Managing Personal Finance

Chapter 7

Introduction:

Have you ever wondered what you would do with the money you had won from the lottery? You see long lines of people in lotto outlets every time the prize money goes up when no one wins in the previous draw. Have you calculated the probability of winning one of the national lottery draws if ever you will buy a single ticket or combination?

Many Filipinos see the lottery as the ultimate shortcut to financial freedom. They see it as a great escape from poverty. Some of us may know previous winners and how their lives have changed ever since winning the lottery. We see those winners buying expensive houses and multiple cars.

We might also have heard of a few winners who went from rags to riches and back to rags again. We probably wondered how they could have squandered huge amounts of money. Some stories tell us how lavishly they spent their winnings and how quickly they reverted to poverty.

This same story is familiar for these lotto winners and some individuals who have mismanaged their finances. Their predicament could have been avoided if they adhered to some basic principles in personal finance management.

This holds for all individuals, not only for these lotto winners. Personal finance management is everyone's concern.

Forbes Magazine listed the Philippines' Richest in 2019. (You may visit the link: **http://www.forbes.com/philippines-billionaires/list/).** Probably none of these billionaires won the lottery, and not everyone inherited it from their ancestors. Some of them started from scratch and worked their way up. Not everyone is expected to join these individuals on the richest list. Still, everyone may be guided to emulate the early steps of their success stories and avoid the pitfalls of those who failed.

Financial Planning and the Individual's Life Cycle

The financial plans would depend on their financial objectives that are very much affected by the stage they are at on an individual life cycle. Brown and Reilly (2014) identified the four life cycle phases as the "accumulation, consolidation, spending, and gifting phases." Burroughs (2018) enumerates four stages of the financial life cycle as "accumulation of wealth, growing or managing wealth, preserving and protecting wealth, and transferring wealth." Likewise, various sources label these as the stages of wealth or the wealth cycle with similar but not exact terms for the various stages, such as wealth creation, wealth enhancement, and wealth distribution, and others. It should be noted that it is possible that these stages overlap and even coincide with the other stages. Individuals under the various stages may encounter the considerations below:

Initial Stages

The creation of wealth due to the commencement of employment or the establishment of business and the continuous, accumulation of assets may be considered the initial stages of the cycle. Those who have just started working or creating their business would fall under these initial stages. Since they are relatively young, they can afford to take on high-risk investments since the year can start again if they fail in some of their business ventures and investments. In these early phases, they are still "accumulating" assets that will satisfy their individual goals. Typical assets that any individual or household would acquire at this stage include their own car or house. At this stage, individuals start living separately from their parents, thus the need to purchase their own car. Individuals may start by first renting a condominium unit or house then eventually buying one of their own.

Because they acquire cars and houses, individuals at these stages also start incurring significant liabilities in the form of (the related) car and home mortgages. These mortgages are typically paid over a long time horizon. Most car loans are repaid over five years, while housing loans extend much longer, even for 20 to 25 years. Individuals must ensure that their earnings are more than enough to cover these fixed obligations and still provide for their daily living expenditures for food, transportation, utilities, clothing, and so on.

It is then crucial that they not enter into these loans if their earnings over the loan amortization period are not enough to pay for the required regular payments.

Aside from these short-term goals, they will also intend to save for future expenditures such as their children's tuition and their eventual retirement if funds are still available after considering the required daily living expenditures and their fixed obligations.

Middle Stages

The middle stages may be considered as a period of consolidating assets and personal wealth. It is assumed that those in this phase already have the necessary assets required of a typical household and have settled most of their outstanding liabilities. Major concerns at this stage include the ability to pay for their children's education (from grade school to college).

Individuals also fulfill some family objectives, such as going on vacations and the purchase of luxury goods. Of course, this is the second priority relative to providing the specific needs of their children —education and their daily allowances.

These individuals take investments of moderate risk since they still have a longer time horizon before retirement, yet would not want to venture on too risky investments since it would be hard for them to start all over again, especially with the needs of their children taking high priority.

Aside from this concern, they need to consolidate and preserve much of the assets they accumulated throughout the years since they want to prepare ahead for future retirement.

The net worth (assets less liabilities) of individuals at the consolidation phase significantly increases compared to the accumulation phase mainly because of the increase in earnings (higher salary or reaping the benefits of earlier investments) and the settlement of the mortgages they entered into the previous stages.

Slide: Financial Planning and the Individual's Life Cycle

- Financial objectives depend on the individual's life cycle stage.
- Brown & Reilly (2014): four life cycle phases → accumulation, consolidation, spending, gifting.
- Burroughs (2018): four stages → accumulation of wealth, growing/managing wealth, preserving/protecting wealth, transferring wealth.
- Stages may overlap or coincide.
- Stages influence financial considerations.

Slide: Initial Stages

- Wealth creation through employment or business.
- Individuals accumulate assets (still in “accumulating” phase).
- Young individuals can afford high-risk investments.
- If business ventures fail, they can restart.
- Begin living independently from parents → need for own car or housing
.
- May start with renting → eventually buying property.

Slide: Loans and Obligations (Continuation of Initial Stages)

• Acquire cars and houses → incur significant liabilities (car loans, mortgages).
• Car loans: usually 5 years.
• Housing loans: 20–25 years.
• Earnings must cover fixed obligations + daily living expenses (food, transport, utilities, clothing, etc.).
• Should avoid loans if income cannot cover amortization.
• Short-term goals: ensure funds remain for daily expenses.
• Long-term goals: saving for children’s tuition and eventual retirement.)

Slide: Middle Stages

- Period of consolidating assets and wealth.
- Assumed individuals now have most necessary assets.
- Major concerns:
- Paying for children’s education (grade school to college).
- Meeting outstanding liabilities.
- Secondary goals: family vacations, luxury purchases.
- Investments: moderate risk (longer time horizon before retirement).
- Avoid too-risky investments (harder to recover losses at this stage).

Slide: Consolidation Stage (Middle to Later Stages)

- Focus on consolidating and preserving accumulated assets.
- Preparing for retirement becomes a priority.
- Net worth increases (assets – liabilities).
- Reasons:
- Higher salaries or benefits from earlier investments.
- Mortgages from earlier stages are being paid off.)

Later Stages

The spending and gifting phases may happen concurrently. It is also expected that not everyone will reach the last stage of wealth transfer or distribution.

Retired individuals belong to the spending stage. Their primary source of income comes from their pension, although they also benefit from the returns of their existing investments. Capital preservation is their main return objective to earn more than inflation to protect the value of their investments in real terms. Capital preservation objectives require the individual to put their money in very safe investments, as described in the previous chapter.

It is called the spending phase since their pensions should cover their daily living needs, yet they have more than enough funds beyond this source for them to enjoy the fruits of their labor throughout their working career. Individuals in this stage must bear in mind that while they typically spend on luxuries, they must not deplete their retirement funds for their remaining years.

Nowadays, various *retirement products* offered by insurance and financial institutions aid these retirees in determining the timing of receipt of the income generated from their insurance and pension plans so that they do not spend much of it in a limited time span.

Some individuals would not have the opportunity to distribute wealth to their intended beneficiaries. This *gifting stage* focuses on how the individual supports family members, friends, or any charitable institution. The individual’s focus is consistent on how he/she wants to allocate his/her funds to these beneficiaries in case of his/her death or even during his/her remaining years.

Basic Principles of Personal Finance

Various experts and authors have summarized the basic personal finance principles. For example, Keown (2010) classified these into 10 principles such as
The Best Pro Knowledge, Nothing Happens Without a Plan, The Time Value of Money, Taxes Affect Personal Finance Decisions, Stuff Happens, or the Importance of Liquidity, Waste Not, Want Not – Smart Spending Matter, Protect Yourself Against Major Catastrophes, Risk and Return Go Hand in Hand, Mind Games, and Your Money and Just Do It."

Mint.com (2020)[5] provided three basic principles: "1) Spend less than you earn;2) Make the money you have work for you; and 3) Be prepared for the unexpected." Bergeron (2016)[6] also highlighted 10 basic principles: "Organize Your Finances, Spend Less Than You Earn, Put Your Money to Work, Limit Debt to Income-Producing Assets, Continuously Educate Yourself, Understand Risk, Diversification is Not Just for Investments, Maximize Your Employment Benefits, Pay Attention to Taxes, and Plan for the Unexpected."

These basic principles espoused by these experts have similar themes summarized below.

1. Importance of Financial Literacy

The chapters of this worktext provide the financial literacy to understand basic finance concepts applicable to businesses and individuals. We have discussed essential finance concepts such as the time value of money and the risk-return trade-off. These concepts also apply to personal finance and should be the guiding principles in assessing potential investment schemes and the related returns promised by these schemes. Individuals should be cautious when reading and understanding the advertisements and leaflets disseminated by the organizers of these schemes, especially if the returns are way above the ordinary. It would be wise to carefully analyze the prospectus details of any financial instrument being offered and determine its risk and return characteristics.

The issuer's financial statements would be a good starting point of your analysis in determining the ability of the company to meet its obligations to the investors. For the same reason, basic fundamental financial statement analysis, as discussed in this worktext, is essential to any finance student and practitioner.

Achieving financial proficiency does not solely involve formulae and computations. Finance is a much broader field that includes the study of behavioral traits and reactions. Behavioral finance is an interesting field to study further and seek applications to personal finance problems.

2. Budget Planning

Financial planning is not restricted to companies alone. Individuals also prepare their financial plans to meet their set objectives and goals. Basic financial plans include the preparation of annual, monthly, weekly, or even daily budgets. Adults prepare the household budget to determine if the sources of funds (e.g., earnings) of the family will meet the required living expenditures and if there will be an excess available for savings and investment. If this is not enough, creating a budget will also trigger the family to seek potential sources of financing (bank borrowings, credit cards, etc.). Even at an early age, individuals should practice financial planning or budget preparation. This could be applied when determining the potential uses of children’s daily or weekly allowances from their parents. They should establish the basic expenditures, such as food, transportation, and school supplies, among others, and determine whether there is money left that they could spend on entertainment, toys, or leisure outside school days.

Another way of setting a budget is by setting a cap for the amount to be spent. Some individuals determine their cap by establishing their total earnings for the period and setting a target amount for savings. Their target spending is the difference between their forecasted earnings and target savings (*Amount to be spent = Forecasted Earnings – Target Savings*). Once the total amount to be spent is established, this is apportioned to the various expenditures of the individual.

Individuals must identify priority goals—both near-term and long-term. This should be the basis in ranking potential purchases, whether staples or capital expenditures. Only when the necessities are taken care of should an individual indulge in more luxurious items. Impulsive buying should be minimized, and a specific budget should be set for these lower priority items.

This list of expenditures should be prepared in order of priority. For example, if an individual set 30% of earnings as the amount available for spending, only those expenditures within the cap are pursued, assuming the basic needs are covered.

3. Application of Basic Long-Term Financial Concepts – Time Value of Money and the Risk-Return Trade-off

Time Value of Money – Remember the power of compound interest. Albert Einstein acknowledged its importance, and individuals must use it to their advantage by investing wisely and avoiding its dangers by borrowing judiciously. Do not forget to select the best investment alternative by determining first a common valuation date, today, for example, then comparing its (present) value before deciding which offers the most attractive proposition. Financing or borrowing options (whether home or car loans) should also be compared based on the (present) values.

The time value of money is also the basis in computing the return promised by an investment scheme and whether this is realistic, given the applicable investment time horizon. A rule of thumb that can be used for this purpose is the "Rule of 72." The "Rule of 72" provides an estimate of the time horizon it will take for you to double your money, assuming annual compounding of interest.

By dividing 72 by the applicable rate of return of your investment (disregard the percentage sign), you get an estimate of how long your money will double. For example, if the rate of return is 10%, then 72 divided by 10 equals 7.2 years. This way, you can check the computations of a "double your money" scheme if offered to you.

You can also use this tool to determine your target rate of return if you desire to double your money within a specific time period. To do this, divide 72 by your desired time period. So, if your target time period is five years, 72 divided by 5 equals 14.4. By adding the percentage sign, you get an estimate of the required rate of return, which is 14.4%.

Foremost, it is necessary to determine whether the promised rate of return of a particular investment scheme is realistic and achievable.

4. Taxes Matter

Almost all transactions involve taxes. Analyze the returns of potential investments on an after-tax basis. Even in determining individual earnings, just like a company, almost 1/3 of the income would go to taxes. Passive income is also subject to taxes, and this must be incorporated in the analysis before making any investment decisions.

5. Contingency Planning

Remember to provide enough leeway for liquidity in the form of cash or any assets easily convertible to cash or with a ready market. This will allow the individual to cover for any unexpected needs and take advantage of unexpected opportunities. Illiquidity may lead the individual to seek funds haphazardly and be subjected to onerous terms by creditors.

Risk management involves protecting the individual and his/her property from event risks, such as natural calamities. This is more urgent in calamity-prone countries such as the Philippines. Insurance policies should include provisions that would cover these events. These clauses are sometimes referred to as "Acts of God" riders. In this case, the individual must not forget payments for insurance premiums as necessary fixed obligations, just like principal and interest payments of his/her mortgages.

Now that you have covered the basic concepts in financial management as provided by this worktext, it is up to you to apply these concepts now and in the future, regardless of the field or career you will specialize in. We have covered a wide range of topics, including financial statement analysis, planning and forecasting, working capital management, short-term and long-term sources of financing, and evaluation of long-term investment. The risk-return trade-off of different investments, like stocks, government securities, and corporate bonds, was also discussed. This last chapter provides basic and simple guiding principles for you to apply and inform other family members about.

SUMMARY

Personal financial management requires an understanding of basic finance concepts such as the time value of money and the risk-retum trade-off, among others. It is a prerequisite for the individual to read the fine print of investment schemes offered to him/her before deciding to allocate a part of his/her funds to these products.

It is also important that he/she assesses his/her ability and willingness to take on risks to set his/her investment objectives properly. This includes evaluating his/her present stage in an individual's life cycle.

With these considerations in mind, it is then up to the individual to decide and put his/her financial plan into action. Developing this financial plan is not exclusive to a specific age range or financial standing. Everyone, including high school learners, should simply start

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