Module 3

Approaches to Financial Planning

FINANCIAL PLANNING APPROACHES

LIFE CYCLE APPROACH

- -PHASES
  - -ASSET ACCUMULATION PHASE
  - -CONSERVATION/RISK MANAGEMENT PHASE
  - -DISTRIBUTION/GIFTING PHASE
- -COMMON GOALS
- -COMMON RISKS

PANEL APPROACHS

- -TWO-STEP APPROACH
  - -COVER RISKS
  - -SAVE AND INVEST
- -THREE-PANEL APPROACH
  - -COVER CATASTROPHIC RISKS
  - -MANAGE DEBT
  - -MEET FINANCIAL GOALS

FINANCIAL PLANNING APPROACHES

STRATEGIC AND CASH FLOW APPROACH

- -STRATEGIC APPROACH
  - -DEFINE GOALS
  - -DEFINE OBJECTIVES
- -CASH FLOW APPROACH
  - -STEPS
  - -CASH FLOW STATEMENT
  - -SAVINGS
  - -EXPENSES

OTHER APPROACHES

- -PIE CHART APPROACH
- -PRESENT VALUE APPROACH
- -RATIO ANALYSIS APPROACH
- -METRICS APPROACH

BUDGETING AND SAVING

BUDGETING

- -BUDGETING TIPS
- -STEPS IN PROCESS
  - -DETERMINE INCOME
  - -DETERMINE EXPENSES
  - -PRESENT EXPENSES
  - -NET DISCRETIONARY CASH FLOW
  - -RECTIFY GOALS

SAVING

- -SAVINGS RATE
  - -CASH FLOW APPROACH
  - -RATIO APPROACH
- -BENCHMARK

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Approaches to Financial Planning

Module 3
Chapter 3

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Objectives

- Obj I: The Life Cycle Approach
- Obj II: Panel Approaches
- Obj III: Strategic and Cash-flow Approaches
- Obj IV: Other Approaches to Financial Planning
- Obj V: Budgeting and Saving

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The Life Cycle Approach

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Life Cycle Approach

- The life cycle approach is an approach to financial planning.
  - Broad view of the client financial profile.
  - Matches a client's goals with their current stage in the life cycle.
- A majority of a client's goals and lifestyle can be explained by their stage in the life cycle.

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Life Cycle Approach

- Three distinct stages:
  - Asset accumulation phase.
  - Conservation/risk management phase.
  - Distribution/gifting phase.
- Each client is different.
  - Risks/goals may not always align with those in the stage they would expect to be in given their age.
  - Can be in multiple stages at once.

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Asset Accumulation Phase

- Asset Accumulation Phase.
  - Early 20s to mid 50s.
    - Usually begins when client enters work force.
  - Primary focus is on accumulating assets.
  - Additional cash for investing is low.
  - Debt to net worth is high.

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Conservation Phase

- Second phase is Wealth Conservation phase.
  - Also known as risk management phase.
  - Late 20s (or early 30s) to early 70s.
    - Usually starts when client is considering starting a family.
- Stage when wealth conservation and risk management are the focus.

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Conservation Phase

- Need to plan for events that could impact long-term planning goals and financial stability.
  - Untimely death.
  - Accidents and illnesses.
  - Unemployment.

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Distribution Phase

- The last phase is the Wealth Distribution/Gifting phase.
  - Mid 50s to end-of-life.
- Client is concerned with living off accumulated assets.
  - Also concerned with preserving wealth for future generations or philanthropic purposes.
- High cash flow, low debt, high net worth.

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Life Cycle Approach

- Clients can be in two or even all phases at once.
  - Conservation phase may come before the accumulation phase if there is early death.
- Common life-cycle goals:
  - Starting a family.
  - Retirement planning.
- Common risks:
  - Disability.
  - Untimely death.
  - Liability.

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Practice

- Juanita, age 60, is married and has two daughters in college. Her primary goals are saving for retirement, supporting her daughters until they graduate from college, and structuring her estate to provide for her daughters and their future families. Which phase(s) of the life-cycle approach is Juanita most likely in?
  - A. The asset-accumulation and conservation/risk management phases.
  - B. The distribution/gifting phase.
  - C. The conservation/risk management phase.
  - D. The conservation/risk management and distribution/gifting phases.

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Panel Approaches

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Two-Step Approach

- The Two-Step approach involves managing risk and saving/investing.
  - Step 1 – cover the risks.
    - Personal risks potentially lead to catastrophic loss.
    - Insurance is recommended to cover the risks of premature death or disability.
  - Step 2 – save and invest.
    - Saving for goals and investing for retirement occurs during this step.

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Three-Panel Approach

- The three-panel approach is similar to the two-step approach.
  - Second step is further divided into short-term and long-term savings.
- Panels of the three-panel approach:
  - Panel 1 – cover catastrophic risks.
  - Panel 2 – meet short-term obligations and manage debt.
  - Panel 3 – meet financial security goals.

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Panel 1

- Panel 1 involves risk management.
  - Personal, property, and liability risks.
  - Catastrophic risks must be covered.
- Evaluate need for:
  - Life insurance.
  - Health, disability, and long-term care insurance.
  - Property and liability insurance.

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Panel 2

- Panel 2 involves short-term savings and managing debt.
  - Focus on meeting short-term obligations.
- Evaluate adequacy of:
  - Emergency fund.
  - Housing costs.
  - Income spent on debt other than housing debt.

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Panel 3

- Panel 3 involves long-term savings and investments.
  - Focus on being financially secure.
- Evaluate progress toward:
  - Retirement goal.
  - Education funding.
  - Large purchase goal.
  - Document creation (POAs, etc.).

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Practice

- Evaluating a client's proportion of income spent on housing would fall into:
  - A. Panel 1 of the three-panel approach.
  - B. Panel 2 of the three-panel approach.
  - C. Panel 3 of the three-panel approach.
  - D. The distribution phase of the life-cycle approach.

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Strategic and Cash-flow Approaches

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Strategic Approach

- The strategic approach to financial planning combines big-picture goals and the external environment.
  - Considers needs vs. wants.
- Includes SWOT analysis:
  - Strengths.
  - Weaknesses.
  - Opportunities.
  - Threats.

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Strategic Approach

- The strategic approach codifies client goals and objectives into a mission statement.
  - Brief long-term statement of the financial plan's overarching purpose or mission.
- Strategic approach defines:
  - Goals – broadly defined.
    - Adequate emergency fund.
  - Objectives – divide goals into discrete and actionable steps.

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Cash Flow Approach

- Planners using strategic approach method often follow with using the cash flow approach.
  - Approach uses statement of income and expenses to make recommendations.
- Steps of cash flow approach:
  - Recommendations with positive cash flow impact are prioritized and implemented.
  - Clients identify recommendations with a negative cash flow impact.
  - Positive cash flows are used to "purchase" the negative cash flow recommendations.

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Cash Flow Approach

- Ways insurance recommendations would affect cash flow:
  - Positive impact – raise deductibles, eliminate duplicate coverage, reduce coverage, replace policy.
  - Negative impact – lower deductibles, purchase new insurance, increase existing coverage.
  - No impact – change beneficiary, reassign policy, stop driving uninsured vehicle.

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Cash Flow Statement

- The Cash Flow Statement is used to determine how much income the client is receiving and how much the client is spending.
  - Statement of Income and Expenses.
- Prepared for a certain period of time.
  - Typically prepared on an annual basis.

Net cash flow = Income – Savings – Expenses

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Savings

- Determining how much a client should be saving is one of the most important elements of financial planning.
  - Financial goals almost always require the accumulation and growth of assets.
- Taxable savings accounts are taxable in the year income is earned.
  - High yield savings accounts, brokerage accounts, etc.

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Savings

- Tax-Deferred Savings accounts grow tax-deferred until the funds are distributed.
  - Contributions may reduce taxable income.
  - Includes most retirement accounts.
    - Traditional IRAs, SEPs, SIMPLE IRAs, 401(k) plans, 403(b) plans.

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Savings

- Tax-Free Savings accounts offer tax-deferred growth and allow for tax-free withdrawals.
  - Roth IRAs.
  - Health savings accounts.
  - Section 529 College Savings Plans.

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Expenses

- Expenses on a Cash Flow Statement are often broken down into:
  - Living expenses – groceries, utilities, rent, internet, insurance.
    - Can be classified as discretionary or non-discretionary.
  - Debt payments – mortgage, credit cards.
  - Insurance expenses – life, disability, health.
  - Taxes – income, real estate.

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Net Discretionary Cash Flow

- Formula for Net Discretionary Cash Flow:
  - Income – Savings – Expenses
- Financial planning recommendations are made on the basis of available cash flow.
  - Long-term success is only possible with positive cash flow.
  - Negative cash flow must be resolved by increasing income or reducing expenses.

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Net Discretionary Cash Flow

- Discretionary expenses are expenses a household can survive without.
  - Nonessential spending.
  - Includes entertainment, vacations, hobbies, restaurants, and gym memberships.
- Non-discretionary expenses are necessary expenses.
  - Includes taxes, groceries, and debt.

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Cash Flow Statement Limitations

- A limitation of a cash flow statement is that only recurring income and expenses are included.
  - Some excluded items can have significant implications for the plan.
- Non-recurring transactions are not reported on the Cash Flow Statement.
  - Includes gifts and inheritances.
  - Should not be ignored.

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Practice

- Which one of the following insurance strategies will result in a positive cash flow?
  - A. Changing the beneficiary from a spouse to a child.
  - B. Increasing insurance deductibles.
  - C. Raising the amount of long-term care insurance coverage.
  - D. Switching from term life insurance to whole life insurance.

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Other Approaches to Financial Planning

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Financial Planning Approaches

- Several additional approaches to financial planning exist.
  - Pie Chart approach.
  - Present Value of All Goals approach.
  - Ratio Analysis approach.
  - Metrics approach.

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Pie Chart Approach

- The Pie Chart approach provides visual display of the balance sheet and cash flow statement.
  - Created after internal data has been collected and financial statements are prepared.
  - Displays percentages of finances.
- Helps client visualize:
  - Percentage of pay that is being saved.
  - Percentage of pay spent on housing.
  - Percentage of pay that is remaining.

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Present Value Approach

- The Present Value of All Goals Approach is a multi-step process.
  - Gives clients a single dollar value to meet all their lifetime goals.
  - Quantifies the amount the client would need to start saving today.
- This method puts a price tag on all of the client's lifetime goals.

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Present Value Approach

- Steps of Present Value approach:
  - Determine individual PVs of each goal.
  - Sum the PVs.
  - Reduce the total by the current resources available.
  - Determine amount of additional savings needed to fund goals.
    - Considered a debt obligation to be retired over the remaining work life expectancy.

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Ratio Analysis Approach

- The Financial Statement and Ratio Analysis Approach uses data within financial statements.
  - Calculates ratios that are used to gauge financial health.
- Categories of ratios:
  - Liquidity ratios.
  - Debt ratios.
  - Financial security ratios.
  - Performance ratios.

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Metrics Approach

- The Metrics approach provides quantitative benchmarks as guidance for achieving goals.
  - Helps to establish objectives that are measurable with ratio analysis.
  - Benchmarks may be stated qualitatively as "rules of thumb."

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Practice

- Which of the following best describes the metrics approach to financial planning?
  - A. An advisor computes a variety of ratios which are then used to gauge a client's financial health.
  - B. An advisor gives their client a single dollar value to meet all their lifetime goals.
  - C. An advisor provides a visual display of the balance sheet and cash flow statements.
  - D. An advisor provides quantitative benchmarks for their client to use as guidance for achieving comprehensive financial goals.

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Budgeting and Saving

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Budgeting

- Important tips for successful budgeting:
  - Be realistic with spending behavior.
  - Include an expense line item for miscellaneous expenses and unforeseen expenses.
  - Being successful with a budget takes practice.

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Budgeting Process

- Steps of the budgeting process:
  - Determine client's income for a time period.
  - Determine fixed and variable expenses for the same time period.
    - Fixed – stable and predictable.
      - Often non-discretionary.
    - Variable – usually discretionary.

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Budgeting Process

- Steps of the budgeting process:
  - Present expenses to the client.
    - Expenses as a percentage of income are generally level or decreasing over time.
  - Determine if net discretionary cash flow is positive or negative.
    - If negative, expenses must be reduced, or income needs to increase.
  - Rectify client's goals and planner recommendations with client's cash flow.

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Savings Rate

- A savings rate can be calculated and compared to appropriate benchmarks.
  - Cash flow approach – savings rate equals:
    - Income – Savings – Expenses
  - Ratio approach – savings rate equals:
    - (Savings + Employer Match)/Gross Pay
- Compare savings rate to benchmark.

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Benchmark Savings Rate

- Appropriate benchmark for a client's savings rate depends on various factors.
  - Annual income, current investment balance, rate of return, and inflation rate.
- Generally, younger clients and clients with fewer goals have lower savings rate benchmarks.
- Older clients and clients with more goals have higher savings rate benchmarks.

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Practice

- What is the first step in the budgeting process?
  - A. Determine the client's income.
  - B. Determine the client's expenses.
  - C. Determine the client's net discretionary cash flow.
  - D. Determine the client's goals.

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Practice

- Janet Smith receives a salary of $150,000. She saves $10,000 in a Section 529 plan for her son and contributes $12,000 to her 401(k) plan. Her employer also makes a $4,000 matching contribution to her 401(k) plan. Assuming Janet also contributes $2,000 into a traditional IRA, what is her savings rate?
  - A. 9.3%
  - B. 12%
  - C. 17.33%
  - D. 18.67%

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