Pretax Dollars

- Deductions are made from your paycheck before taxes are calculated
- The result can be lower out-of-pocket costs
- Some examples:
  - Health or dependent care
  - Transportation costs
  - Retirement plan contributions (e.g., 401(k))

Tax-Deferred Growth

- No taxes are due until funds are withdrawn from the account
- In certain cases, qualified distributions are tax free
- Some examples:
  - 529 college savings and prepaid tuition plans
  - Retirement plans--traditional and Roth IRAs
  - Penalty tax applies in some situations (early withdrawals, nonqualified distributions)
The Value of Tax Deferral

- $20,000 invested in Year 1
- 6% annual growth rate
- 28% tax rate
- Taxes paid with account assets

This hypothetical example is for illustrative purposes only, and its results are not representative of any specific investment or mix of investments. Actual results will vary. The taxable account balance assumes that earnings are taxed as ordinary income and does not reflect possible lower maximum tax rates on capital gains and dividends which would make the taxable investment return more favorable thereby reducing the difference in performance between the accounts shown. Investment fees and expenses have not been deducted. If they had been, the results would have been lower. You should consider your personal investment horizon and income tax brackets, both current and anticipated, when making an investment decision as these may further impact the results of the comparison. This illustration assumes a fixed annual rate of return; the rate of return on your actual investment portfolio will be different and will vary over time, according to actual market performance. This is particularly true for long-term investments. It is important to note that investments offering the potential for higher rates of return also involve a higher degree of risk to principal.
Investors should consider the investment objectives, risks, charges and expenses associated with 529 plans carefully before investing. More information about 529 plans is available in the issuer’s official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits. The availability of the tax or other benefits mentioned may be conditioned on meeting certain requirements.

529 plans

- Individual account
- Pre-established portfolios
- Returns not guaranteed
- Can be used at any college
- Can join any state’s plan

Prepaid tuition plans

- Prepay tuition today
- Return guaranteed—in form of tuition coverage
- Limited to your state’s plan
- In-state public colleges
Retirement: Start Now

Don’t put off planning and investing for retirement.

The sooner you start, the longer your investments have a chance to grow.

Playing “catch-up” later can be difficult and expensive.

$3,000 annual investment at 6% annual growth, assuming reinvestment of all earnings and no tax.

$679,500

$254,400

$120,000

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Retirement: Basic Considerations

- What kind of retirement do you want?
  - Financial independence
  - Freedom to travel, pursue hobbies
  - Ability to live where you want (e.g., in current home, vacation home)
  - Opportunity to provide financially for children or grandchildren

- When do you want to retire?
  - The earlier you retire, the shorter the period of time you have to accumulate funds and the longer those dollars will need to last
  - Social Security isn’t available until age 62
  - Medicare eligibility begins at age 65

- How long will retirement last?
  - Average life expectancy is likely to continue to increase
  - Retirement may last 25 years or more
Retirement: Tax-Advantaged Savings Vehicles

- Tax deferral can help your money grow
- Take full advantage of 401(k)s and other employer-sponsored retirement plans
- Contribute to a traditional or Roth IRA if you qualify
- 10% additional penalty tax applies for early withdrawals
Estate Planning Fundamentals

- Intestacy
- Wills
- Trusts
- Planning for incapacity
Estate Planning: Intestacy

- Intestacy laws vary from state to state
- Typical pattern of distribution divides property between surviving spouse and children
- Your actual wishes are irrelevant
- Many potential problems
Estate Planning: Wills

- A will is the cornerstone of an estate plan
- Directs how your property will be distributed
- Names executor and guardian for minor children
- Can accomplish other estate planning goals (e.g., minimizing taxes)
- Must be written, signed by you, and witnessed
Estate Planning: Planning for Incapacity

- Incapacity can strike anyone at any time
- Failing to plan means a court would have to appoint a guardian
- Lack of planning increases the burden on your guardian
- Your guardian’s decisions might not be what you would want
There’s a Lot to Consider

Ask questions, and start planning now.
Financial Planning

Why Bowers?

CPA – Most Trusted Advisor
CPA approach to planning
Tax considerations in all planning
Clients best interest!!!!
All services but the legal documents
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