Personal Financial Management

Michael Li

Contents

1 Credit, Debt, and Money **2**
1.1 Monetary Instruments 2
1.2 Common Credit Terminology 2
1.3 Fine Print 3

2 Credit Reports and Credit Scores **3**
2.1 Three Important Numbers 3

3 Contracts **3**

4 Social Security and Medicare **4**
4.1 Social Security 4
4.2 Medicare 4

5 Government Revenue and Expenses **4**
5.1 Tax Basics 5

6 Beginning to Save **5**
6.1 Magic of Compounding 5
6.2 Savings Guide 6

7 Investment Vehicles **6**
7.1 Business Structures 6
7.2 Investment Instruments 6

Notes are based on Fred Selinger's *Personal Financial Management*.

1 Credit, Debt, and Money

Good Debt: Money spent investing in yourself

Bad Debt: Money spent on sheer consumption and has no financial value

1.1 Monetary Instruments

To achieve good credit, you must borrow money and pay it back on time.

Credit Card: Unsecured line of credit where a lender lends you money based on your good faith and credit score

- Loan is paid back with an interest
- Not paying the loan back reduces your credit score
- Be sure to understand additional credit card related fees such as
  - Fees for using another bank's ATM
  - Late payment fees
- **Note**: Interest can be charged on penalties and fees

Debit Card: Secured bank card that takes money out of your bank account to pay for purchases

- Using a debit card doesn't help you establish credit since you aren't asking a loan from the bank

Installment Debt: Money borrowed to purchase large items (e,g. cars), paying for them over time. The purchaser pays for it at regular intervals until the loan is paid back

- Interest comprises most of the early installment payments and principal comprises most of the payment in later installments

Deferred Interest Plan: Plan that enables customers to purchase large items (e.g. cars) with a low teaser interest rate over a promotional period (e.g. a year)

- **Note**: If the entire balance is not paid off by the end of the period, interest may be retroactively charged on the entire balance during the promotion

Cashier's Check: Check purchased by you from a bank, payable to a designated third party

Certified Check: Personal check the bank guarantees as being supported by funds in your account that is made payable to a designated third party

1.2 Common Credit Terminology

Credit: Amount of money a lender is willing to lend subject to repayment terms and conditions

Debt: State of owing something such as money

Debtor (Borrower): Person with debt who has an obligation to pay said debt

Principal: Amount of money loaned

Interest: Cost of money received by the lender for providing the principal. Usually expressed as an **Annual Percentage Rate (APR)** of the principal

- The more often interest is compounded, the higher the interest rate becomes

Fixed Rate of Interest: Loan with an interest rate that will remain fixed for the term of the loan

Adjustable Rate of Interest: Loan where the rate of interest may change at various specified times

- An example is home loans where the interest rate is established for a few years but then changes to a new rate for the balance of the loan

Variable Rate of Interest: Interest rate that moves based upon a benchmark interest

- An example would be to base variable rate on the "prime rate" of interest that banks charge their best customers

Go-To Rate: Interest rate charged on unpaid credit card balances, in addition to the variable rate, to determine the total rate of interest on your account

- Go-to rate will decrease as your credit history improves
- For example, if your go-to rate is 8% and the variable rate is 3%, then your total rate of interest for unpaid balances is 11%

Revolving Credit: Credit made available for use at any time, subject to terms of repayment

- Credit cards provide a revolving line of credit that you must pay off

Default Rate: Accelerated rate of interest (usually 28% to 35%) charged on your credit balance as a penalty when either

- Issuer did not meet the minimum payment due
- Paymet is not honored by your bank (e.g. bounched check)

Balance Transfer Fee: Fee charged when transferring the credit card balance from one provider to another, usually between 2% to 5% of the balance being transferred

Grace Period: Period of the billing cycle in which no penalty is due as long as payment is received on time by the lender

Stop Payment: Requesting the bank to reject payment of a check when presented

1.3 Fine Print

Questions to ask when applying for credit

- What is the interest rate on unpaid balances?
- What is the creid tlimit?
- What is the minimum payment required to avoid penalty? (e.g. 3% of oustanding balance)
- Is there a grace period?

2 Credit Reports and Credit Scores

Credit Report: Financial report card telling you if you have been making payments on time, as well as personal information. All of this information determines you **credit score**

- **Note**: Your credit score is not part of the credit report

There are 3 major reporting agencies

- Transunion (Empirica score)
- Equifax (Beacon score)
- Experian (Experian model)

Requests to see your report are either

- **Voluntary**: requests authorized by you so that a lender can legally get a copy of your credit report
- **Involuntary**: requests from lenders interested in soliciting you by mail for a preapproved credit offer

2.1 Three Important Numbers

Your 3 digit **FICO score** determines if you are a good or bad credit risk. The higher the score, the more likely you will repay loans

- Each credit bureau may have slightly different FICO scores

3 Contracts

Contract: Binding agreement made by two or more competent parties

- 2 party contracts are referred to as **bilateral** contracts
- Contracts with 3 or more parties are called **multilateral** contracts
- Commitements in a contract may last a long time and have serious repercussions if violated

Before a contract can be binding, all parties must offer a **condieration**: a mutual obligation to perform in exchange for something of value

Checklist of things to consider when looking at a contact

- Know how much you are required to pay and when
- Know how long the term of contract will be
- Know how amendments can be made to the contract
- What happens if either party fails to perform?
- Make sure all blanks are filled so changes cannot be made without your knowing about them
- Get a copy of the contract you sign

4 Social Security and Medicare

4.1 Social Security

Social Security is an **entitlement program** with a few basic requirements to receive retirement benefits

- Age
- Required number of quarters you have paid the system
- Minimal amount of income earned over those quarters
- Citizen or lawlful alien

Social security was designed when life expectancies were shorter. In modern times, more elders are taking from the program and fewer young workers are contributing to the program

Currently, seniors can take full benefits at 66 and 4 months, or reduced benefits at age 62

- By taking early retirement at age 62, the monthly retirement benefit is reduced by 25%

4.2 Medicare

Medicare is a three-part health care entitlement program for most people at age 65. Similar to Social Security, Medicare is spending far more than it takes in

- Part A of Medicare is free to seniors who apply, covering major items such as hospitals, nursing homes
- Part B of Medicare is optional and include doctor, lab work, and other services
  - Recipients are responsible for monthly premiums, copayments, and deductibles and costs not eligible for Medicare
- Part D of Medicare is optional and is a prescription drug plan provided by private insruance companies funded by monthly premiums and taxes
  - Only covers prescription drugs

5 Government Revenue and Expenses

Over your lifetime, taxes are probably your biggest single expense. Thus your goal is to

- Conserve as much income as you can by only paying taxes you are required to pay
- Take advantage of special tax subsidies such as home ownership, medical care
- Better manage your investments

Federal income tax is pay-as-you-go, which has 2 ways of operating

- Your employer is required to withhold and pay the Treasury a tax based on your **filing status** (single, married, etc.)
- Your **payroll amount**

You may also be required to pay an additional **quartely estimated tax** based on income for which no tax has been withheld (e.g. comissions) and income from royalties

W-4 form lets your employer know how much it must deduct from your paycheck for your personal income taxes, both federal and state

5.1 Tax Basics

Filing Status: Single, married filing jointly, married filing separately, head of household, and window with dependent child. These status determines the tax bracket that apply to your income

Earned Income: All money you have received for your personal services

- These are evidenced by a W-2 form from each employer to be filed with your tax return

Total Income: This is earned income plus **unearned income** (e.g. taxable interest, capital gains on investments, etc).

Adjusted Gross Income (AGI): Subtract from the total income any specific deductions such as contributions to retirement plans, student loan interest, etc

Capital Gain Tax: Reported on the designated Form 1040 and is a tax on profit from the sale of an asset which you won (e.g. stocks, bonds, real estate). There are 2 types of capital gains

- **Short Term**: Assets owned 12 months or less. The profit is added to your income and is taxed at your individual tax rate
- **Long Term**: Assets owned over 12 months. The profit is subject to a different tax rate
- **Note**: **Capital Losses** can be used to offset capital gains for tax purposes. First apply short-term losses against short-term gains, then long-term losses against long-term gains
- **Note**: Capital losses in excess of gains can be used to reduce taxable ordinary income, up to a $3,000 per year. Any remaining losses beyond this cap can be carried forward to offset future years' capital gains until the loss is exhausted

Tax Deductions: Expenses you are permitted to subtract from your taxable income

- **Standard Deductions**: No-questions asked deductions to income before calculating taxes. No records are required
  - If you are single, standard deduction is $12,000
  - If you are married and filing jointly, standard deduction is $24,000
- **Itemized Deductions**: Itemize several deducions on the 1040 form. Make sure to maintain records since proof may be required

Tax Credit: Reduce the amount of tax you owe dollar for dollar and are worth more than tax deduction since the latter only targets taxable income

Marriage Tax Penalty: Those who are married may have additional taxes if their combined income exceeds $400,000

Gift Tax: Tax to prevent people from avoiding estate taxes by giving away their assets anticipating death

Federal Estate Tax

Excise Tax: Tax on purchases of a specific product (e.g. furs)

6 Beginning to Save

Saving needs to become a priority. Investing is other half of the story

Cash sitting in a savings account is money loss due to inflation

6.1 Magic of Compounding

Compound Interest occurs when interest is paid on **both** the principal and accumulated interest

In comparison, **Simple Interest** is calculated as a percentage of the initial investment on an annual asis

Interest calculators exist but you can also use the **Rule of 72** to estimate how long it will take for a sum of money to double given the interest rate, assuming interest is compounded annually

- Divide 72 by the interest rate to see how many years it will take to double to money

- Divide 72 by the number of years it would take to double your money and it will tell you the interest rate you will need to earn it

6.2 Savings Guide

Establish an emergency fund to cover at least 3-6 months of living expenses

Contribute about 15% of your income to investing

- A simple investing is CDs or a money market deposit account, which will earn a higher rate of interest than a savings account

7 Investment Vehicles

7.1 Business Structures

Sole Proprietorship: Business owned by one person who is responsible for everything and thus has **unlimited personal liability**

- Sole Proprietors have a separate Schedule to file for their 1040 tax return

Partnership: Company owned by two or more entites. There are two types of partners

- **General Partner**: Manages and runs the partnership, and has unlimited liability
- **Limited Partner**: Invest in the business and have limited liability

Parternships do not pay federal income taxes. The individual parterns are allocated their proprotional share of the profits and losses, and pay taxes on these

Corporations: Have the greatest ability to raise large amounts of money and provide limited liability to its shareholders

- **Dividends** are parts of the earnings of a coporation that are distributed between the shareholders They are paid out of the coporation's **after-tax profits** and are usually distributed quarterly to shareholders
  - Dividends are taxed again to the shareholder. Thus **dividends** are taxed twice

Corporate structures include:

- **Character Corporations (C-Corp)**: Owned by shareholders who purchase shares and have the rite to vote on issues and receive dividends. These corporations file their own tax returns and shareholders are not responsible for taxes on the profits of the corporation
- **Subchapter S Corporation (S-Corp)**: Owned by shareholders but S-Corps don't pay dividends. Instead, profits and losses are passed through to the shareholders and reported on their individual tax returns
- **Limited Liability Coporation (LLC)**: Do not pay dividends to shareholders. Profits and losses are passed through to the owners individually and accounted for during their individual tax returns

7.2 Investment Instruments

Common Stock: