

INVESTMENTS



COMMENTARY
by Christine Benz

Crafting a satisfying financial plan

Your future can be satisfied by the right plan

You’ve probably heard about studies showing that the typical American spends more time researching vacation destinations than crafting a financial plan. And let’s be honest here: Did financial planning even have a chance?

After all, thoughts of vacation are happy ones, whether your idea of a good trip is a trek in the Himalayas or lying on the beach with the sole occupation of keeping sand out of your cocktail.

Financial planning, meanwhile, conjures up drudgery for most of us: spreadsheets, calculators, financial statements — in short, something that feels a whole lot like our day jobs. For many, the thought of getting elbow-deep in their finances feels even worse than a day job — probably not surprising given that we’re coming through a period of stagnant wage growth for most earners, a housing market bust and two major bear markets over the past few decades.

But I think there’s another reason people get into vacation planning more than they do their financial lives. The former is one and done: Spend a few hours researching potential spots, consult with fellow travelers on the plan and book it. At the end, you have a feeling of satisfaction and something to look forward to.

Crafting a financial plan, meanwhile, is not one and done at all. It’s a process, something that you’re going to have to keep toiling with for the rest of your life.

But does it have to be that way? I’d say no. Individuals can bring a bit of “one and done” gratification to their financial plans by tackling their key financial tasks one at a time rather than viewing them as a time-sucking, soul-crushing black hole of obligation.

Helping you cross some of those key financial planning tasks off your list is the focus of this supplement. Harnessing research and guidance from Morningstar.com, this guide is designed to help you knock off many specific financial planning jobs, one by one.

Some of these tasks fall into the category of financial-planning 101 — crafting a budget and making sure you have an adequate emergency fund, for example. Others, such as reducing the drag of taxes on your portfolio or testing retirement readiness, are appropriate for more seasoned investors.

If you feel like you’re in good shape on one of the tasks or it’s not relevant to your financial life, you can move on to the next one. And even if you don’t make it all the way through, our goal is that you’ll end up more financially fit than you started out.

As always, you can count on Morningstar guidance to be objective — that is, we don’t have a vested interest in whether you choose to do business with one financial provider over another, or whether you buy individual stocks, mutual funds or exchange-traded funds.

The goal of this supplement, and all of our work on Morningstar.com, is to help individual investors improve their financial well-being so they can enjoy the nonfinancial parts of their lives. Like vacation.

Christine Benz is director of Personal Finance at Morningstar Inc.

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DAY 2: TAKE STOCK OF YOUR ASSETS AND LIABILITIES

Degree of difficulty: Moderate

Now that you’re getting warmed up, it’s time to move on to the key task that will show you how you’re doing financially: checking up on your net worth.

If you keep good records and don’t have many financial accounts, enumerating your assets and liabilities will be pretty straightforward and shouldn’t be time-consuming. You’ve got more work ahead of you if your records and portfolio are in a state of sprawl, but think of this as your impetus to streamline and get organized.

You don’t need to get especially fancy. To document your assets, simply retrieve your latest account balances and estimate the worth of your personal possessions, including real estate. On the other side of the ledger, record any debts you owe, including your mortgage, student, home equity or auto loans, and credit card balances. Subtract your liabilities from your assets and you’re looking at your net worth.

If your net worth is negative or barely positive, you’ve got your work cut out for you. Creating and sticking to a budget should be a key priority in the years ahead. And even if your net worth is comfortably positive, you still should spend time digging into the numbers. Is most of your money tied up in a single asset, such as company stock or your house? If so, a key goal should be to diversify your financial assets in the years ahead. Do you have an adequate amount — six months’ worth of living expenses at a minimum — stashed in an emergency fund? If you don’t, prioritize building up your position in ultrasafe (and unfortunately, ultra-low-yielding) investments before investing in longer-term assets like stocks.

DAY 3: CHECK YOUR EMERGENCY FUND

Degree of difficulty: Easy

Before you begin saving for your long-term goals, it’s crucial that you build an emergency fund — a basket of ultra-liquid investments that you can tap in case you lose your job or confront an unanticipated car or home repair.

The typical rule of thumb is to keep three to six months’ worth of living expenses in your emergency fund. But perhaps a better way to decide how much to store in cash is to think about how much of a cushion you’d like to have in case you lost your job. If you go through that exercise, you’re apt to conclude that three months’ worth of living expenses is nowhere near enough. But don’t go overboard with your cash hoard, either. After all, interest rates on money market accounts and funds are low, so being too conservative has an opportunity cost. As you calculate your emergency-fund requirement, don’t use your real spending patterns to set your living expenses. Think about how much you could get by on in a pinch, excluding dinners out, house cleaners and vacations.

Compare your emergency-fund target with the amount you have saved in CDs, money market accounts and funds, and checking and savings accounts. Don’t include cash holdings that appear in long-term mutual funds. Building your emergency fund up to your target level should trump saving and investing for other goals, such as retirement or college.

DAY 4: GET MAXIMUM MILEAGE FROM YOUR CASH HOLDINGS

Degree of difficulty: Easy to moderate

Everyone needs cash, both for an emergency fund and to cover upcoming expenses such as your property tax bill or college tuition. Keeping that money safe is important, but the big drawback is that yields on CDs, money market accounts and other cashlike vehicles often are low.

When shopping for the best yields on cash investments, the list of don’ts is almost as long as the list of dos. While it’s smart to be opportunistic and scout around for the best yields, my key piece of advice is not to get too cute. Safety is key for this portion of your portfolio, so resist the temptation to park some or all of your assets into a “cashlike” vehicle that offers a higher yield but also a greater risk to your principal. Ultrashort-bond funds and bank-loan funds are a great example of why you shouldn’t chase yield: Although some investors had used funds in both categories as a higher-yielding money market substitute, the average fund in these groups lost 8 percent and 30 percent, respectively, in 2008’s flight to quality.

CDs usually offer higher yields than money market funds and other cashlike vehicles, and they offer FDIC protection to boot. The big drawback is that you’re locking yourself into a fixed term and rate. Money market mutual funds, bank-offered money market accounts and high-yield savings accounts offered by online banks and credit unions can buy new, higher-yielding securities if rates move up.

If you’re in a high tax bracket, another



option for your cash is a municipal money market fund, whose income will be free of federal income tax. Most fund companies have a tax-equivalent yield function on their bond calculators that can help you determine whether you’re better off in a muni or taxable money market fund once the tax effects are factored in.

DAY 5: MAP OUT YOUR FINANCIAL GOALS

Degree of difficulty: Easy

Most of us have a running list of financial goals: whether it’s paying off our homes, financing college for the kids and grandkids, funding a comfortable retirement or paying for here-and-now creature comforts like vacations and new cars. Few people, however, take time to document their goals and quantify exactly how much they’ll cost, even though that step is key to helping you set your household’s financial priorities. It’s also pretty easy.

Today, take a moment to jot down your goals. Group them into one of three bands: short-term goals (goals you’d like to achieve in five or fewer years), intermediate-term goals (five to 15 years from now), and long-term goals (15 years or more in the future). Once you’ve done that, prioritize your goals within each time frame. Be sure to include debt retirement on your list of goals.

The next step is to estimate exactly how much those goals will cost you. If your goal is close at hand, such as buying a car next summer, quantifying it is straightforward. But if it’s a goal that’s further in the future or one that you’ll pay for over several years, the calculation may be more complicated and you’ll also have to factor in inflation. FinAid’s College Cost Projector (finaid.org) can help you calculate the cost of college using historic (and historically scary) inflation rates, and Bankrate’s Retirement Calculator (bankrate.com) shows you how much you’ll need to save for retirement. Morningstar.com’s Savings Calculator is a multipurpose calculator that helps you see the interplay between your current savings, future contributions, and your expected rate of return.

DAY 6: ALLOCATE CAPITAL LIKE A PRO

Degree of difficulty: Moderate to difficult

Although Morningstar focuses on helping you invest in stocks, funds and

exchange-traded funds, the reality is that investors’ highest-impact decisions precede the decision to invest in the market. Do you save enough? And when you have extra cash on hand, do you pay down debt, invest or do a little of both?

When it comes to the latter decision, it’s helpful to think of yourself as a business owner, steering your cash toward the opportunity that is apt to offer you the best return on your capital.

Paying off debt — even more benign types of debt like mortgage debt or student loans — offers you a knowable return on your money, which is always a good thing. If you’re receiving a tax break on your debt, as is the case with some mortgages and student loans, you’ll get less of a bang out of paying off the note prematurely. However, it’s worth noting that recent changes to the tax code — including higher standard deductions and new limits on the tax-deductibility of mortgage interest — mean that fewer taxpayers will receive a significant tax break from carrying a mortgage than was the case before.

Investing in the market offers a potentially higher rate of return, but the hitch is that return, unlike paying off debt, isn’t guaranteed. When forecasting returns for your investments, be conservative. I usually use a 6 percent rate of return for equities, a 2 percent return for bonds, and a 1 percent return for cash. Based on the asset mix of your portfolio, you then can forecast a ballpark return for it. Armed with that information, you then can determine whether investing in the market or paying off debt is the best return on your dough.

DAY 7: INVEST FOR MID-TERM GOALS

Degree of difficulty: Moderate

Yes, yields on truly safe investments like CDs and money market funds often are shrimpy. But if you’re building an emergency fund or saving for a goal that’s close at hand, the risks of venturing beyond ultra-safe investments outweigh any extra yield you’re able to pick up. It’s boring, but you’ll need to rely on your own savings, rather than investment returns, to do the heavy lifting in these instances.

But what if you’re saving for an intermediate-term goal and don’t expect to need the money for another couple of years or even more? In that case, you can tolerate modest fluctuations in the