THE FIVE ESSENTIAL ELEMENTS OF FINANCIAL PLANNING

Your Go-To Guide for Smart Money Management

di ON DEMAND

ELEMENT #1:

Develop a spending plan

A spending plan is a guide of how to best allocate the money you make. It is similar to a budget, but the word "budget" carries negative connotations and is associated with anxiety, arguments, and acrimony. A spending plan is a positive tool. It is your plan. You set it and adjust it as needed.

Think of your spending plan as a financial map. You wouldn't start a cross-country road trip without knowing your destination, what routes you'll take, and some idea of how much fuel you'll need. Your budget serves the same purpose. Your destination is your financial vision for the future. What you save for, such as a college education, a vacation home, or early retirement are similar to the stops along your route. Estimating your fuel consumption is similar to estimating how much of your income you'll need to allocate to living expenses, savings and retirement.

Creating a spending plan doesn't have to be complicated. Here's a quick and simple four-step process.

- **Step 1: Identify regular expenses.** Start with current monthly expenses such as utilities, housing, transportation costs, credit cards and childcare. Then add in annual expenses such as auto registration, insurance, subscriptions, medical and dental costs, birthdays and holidays.
- **Step 2: Calculate your total income.** This should include wages, bonuses and any other sources of income.
- **Step 3: Assess the current expense vs. income situation.** For some this can be a revelation, like stepping on the scale. When you weigh, there are three outcomes: You've either gained weight, lost weight, or stayed the same. Evaluating your spending plan can have only three outcomes as well; you live within your means, you overspend, or you have some financial wiggle room.
- **Step 4: Envision your financial future.** Do you want to send your children to college? Have you always dreamed of a vacation home? When do you ideally want to retire? What lifestyle do you want in retirement? What is your comfort level with debt or with unexpected expenses? If you are a couple, it is critical that you ponder these questions together.

Now that you have a clear understanding of your current expenses, income and vision for your financial future, it's time to create a plan to reach your goals. You may have to reallocate how much you spend and on what. But these are your choices to make. Make the commitment to yourself (and your partner) to strengthen your financial willpower and make the necessary spending changes.

TIP

An easy way to get started is to review your checkbook entries for the last 12 months.

FINANCIAL BENCHMARKS

- Housing costs should be between 25 and 30% of your gross income.
- Total monthly debt payments should not exceed 36% of total gross income.
- Credit card debt should not exceed 30% of the total credit card limits available

ELEMENT #2:

Establish short-term savings

Unplanned expenses can wreak havoc with your spending plan. Avoid extra money stress by establishing a short-term savings plan or emergency fund. Then, when an unexpected auto repair, home repair or medical emergency comes up, you'll be ready. Think of your emergency fund as a financial cushion for unexpected expenses.

Strive to save an emergency fund equal to three to six months of monthly expenses. Of course this won't happen overnight, but if you allocate funds in your spending plan, you can achieve this goal over time.

For example, let's say your monthly expenses are $2,500. Your emergency fund should be $7,500 to $15,000. It may take four to five years of faithfully earmarking a portion of every paycheck to the emergency fund before you reach your ultimate goal.

While you build your emergency fund, also work to pay down any credit card debt. Start by selecting the credit card with the highest interest rate. Do your best to pay something more than the minimum monthly payment for that card and avoid additional charges on that card. If you have to use credit, choose the card with the lowest interest rate.

Some credit card companies offer a lower interest rate on balance transfers. Investigate transferring the balance from a high interest rate card to a card offering better terms. You may not want to close that credit card, but definitely avoid new charges.

Getting to a secure financial position is a journey, especially if you are paying down debt. Chink away at it one step at a time.

TIP

Ask your employer to automatically deposit a specific amount of your paycheck into a separate emergency fund account every month. Keep your emergency money separate from your checking account. Only use it in the case of true emergencies.

ELEMENT #3:

Establish long-term savings

Long-term savings are essential for retirement planning and other goals such as saving for a home, a college fund or even a dream vacation. A sound spending plan includes an ample contribution to long-term savings.

Saving for long-range goals typically takes many years. Let's say you have seventeen years to save for the projected tuition at a four-year public university of $281,000. Using simple math, you would need to save about $16,500 annually. That's a staggering number for sure. Thankfully, you have the magic of compounding interest on your side to help reach your goal.

Compounding interest

Assume your savings will earn 10% compounded annually (10% is a much higher interest rate than currently offered but it makes the calculations easier to illustrate.) At the end of the first year, you saved $16,000 and earn $1,600 interest. ($16,000 x 10% = $1,600). By the end of the second year, your total contributions are $32,000 and thanks to compounding interest the account value is $36,960. Over the 17-year saving period, contributions and compounding interest result in an account value of $713,500!

Your college fund savings goal is only $281,000. Due to compounding interest, you need to save only $6,300 annually over 17 years to reach the goal of $281,000. That is much more manageable than $16,000!

TIP

Consider using a personal finance online service like Mint.com (free) or You Need a Budget ($60) to track your spending. You'll also find helpful information about setting savings goals.

Saving for retirement

Preparing for retirement is your most important long-term savings. Many retirees can expect to live 30 years or more in retirement. Even with Social Security benefits, you will need additional retirement savings. It's never too soon to save for retirement.

To maximize your retirement savings, you will want to take advantage of a tax-favored retirement plans. Some plans, like a 401(k) or 403(b) are offered by your employer. If you are fortunate and have a retirement plan at work, participate in the plan as soon as you become eligible. You designate how much of your paycheck should be directed to your account. Some employers will contribute to your account as well.

In addition to your employer sponsored retirement plan, you may be eligible to contribute to a traditional IRA (Individual Retirement Account) or a Roth IRA. If you are enrolled in an employer sponsored plan, the IRS annually declares the maximum you may contribute to retirement accounts. Check the IRS website or ask your financial professional for more information.

In general, retirement accounts are tax-favored. Accounts such as 401(k)s and 403(b)s allow pre-tax contributions, up to an annual maximum. That means when calculating your federal income tax withholding the amount of taxable income is reduced by the amount you contribute to your retirement account. Traditional IRAs allow a tax deduction for annual contributions up to a maximum. Another tax benefit of most retirement plans is that income tax on the account is deferred until you begin withdrawals. You must begin minimum withdrawals by age 70 ½.

A Roth IRA however, does not allow pre-tax or tax deductions for contributions, but minimum distributions are not required and withdrawals are not taxable. Talk to a financial professional about which retirement account works best for your situation.

There's also a new kid on the retirement account block. In 2014, President Obama announced the MyRA, a new retirement account specifically for workers without access to an employer sponsored plan. You must earn less than $191,000 to be eligible to invest and the maximum account value is $15,000. To learn more about MyRA, check out this fact sheet.

TIP

Knowing how much you should be saving for retirement is important. Fidelity offers a helpful suggestion based on your age. For instance, by 35 your retirement account balance be the equivalent of your current salary. At age 45, the account balance should be three times your current salary, and five times your current salary by age 55. The ultimate goal is to have eight times your current salary stashed away in your retirement account(s) by the time you are ready to retire. Read more about the variables that influence how much to save at Fidelity.com.

ELEMENT #4:

Protection for Life

There's security in knowing you have a financial plan. You are accumulating assets, a home, short-term and long-term savings and managing your spending. However, even the best plans can hit a snag. Protect the results of your hard work with insurance products that help protect against the financial risk of something unforeseeable happening.

Insurance products share the financial risk of losing something valuable. It is essential to have a combination of the following four insurance products to properly cover your assets.

- **Property insurance** – Protection against losses to your home, auto, and other personal property.
- **Paycheck protection** – Your ability to earn an income may actually be your greatest asset. Your income is what allows you to acquire assets. Disability income insurance provides a steady, predictable, income stream if you became ill or injured and are unable to work. The risk of being disabled is higher than you may think. In fact, statistics show that 30 percent of workers are likely to be unable to work for three months or more, due to an illness or injury.
- **Critical illness protection** – Science and technology have improved the outcomes of common diseases. More people survive cancer, stroke and heart attacks than ever before. Critical illness benefits fill financial gaps not covered by health insurance.
- **Long-term care protection** – As we age, the probability of needing long-term care increases. Unfortunately, long-term care expenses can quickly deplete long-term savings. Long-term care insurance can help defray those costs.

Below is a summary of each type of protection.

	PROPERTY INSURANCE	DISABILITY INSURANCE	CRITICAL ILLNESS INSURANCE	LONG-TERM CARE INSURANCE
WHAT IT PROTECTS	Physical assets: • Home • Auto • Personal property	Income protection in the event of: • Illness • Injury	Provides financial supplement in the event of a specific illness: • Heart attack • Stroke • Cancer	Provides financial supplement by covering expenses associated with: • Home care • Assisted living • Nursing home care
HOW IT WORKS	Shares part or all of the cost of replacement or repair	Provides a stream of income until able to return to work	Provides a fixed benefit amount intended to help offset expenses not covered by health insurance	Depending on type of product provides a fixed monthly benefit amount or reimbursement of paid expenses until maximum benefit amount is distributed

TIP

A financial professional will explain the details of these products and offer recommendations about the amount of coverage for your situation and affordable options. Most independent agents are versed in these products or work with a colleague who specializes in a product.

ELEMENT #5:

Protection for Death

As unsettling as it might be to consider a premature death, life insurance is the capstone to a sound financial plan. Life insurance eases the financial strain of maintaining what you planned for the people you leave behind.

You and your spouse may have planned to send your children to college for instance. Even if your spouse earns a similar income, it may not be enough to raise the children in the family home and continue to contribute to a college fund. Once the kids are out of school, many couples step up contributions to retirement savings. The retirement you planned as a couple may not become a reality for your spouse if contributions to the retirement account are constrained by one income.

Some financial needs are temporary, while others are lifelong. For this reason, temporary (term) and permanent insurance both have their place.

There are several kinds of life insurance products, each designed to address a specific need and type of protection.

	TERM INSURANCE	PERMANENT INSURANCE	UNIVERSAL LIFE INSURANCE
BEST FOR	Temporary needs: • Mortgage • College education	Lifetime needs: • Retirement • Final expense	Lifetime needs: • Retirement income • Interest sensitive

Completing your Financial Plan

Now that we've covered the five essential elements, you have the foundation to develop a solid financial plan. Get started on your spending plan and emergency fund today.

When you're ready to cover your paycheck protection needs, look no further than DIonDEMAND. We are dedicated to providing affordable income protection for all Americans.

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