LESSON SIX

Dynamics of Financial Freedom

THE FINANCIAL PLAN AS YOUR CORNERSTONE

THE NEED FOR A PLAN

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Your *Plan for Financial Independence* will become the cornerstone of the estate and the life you are building. Before you invest in any venture it is wise to formulate your own financial plan that enables you to take a look at the entire picture of your financial situation now and to formulate a projection for the future. It should take into account all of your needs, both those that exist presently and those that may arise in the future. Begin by putting your financial house in order. Know what you have, what you are worth, what you want to acquire, and what net worth you wish to attain in the future.

As you develop your financial plan, you may find a need for consulting various types of advisors who can apply their expertise to your situation and help you formulate some basic strategies and principles upon which to build. Of course, you can work out your plan without help, gaining the information you need through research or trial and error. Remember, however, that one of the keys to achieving financial freedom is learning how to use other people's time. That principle applies here. Use the years of study and experience possessed by various types of experts who can help you develop and operate your plan. You will save time and avoid mistakes. Your personal advisors may include some or all of these:

1. Tax advisor (accountant and/or lawyer)
2. Real estate specialist
3. Accountant
4. Lawyer
5. Appraiser
6. Insurance agent
7. Engineer or construction expert
8. Banker
9. Stock broker

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LIQUID ASSETS

You always need to be able to put your hands on some cash reserves for unforeseen emergencies. The amount needed varies according to life style. Closely related to the need for cash reserves is the need to determine the security of your regular income. No hard and fast rules can be set out to govern the size of liquid reserves you should maintain; an old rule of thumb, however, is to have at least three months' living expenses in a savings or similar type of account. Liquid reserves should never be kept in a bank checking account where they draw no interest. One popular strategy for maintaining liquid reserves is to place them in interest-bearing savings accounts, Certificates of Deposit, or Money Market Certificates. The yield on Bank or Savings and Loan passbooks savings accounts is low and limited by law. But both a Savings and Loan Association and a Bank can offer considerably higher interest rates on Certificates of Deposit or Money Market Certificates than on a regular savings account. Certificates of Deposit or Money Market Certificates exact a substantial penalty for redemption before maturity, but they are excellent collateral for a loan in the event of an emergency.

U.S. Government Treasury Notes are also worth consideration. These Notes come in a minimum denomination of $1,000. Rates on Treasury Notes have climbed significantly in recent years and are considerably higher than the rates offered by savings banks.

The important point to remember is that some liquid reserves need to be available so that you will feel secure in taking the necessary steps to become financially independent. Be creative in providing liquid assets. Develop a number of attractive alternatives for assuring yourself that cash will be available in the event of an unexpected need.

MEDICAL INSURANCE

The high cost of medical care makes it essential to carry adequate accident and health insurance. Most employers today provide medical insurance plans for employees.

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Two types of health insurance are essential to your peace of mind. The first is ordinary health insurance which pays expenses after a small deductible for most illnesses. The second type is a major medical plan which pays expenses in the event of a long or catastrophic illness. Such plans have upper limits as high as $250,000 in benefits. In most plans, the insurance company pays 80%, and you pay 20% of the expenses. Examine available plans with an independent insurance agent and find a plan that fits your needs.

The importance of an adequate medical insurance program cannot be over-emphasized. There is no way to establish adequate cash reserves for catastrophic illness. A serious illness or accident might cost you two or three years' income — or more.

INCOME PROTECTION PLAN

Income protection plans guarantee you a certain income should you become disabled. The amount of disability income you would receive is usually less than your normal income, but would be a valuable asset during temporary or long-term illness. Many different income protection plans are offered. Because specific clauses limit how income will be paid, it is essential to read and understand the limitations under which the company will pay you on any income protection plan you consider. In some instances, the plan pays if you are not able to perform in your chosen profession, while other plans will pay only if you cannot work at all. When you have the security of a good income protection plan, you feel free to be more aggressive in your investment decisions.

LIFE INSURANCE

Review your life insurance program as you build your financial plan. The amount of life insurance you need depends upon your current savings position and the number and age of your dependents. It is obvious that in inflationary times, a relatively high level of protection is needed. Most families are under-insured.

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Two basic kinds of insurance are available: whole life and term. Term insurance provides basic coverage over a period of years, but carries no cash value. It is considerably cheaper than whole life. Most company or group insurance plans are term insurance. Whole, or ordinary life, in addition to providing life insurance, offers other benefits such as policy-holder dividends, loan features, or cash payments upon maturity. Always remember that the return from whole life insurance is too low to be valuable as an investment strategy.

Hundreds of ordinary and whole life plans are available, each with its own unique characteristics. Choose a reliable and knowledgeable insurance advisor and review your insurance plan as a part of your *Plan for Financial Independence.*

HOME OWNERSHIP

During the past two decades, the value of homes has risen faster than inflation. With the cost of construction and land continuing to rise, home ownership should be considered as a part of your financial plan. Home ownership presents three benefits:

1. A good hedge against inflation: the trend over the past several years suggests that the value of homes will continue to rise;

2. An effective and safe method of sheltering income from taxes: this assumes that you still have a mortgage with interest payments to deduct on your income tax return; and

3. The dividend your home pays every day by providing pleasant and secure surroundings for you and your family.

The combination of possible appreciation through inflation and available tax deductions makes home ownership preferable to renting for most people. A home owner receives two tax deductions: real estate taxes and the interest paid on the mortgage. The higher your income, the more advantageous these deductions become. The case for home ownership is compelling. While it is advantageous to own your home, over-extending yourself and living beyond your means cancels out all those benefits. While it usually provides good appreciation, home ownership can never take the place of the type of the investment strategies required to achieve financial independence.

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TAX SHELTERS

The term tax shelter is often misunderstood. What tax shelters do is to defer taxation — not eliminate it. In other words, when you are in a high tax bracket, you may receive an immediate tax write-off for certain items and pay the taxes later through capital gains or as income in the future when you will possibly be in a lower tax bracket. A variety of tax shelter plans is available, ranging from real estate depreciation to oil and gas depletion allowances and even to airplane or computer leasing. Tax shelters assume major importance when you are in a 50% or higher income tax bracket.

Two important facets of tax shelters must be examined. The first, and often misunderstood, is the amount of tax write-off involved. The second, and probably more important, is the economic benefit to be derived from the investment. It makes little sense to have 100% write-off of what you put in if you receive no long-term benefit. You could do better with your money by giving it to your favorite charity.

Real estate has long been an area that provides both tax shelter and economic benefits. Real estate investment is discussed extensively in Lessons Nine through Fourteen. In recent years, oil and gas exploration and production have become popular areas because of the substantial rise in the prices of petroleum products.

Many different types of investment tax shelters exist and any brokerage firm can supply information about them. Some projected plans for tax shelters border on fraud; be sure that tax-sheltered investments you consider are legitimate.

Two possible disadvantages to tax shelters should be considered. The first is the substantial sales charge incurred right off the top. The second is a lack of investment liquidity.

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Because tax laws are extremely complicated, a good understanding of the shelter and how it fits into your income is vital. Enlist the advice of a competent tax advisor to help you plan for tax shelters.

INDIVIDUAL RETIREMENT PLANS

The majority of people with any type of earning should have some form of retirement plan. The advantage of a retirement plan is that interest, dividends, and capital gains are tax-free throughout the life of the plan. The profits compounded over your working life time without paying taxes is substantial. Congress passed the Employee's Retirement Investment Security Act (ERISA) in 1974 to provide two major types of plans:

1. *The Keogh Plan*

   The Keogh Plan is for self-employed people like lawyers, dentists, accountants, doctors, and small businessmen who are not covered by other pension plans. The Keogh Plan currently allows an individual to contribute up to 15% of annual earnings to a maximum of $7,500. A $750 contribution is allowable regardless of the level of income.

2. *Individual Retirement Accounts*

   For those who do not qualify for a Keogh Plan, the Individual Retirement Account (IRA) allows an individual contribution of 15% of income each year, up to a maximum of $1,500. If your spouse has no pension plan, the limit is $1,750. Contributions need not be made each year, but if they are omitted in one year, they cannot be made up in subsequent years.

Either of these retirement plans must be invested with an authorized trustee. Alternatives range from Bank or Savings and Loan accounts to common stocks or mutual funds. How you invest your money will depend on how aggressive you want to be. If you have an income of $25,000 a year for a thirty-year period and invest a full 15% deduction at a long-term rate of return on common stocks of 9.2%, at the end of the 30 years, you would have $580,000. If you are eligible for the full

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$7,500 deduction under the Keogh Plan and you earn the same return of 9.2%, your estate would be worth $1,200,000 at the end of the 30-year period. Your retirement plan should, of course, consider the probable future buying power of the money and provide for supplementing it with other, more aggressive strategies. One of the advantages of a retirement plan is the freedom you have to be more aggressive in your investment program because you know that you have made provision for basic needs even if some of your investments fail.

If you withdraw your retirement funds before age 59½, you lose the tax shelter; you may, however, keep the tax shelter until you are 70 years old by leaving the fund untouched. The idea is that when you retire, you expect to be in a significantly lower income tax bracket; the tax due will be smaller, and you will have derived the benefit of compounded interest. Penalties for early withdrawal amount to 10% on any withdrawal and the entire amount withdrawn is, in addition, taxed at your current tax rate.

If you are not already covered through an employees' pension plan, consider the various plans available to you. They provide excellent tax shelters and their advantages should be considered as you design your financial plan.

A COMPLETED FINANCIAL PLAN

The main purpose of a financial plan is to provide you with the freedom to be more aggressive in the investment areas you choose. With your financial house in order, you can afford to take larger risks to achieve the kind of financial freedom you desire.

In the *Plan for Financial Independence*, turn to the tab sheet, **Defining Financial Priorities**. Review the portion of the introductory material dealing with **Net Worth Forecasting.** Look at the sample provided and then begin to make your own **Net Worth Forecast** for the next year.