Foreword

The idea of creating a consumer awareness guide struck me when I realized just how widely our discussions with clients range over the entire spectrum of their financial lives. I came to realize that many people are simply unaware of all of the opportunities and possible pitfalls they may encounter throughout their lives when it comes to money. The process of financial planning is not simply, set up a 401(k) and start contributing 10% of your income. In fact, the breadth of financial planning should cover every aspect of a client’s financial wellbeing.

Beginning with the basics of BUDGETING and creating a foundation, to adequately protecting their current financial position with INSURANCE planning. Then addressing, INVESTMENT and ASSET ALLOCATION modeling to manage investment risk, TAX planning strategies with which to minimize, avoid or capitalize on opportunities, RETIREMENT INCOME planning to identify sources of income and expenses in retirement and securely providing for that retirement you’ve dreamed of and finally ESTATE planning to be sure our client’s wishes are fulfilled.

All of these concepts have inherent opportunities or strategies associated with them. I believe the first step to motivate someone, to want to begin the process of financial planning, is to get them to understand that there are many things that they may not be aware of and the key is to simply recognize and be open to the idea of exploring possibilities. I hope this guide will offer some insight into your own personal financial planning, possibly enlighten you or encourage you to address those issues and finally, motivate you to take action to be sure to capitalize on every opportunity you have available. Some of these concepts are subjective and many times there is no right or wrong answer. However, this should offer a clearer understanding of the scope of what financial planning really is. Thanks for reading and hope you enjoy!

The three “P’s” to build a strong financial pyramid.

Whether you find yourself starting from scratch, or maybe starting over, you have to start somewhere. There is a process to build a solid financial foundation from the ground up. If you think of a pyramid, the base of the pyramid is enormous, supporting the entire structure. That’s why creating a solid base is the key to building your own “financial” pyramid. If you break that pyramid into thirds (bottom, middle and top), the first and most significant part is the base. I call this portion of your plan the “PROTECT” what you have.

Clearly the idea of protecting what you have is related to insurance planning. If you think of the analogy, climbing the face of a rock wall is like amassing your own wealth over time. However, people find themselves one day, dangling from that ledge, 100 feet in the air, realizing that everything is at risk if they fall. For some they’ve made the climb using these little safety devices called “chocks” that get hammered into the wall as they make their ascent. Insurance is like these chocks. A well thought out insurance plan will not keep you from falling, however it will keep you alive and able to rebuild. So the first thing I like to recommend, is to identify what you have to lose. For some, their income is their largest asset and they don’t even know it. Life insurance and disability insurance are designed to replace that lost income in case of a tragic event. Other types of insurance such as homeowner’s, renters, auto and liability, protect, both your assets and also your liability risks. I learned a long time ago, the only time you ever want to insure something, is if the potential loss if devastating and it would happen very infrequently. In each of these cases, the potential loss could completely derail the best investment plan in world.

The second, or middle part of the pyramid, is what I refer to as “PREPARE”. Life can and will always throw curve balls regardless of how young or old you are. It just seems, the older you get, wisdom and experience seem to offer a friendly reminder that right around the corner will be a rainy day. And you know what they say about those rainy days. So the next step is to create an emergency fund and begin systematically saving for all of those unknowns that will (I assure you, they will) come.

And finally we come to the top of the pyramid. This is the part that everyone wants to think about when it comes to financial planning. I call this the “PLAN”. Now that you’ve protected what you have, prepared for your emergencies that will eventually come, it’s time to start thinking about the future and what you want to achieve financially. This is the part of the process that you should begin thinking about goals such as saving for retirement, buying a home or a second home, buying a boat, sending your children to college, traveling and whatever else you can dream of. Obviously you may not be able to accomplish everything on your list, but with a list, I can almost guarantee, you will be further ahead than most who don’t have a plan. So understanding that the idea of financial planning is not a result, but instead a process that changes over time, will hopefully get you to take the initiative to start your own plan and build your own financial pyramid!

How much should I keep in my emergency funds?

I’ve heard many financial planners say that you need to keep 3 months of your income in an emergency fund. I think, for some people that goal seems almost unattainable, especially if you’re just starting out. The biggest disadvantage of keeping too much in liquid, emergency funds is that your money just won’t grow. Especially in this interest rate environment we’ve been in for the past decade. The philosophy that I’ve adopted in my practice is to maintain a certain amount of your “non-discretionary” monthly expenses in an emergency fund. I believe this goal is more attainable and it also makes a lot of sense. Let’s take a look at an example.

Let’s say the Smith family has dual incomes. Both Mr. and Mrs. Smith are making a combined income of $100,000, both contributing equally to the household expenses. Under the traditional three months of income, they would want to accumulate $25,000 in liquid emergency funds. However, after carefully reviewing their budget, we determine they have basic monthly living expenses of $3,500 which includes the necessities such as the mortgage payment, a car lease, gasoline, their utility bills and groceries. All of the other things such as entertainment, dining out, etc. is left out of the calculation. Because in the event of a real emergency would you still expect to spend on those frivolous items? Probably not, so why plan to have that much set aside? So in this case, I would suggest we shoot for a goal of 3 times their monthly non discretionary expenses which would total $10,500. A more realistic number, I believe. This way in the event that both of their incomes ceased, they could continue to meet their basic living expenses for a minimum of 3 months. The likelihood of both losing their incomes at the same time is pretty rare, so the family, in all reality, could continue for some time past the 3 months on just one income along with the emergency funds to supplement their basic needs.

The challenge is when there is only one income. If, on the other hand, only one spouse is contributing 100% of the income and paying all of the bills, I believe it would be more prudent to shoot for an emergency funds goal of 6 months of those non-discretionary expenses. In other words, $21,000, which brings us much closer to the 3 months of income that many financial planners use. I think, when determining anything related to financial planning, such as how much do I need to save, how much life insurance do we need, how much in emergency funds should we keep, everything should have a measurable calculation of how you’ve determined the goal.

Pay yourself FIRST!

This whole concept of “pay yourself first” sounds great, but what if I’m living paycheck to paycheck and I don’t have the extra money to pay myself first, when all of those bills need to be paid? For many of us, this is a common thought. However, over the years, I have come to realize that there is NEVER money left over at the end of the month. The more money you make, the more money you spend. Period. That’s why they call cash, “liquid”. It’s like trying to hold onto a handful of water. Impossible. Or is it?

To be able to pay yourself first, you have to go through your personal spending habits and create a workable budget. Yes, a budget. A budget is no more than a roadmap to see where your cash is going which will help you make constructive decisions about how you’re spending your money. You can download a number of great budget sheets online to act as a guide to help you identify where the money goes.

The first step in creating a budget is to list your “fixed” expenses. This is pretty straightforward. Things like your mortgage payment, auto loan or any other recurring monthly expenses that are the same. The next step is to list your “variable” expenses and come up with a reasonable estimate of how much you think you will need to spend on these items. Variable expenses are things such as gas, food, electric, water, etc. Necessary and basic living expenses that may change somewhat from month to month. Don’t forget to consider expenses that only occur annually, or quarterly. Things such as property taxes and insurance. When creating the budget, you will want to include these annual expenses into the monthly breakdown. I highly recommend setting up a separate savings or checking account that you can sweep money into monthly to prepare for these annual expenses, so you’re not relying on credit cards or having to borrow from Peter to pay Paul when these expenses come up unexpectedly. I know in my own personal financial planning this simple trick has helped me tremendously but I will elaborate a little more in a future article.

Lastly, this is the exercise in budget planning that is the most difficult. A good plan will have things such as dining out, vacations, going to the movies, having a few drinks after work with friends, etc. included. Not surprisingly, this is why there is never any money left over at the end of the month. There tends to be a pattern of behavioral finance that I’ve seen over and over again. If there’s some money left in the checking account, your brain gives you permission to spend it. However, if you’re reading this, my guess is that you want to take control of your cash flow. So as difficult as it may seem, you need to plan for your “discretionary” expenses and prioritize what’s really important to you. Once you commit to spending a certain amount on those discretionary expenses, now we simply do the math. How much income do you have, subtract out the fixed, variable and discretionary expenses and there you go. Hopefully, there’s a bit of a “surplus”. If not then, you have no choice but to look for ways to cut spending. But if there is that surplus, this is what you commit to using to pay yourself first by having that amount automatically swept into an emergency fund, or retirement account, or combination of both.

Out of sight, out of mind.

One of the challenges that we as humans have, is the ability to refrain from spending every last penny left in our checking accounts. I’ve been there. Over the years I have learned some simple ways to trick myself into spending a little less money and believe me, those pennies do add up. When you go online and look at your balance and see there’s money in there, your brain gives you a permission slip to loosen up the purse strings and be a little freer with that cash. (This is the same mental pitfall that credit cards use to get you deeper into debt). Once you become so used to living on 100% of what you’re earning, it’s really difficult to change, because change means cutting back. But, what I’ve discovered is one simple technique to get on track with your savings which is keeping part of your paycheck, out of sight and out of mind.

By having funds come out of your check automatically, you seem to never really miss them. It’s funny. You just simply adjust your spending according to what you have coming in and for most, without even skipping a beat. One way to begin working towards a savings goal is to establish a separate account for each and every goal. I, personally, have one for our Christmas spending fund, one for emergencies, one for my projected business expenses, one for my health savings account and finally one for our annual vacation fund. Each of these accounts are meant to be spent at some point in the future. Most payroll companies will allow you to set up direct deposit into one or several credit unions or banks. I actually prefer using online savings accounts, because many of them don’t have any monthly fees and you can set up direct deposit or an automatic sweep right out of your checking account as frequently as weekly by simply linking them. They are a bit more difficult to get your hands on, since you have to move funds back into your checking account electronically and that could take a few days. But what an incredibly easy way to start saving for any financial goal you set. The key is to simply start. By fragmenting your accounts, you will only spend what’s in your checking, while beginning to accumulate money for your real future spending goals. The most rewarding result you will find, is that the money will always be there when you need it and you can spend it without any guilt because you’ve done an exceptional job at planning.

Roth IRA as an emergency fund, huh?

Many people generally understand that “retirement accounts” are just that, for retirement. In fact most retirement accounts have significant penalties and tax implications for withdrawing money before age 59 ½. However, what most people are unaware of, is that Roth IRA’s have some very unique characteristics, different from other retirement accounts. The first, most notable quality is the tax free treatment. Just like a traditional IRA, Roth IRA’s have a maximum contribution limit (also subject to income limitations).For 2016, it’s 100% of your earned income up to $5,500 (whichever is less).

For those age 50 and older, they can contribute an additional $1,000 known as a “catch up” contribution. When contributing to a Roth IRA, none of the money going in is tax deductible on your tax return, however, all of the future growth on the account is completely tax free, assuming strict guidelines are met. The initial Roth IRA has to be established, the longer of 5 years or held all the way to age 59 ½ for “qualified” distributions to be considered tax free.

You’ll notice, I said “qualified” distributions. They only take into account, the untaxed earnings or any Roth IRA conversions that had been done. But because all of the annual **contributions** to the account were made with after tax money, these are never considered “qualified” withdrawals. So what that means is, you can pull out your **contributions** that you’ve made over the years, at any time, at any age and for any reason without penalty or tax! Let’s look at an example. Say you’ve invested $5,500 per year over the last two years into a Roth IRA and it’s grown to $13,000. You have a total of $2,000 of untaxed gains on the account. This would be subject to the early withdrawal penalties and tax. However, the initial $11,000 you’ve contributed, would not be and would always be treated as coming out first!

This is a missed opportunity for many people, especially younger clients. I believe a good way to capitalize on this, is to begin funding an emergency fund, but set it up as a Roth IRA. Clearly, you would want to keep the investments inside the Roth IRA very safe, such as a savings account or money market. Then, as you continue to build up your emergency fund, let’s just say that emergency never happens. Let’s also assume that down the road, you sell your home or receive some cash in an inheritance, etc that you can treat as an emergency fund. You’ve now built up a sizable Roth IRA and can invest that for longer term growth, enjoying all of the tax free benefits throughout retirement! Worst case scenario is, the interest on the Roth would need to stay in the Roth to avoid penalty, but most savings accounts or money markets these days aren’t really paying much in the way of interest anyway. Obviously you would want to check with your tax advisor first to make sure you are eligible to contribute to a Roth IRA. And as the adage goes, it’s like killing two birds with one stone!

Just can’t remember to pay that bill on time?

Just as important as knowing where your money is going, it is knowing when your money needs to go there. For some, setting up an automatic monthly draft is an option. I personally don’t like anything being automatically drafted from my account, if at all possible. For whatever reason, if you change banks, it becomes daunting to have to switch all of your monthly debits as well. This is why the banks love you to set up bill pay. It makes your accounts with them much stickier so you just give up and never leave.

One thing that has helped me in my own personal planning is creating a monthly spreadsheet, so I know exactly when every bill will be due. I’ve used Microsoft Excel’s spreadsheet to manage all of my monthly timing of payments. It sounds more complicated than it really is. Basically, I’ve set up four columns across the top of the spreadsheet, one for each week of the month. Then, along the left hand side of the spreadsheet I listed my recurring expenses such as mortgage payment, life insurance, water bill, electric, etc. I’ve placed the total amount of the bill under the week that it’s due. In other words, my mortgage is $1400 per month, due on the second week of the month. Once you fill out the entire grid, you’ll see very clearly from week to week what you owe and how much you owe. You’ll be one step closer to taking absolute control of your spending.

Now that you’ve created the first month of bills, all you need to do is highlight, copy and paste for every month of the year. Also, don’t forget to include those other expenses that don’t occur every month, such as your property taxes or insurance, etc. By having your annual expense breakdown, you will be able to more easily track your monthly expenses, identify upcoming annual expenses and will never be late on a payment again!



Should I invest in a Traditional IRA or a Roth IRA?

I must first clarify the difference between a Traditional IRA and a Roth IRA. Many people assume an IRA is an investment. It is not. It’s simply a “type” of account with certain tax rules associated with it. Much like a 401(k) is not the investment, but the mutual funds within the 401(k) are the investments.

The most notable difference between a Traditional IRA and a Roth IRA is the tax treatment. That’s really all. You can own the same types of investments in either account. When you make a contribution to a Traditional IRA you will most likely get to deduct that amount from your taxable income and would not have to pay tax on that amount in the year you make the contribution. However, when you decide to begin withdrawing money from the IRA, it is treated as ordinary income and subject to your “marginal” tax rate.

The Roth IRA, on the other hand, is not deductible when you invest the money. So you’re essentially paying tax now and then with what’s left, you’re depositing into the Roth IRA. However, assuming you meet certain requirements, then all future withdrawals would be tax free. And there aren’t many tax free investments out there.

I’m a big believer in not only diversifying your investments, but also diversifying your tax treatment of your accounts. Remember, tax rates can and probably will change at some point in the future. So having different pots of money to pull from may allow you to take advantage of future tax law changes.

So again, getting back to the original question, “Should you invest into a Traditional IRA or a Roth IRA?” If you find yourself in the 25% tax bracket or greater, my belief is to first invest into a Traditional IRA or 401k or other qualified retirement plan and avoid paying that 25% tax rate now. For every dollar you invest, Uncle Sam gives you back 25 cents. Over time, that tax savings can make a big difference. Yes, you will have to pay tax when you withdraw, however you’ve essentially been able to earn compound interest on Uncle Sam’s money over all of those years. Plus what I’ve found, is most clients tend to fall into a lower margin tax bracket at retirement.

Now, on the other hand, assuming you’ve been able to reduce your taxable income down into the 15% bracket (which may or may not even be possible depending on your total income) then Roth IRA contributions become very compelling, in my mind. Paying tax now at 15% and investing with the expectation that those savings will grow completely tax free forever, makes a lot of sense. It wasn’t that long ago that the more favorable “capital gains” tax rate was 20%. So even though you would be paying some tax today, 15% may not be too bad, considering we really don’t know what taxes will be in the future. Ultimately, having a clear financial plan in place that looks at your personal future income needs, etc. should offer some clearer guidance on what would be the most appropriate retirement savings plan.

If you will have a PENSION, you don’t want to miss this.

The elusive Pension, otherwise known as a defined benefit plan has become less and less popular for employers to offer over the last 30 or so years. There are several reasons for this, such as the rise in popularity of the 401(k) plan, increasing life expectancies, costs associates with administering pension plans, etc. But if you are one of the select few that will be entitled to receiving a pension, you should know your options far in advance before you’re sitting across the table from H.R. and they expect you to make irrevocable and permanent lifetime decisions regarding your pension payout and most likely your largest financial asset.

Under a normal pension plan, there is a calculation to determine your future benefits. Let’s look at the Florida Retirement System for example. For normal risk employees, the way they figure out how much you will be entitled to is based on your number of years of service multiplied by 1.6% and again multiplied by your average, highest 5 or 8 fiscal years of your salary (depending when you were hired). <https://www.myfrs.com/FRSPro_ComparePlan_BenificCal.htm>

So let’s take a quick look at an example. Let’s say you’ve worked as a teacher for FRS for the last 30 years. Your final average highest 5 years of salary amount to $60,000. In this case, you take 30 years multiplied by 1.6% and then again multiplied by $60,000 which equals $28,800. This means that at your FRA (Full Retirement Age) normally age 62, you are eligible to receive a $2,400 monthly pension for the rest of your life. However, there are a few choices under all pension plans that have to be made prior to beginning the pension and they all relate to survivor benefits for your spouse and/or possibly dependents.

Under the FRS pension plan you have…..

Option #1 – A full monthly payment for your life only. In this case it’s $2,400 per month.

Option #2 – A life with 10 year certain. All this means is that as long as you’re alive you will continue to receive the benefit. However if you were to die within the first 10 years of receiving the pension, a survivor would be named as the beneficiary. There is a cost for this though. Instead of receiving $2,400 per month, you would be receiving $2,340 per month let’s say. (This is only for illustrative purposes – actual pension estimates would have to be determined by the plan administrator or actuary of the pension).

Option #3 – This option provides a 100% survivor benefit for your spouse. I believe most clients would be inclined to choose option #3. However choosing option #3 will result in the largest reduction of benefits. Normally, around 25%. However it depends on the spouse’s age. A younger spouse will effect it more because the pension fund would be required to payout benefits for a longer period of time. So if option #3 were chosen, the original lifetime benefit would be reduced by approximately 25% ($600) which would result in a pension benefit of $1800 per month, for both your’s and your spouse’s lifetimes. (We’ll revisit these numbers in just a minute)

Option #4 – Finally the fourth option, which is similar to option #3, but instead pays a 2/3 benefit to your spouse. So again, in this example the pension would be reduced by, let’s say 15% ($360) which would provide lifetime benefits for the pensioner of $2,040 and in the event of their death, their spouse would receive 2/3 of that, or $1,360 per month for life.

I’m sure by now you’re somewhat confused. Now, imagine sitting down with H.R., having to elect this irrevocable, permanent lifetime decision regarding your largest financial asset you own! What if there was an option #5? Unfortunately there is no option #5 unless you create one. So let’s take a closer look…

Option #5 – Select the full pension benefit ($2,400 per month). Out of that, take $600 per month and buy a life insurance policy. How much life insurance can you buy for $600 per month? Ironically, it’s probably pretty close to what you would need (assuming you are in decent health) to have enough to provide for your spouse’s remaining life expectancy assuming some reasonably conservative estimates. So let’s look at an example….

Mr. Smith, age 65, in generally good health is retiring and has earned a $2,400 pension benefit. His wife, Mrs. Smith is also age 65 and in generally good health. Her remaining life expectancy is 20 years, let’s say. Under option #3 she would only receive $1,800 per month. So how much life insurance would Mrs. Smith need, if Mr. Smith died first? Using a financial calculator, to provide $1,800 in monthly income for the next 20 years assuming an average growth rate of 5%, would require $273,882 in cash invested to last for 20 years. This example does not take into account a cost of living the pension may have provided, however assuming a 3% cost of living adjustment every year and all else being equal, the amount of life insurance would be increased to $358,339. So if Mr. Smith were to purchase a $358,339 permanent life insurance policy, if he died the next day, under these assumptions, Mrs. Smith could receive $1,800 per month for her remaining 20 year life expectancy. Now that you understand there is a 5th option, let’s look at the potential this could provide, both for yourself, your spouse and possibly your children.

#1 - If you elect to take a survivor benefit for your spouse (going back to option #3), losing as much as 25% ($600) per month in lifetime income and your spouse dies before you do, your benefits do not get restored back to $2,400 per month (some pension plans may allow for restoration of benefits)! You have permanently lost $600 per month in pension income forever!

#2 – Let’s say, both you and your spouse live until you’re each 100 years old. A long fruitful retirement. You have sacrificed $600 per month over your entire retirement with nothing to show for it.

#3 – Now let’s assume you did select the life insurance option and your spouse dies first. Permanent life insurance may build up cash value over time. So you could cancel the insurance and cash it in, stop paying the premiums and actually receive an increase to your net income since the benefits would still be paying you $2,400 per month but without a life insurance premium to pay any longer!

#4 – On the other hand, let’s say you both live to the ripe old age of 100. You’ve built up equity in your life insurance that you could tap into, throughout retirement, if you needed to. If not, then the life insurance policy death benefit could eventually be left to your children. For some people, this gives you the free ticket to spend more of your own money, knowing your kids will receive the life insurance.

#5 – Lastly, in the event that you prematurely die before your spouse, the pension income would stop, but he or she would receive the life insurance, tax free. With some basic assumptions, if she were to invest $358,339 and could reasonably expect to earn 5% average returns over 20 years, she could withdraw $1,800 per month, inflating that income by 3% annually until it’s finally exhausted at the end of the 20th year.

This concept has been known as pension maximization. Unfortunately, most clients, unless they’ve consulted with a financial planner, would never be aware of Option #5. Not because H.R. or the pension plan administrator is trying to hide it, just because that’s not an option to select, you have to create Option #5 yourself or with the help of a financial planner.

Final Page

I hope, after reading these basic concepts of the foundations of financial planning, you will be able to immediately begin implementing them into your own finances and start to really take control of your spending. Many people struggle with managing their cash flow, so just realize you’re not alone. The difference is whether you’re willing to begin to make constructive steps towards taking control of your money or just hope for the best. The task is daunting, but just remember, the way you eat an elephant……**is one bite at a time!** Best of luck on your journey and if our firm could be of assistance, please feel free to contact us for a complimentary financial evaluation.

Scott Weidman, CFP®

CERTIFIED FINANCIAL PLANNER TM

Savannah Court Financial Advisors, Inc.

386.299.2893

