

Personal Financial Planning

Authors: **Kwok Ho, Grady Perdue and Chris Robinson**
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This is now my favorite personal finance textbook, although it might not be everyone's cup of tea. It is designed to be an introductory personal textbook, but it has quite a few mathematical formulas. Example (p. 51):

$$W_n = W_0(1+k)^n + \sum_{t=1}^n (E_t - C_t)(1+k)^{n-t}$$

Of course, in English, this means (taken exactly from textbook):

Financial goal (at time n)

= Existing savings + investment income for n years on existing savings + (Earnings - consumption each year) + investment income on the annual savings, n .

You can earn a real annual rate of k on your savings.

The advantage of introducing the mathematical formulations is that students who understand it will be more likely to properly enter numbers in financial calculators, or set up a spreadsheet correctly. The authors extend the formula to retirement planning. In one example (pp. 52-53), they show that given \$5,000 annual savings, an investor would have to earn a 24% rate of return in order to reach his goal. Obviously (although not necessarily to students who have only experienced bull markets) that is an unrealistic projection, so what can he do? The authors point out that he can change his goal, change the initial investment, increase his annual savings, or change his investment horizon. An instructor might point out that the phrase "change his investment horizon" in this example means delaying the planned age of retirement.

The authors mention solving this problem by trial and error, and it would be up to the instructor to tell students that trial and error in this case would mean using a financial calculator (covered elsewhere in the text) or setting this up in a spreadsheet and using a *solve for* or

goal seeking feature.

An unanswered question in such problems is how does one allow for changing real income patterns? The usual answer is to contribute the same amount each year for a goal, even if the household income drops because of unemployment or some other reason. The Life Cycle Savings program (Hanna, Fan & Chang, 1995) provides a way to implement the formula with any type of projection of household income patterns, and without having to specify annual consumption.

Despite the dosages of mathematics, this book is not just another *Mathematics of Personal Finance*. The book is well written and has plenty of clear, plain English explanations. The book is far superior to any other personal finance textbook in topics I consider important, such as human capital and the surplus. For instance, in a section titled *How much did you save?* (p. 74) they describe an example of a family income statement where the net cash flow is \$1,044. "Appearances are deceiving, however, and they have saved a good deal more than that. ... they have been forced to save by repaying the principal on the mortgage, and by contributions to pension plans, too."

The book includes a number of cute and relevant *Sally Forth* comic strips. It includes more than the usual number of appendix tables, including mortality tables and nominal and real returns on financial assets. It also has an interesting table listing the significance of six different personal finance elements in eight family life cycle categories. The authors list elements as having low, medium, and high significance. I am not quite sure whether they intended this to be descriptive or prescriptive, but, for instance, retirement planning is not listed as having high significance until the *older, single* stage, and is listed as low significance for all stages with children. This is surely a limited view of retirement planning, perhaps similar to the audience for retirement

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planning seminars. Most who attend such seminars are over 50 but should have started thinking about retirement planning before age 30.

There is a good discussion of insurance, including the concept of the optimal deductible. The authors state (p. 192) "... many financial experts recommend that a deductible equal to 3% of your net worth." This rule of thumb should, of course, not be used for certain types of insurance, such as homeowners insurance. It is based on ideas about individual utility functions and typical loads on insurance policies, although I think it would be more reasonable to use total wealth, including human capital, as the basis of the rule of thumb (Hanna, 1989). Should a 25 year old with zero net worth choose the lowest deductible on an auto insurance collision policy? The reasonable answer is that a high deductible, perhaps \$500, should be chosen, as long as the person has some access to credit at reasonable rates. Those with higher net worth levels should choose very high deductibles. (I do not share the authors' opinion that one can say nothing about utility functions.) Besides homeowners insurance, the main exception to the high deductible rule for any private insurance is if the consumer knows that his or her true risk is much higher than what the insurance company would assume in setting rates.

The authors have a very sensible discussion of the risks to consider in deciding how much credit is safe (pp. 204-205). They also have a good discussion of ratios such as the Gross Debt Service (GDS). They state (p. 238) "For most families these rules are a reasonable guideline. However, suppose a family enjoys being able to travel to Europe every summer and ski at Aspen every winter. Their budget may not support even 30% GDS." Despite a good discussion of credit issues, however, they do not discuss bankruptcy anywhere in the book.

There is a good discussion of housing and of investing in real estate, and the risks of real estate. There is a good explanation of estimating the market value of a house. The authors point out that reliance on rental real estate as one's main investment for retirement is a flawed strategy, because of the lack of true diversification.

The coverage of investments is excellent. They come down 98% on the side of efficient markets, which makes their book better than most other personal finance textbooks. They state (p. 313) "There are as many theories about investing, strategy, and pricing, as there are grains of sand on a beach. Most of them are wrong." This textbook wisely avoids detailed discussion of

methods such as technical analysis, which has as much value as stock picking and timing based on astrological considerations. From my point of view, teaching students all of the many methods of picking stocks is a waste of time. Advocates of particular methods can always point to some time period when a particular method seems to work. Every so often, I distribute pennies to a class and ask students to flip the coins until they stop getting heads. The student who has the most heads in a row is proclaimed the best stock picker.

The authors suggest that equity index funds are the best choice for retirement funds, although they also discuss choosing some diversification between stocks and other financial asset categories. I think it is simpler to recommend 100% in an index stock fund for anyone more than 25 years away from retirement – there has never been a 25 year period since 1925 when this strategy would have been worse than any mixed portfolio.

The superiority of this book over other introductory, intermediate, or advanced personal textbooks is most apparent in its coverage of retirement planning. The authors have exceptional understanding of optimal investing during retirement, and do a pretty good job of clearly explaining the issues. They have a table (p. 410) that will be difficult to understand the first time most people view it, but it is well worth the effort. What is the optimal asset allocation for retirees? How much can you safely spend of your wealth each year in retirement? If you put all of your portfolio in inflation-linked bonds, then your assets would never run out, but you could only spend about 3% of your wealth each year. The historical record is even more dismal, and the more you try pushing your spending above 3% of your wealth, the greater the chance that you might run out of money if you live long enough. Most retirees should keep some proportion of their portfolios in stocks. I would add that if a retiree could cover most necessary expenses with pension income, a higher stock proportion would be more prudent than what the authors imply.

Rather than having a separate chapter on estate planning, the authors include that topic in a chapter titled *Maturation of the Retirement Plan*. This is surely a flaw, as it implies that only retired people should worry about estate planning. However, the discussion is very good. One little error – even though they discuss the 1998 unified credit of \$202,050 (p. 419) – on the following page, the old unified credit of \$192,800 is listed at the bottom of a table.

I have adopted this textbook for my financial planning class and will probably order it also for an intermediate class. The book's mixing of introductory coverage with references to the student's role as an advisor is somewhat curious. Clearly, the authors intend this book to be used for students planning to go into financial services careers. The last chapter includes an example of a financial plan.

I have started strongly recommending this textbook to graduate students who have not had a personal finance course at a U.S. university, as it has both a comprehensive introductory level coverage of personal finance topics, and an exemplary explanation of concepts that are important in personal finance research.

One minor irritation – the textbook manager of the university bookstore reported more than the usual hassles with obtaining the book, so if you order the book, warn the bookstore.

References

- Hanna, S. (1989). Risk aversion and optimal insurance deductibles. *American Council on Consumer Interests Proceedings*, 141-147.
- Hanna, S., Fan, X.J. & Y. R. Chang (1995). Optimal life cycle savings, *Financial Counseling and Planning*, 6, 1-15.