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The ABC's (& D) of Personal Finance

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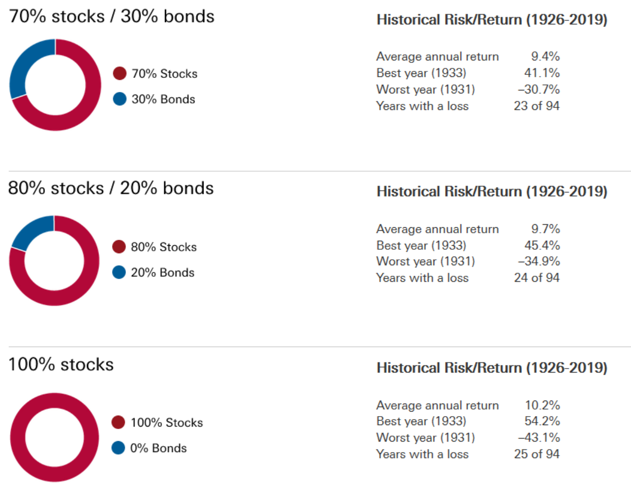
Success is almost always a relative term, but this is especially the case when it comes to your personal finances. Ultimately, you decide what financial success means to you. Regardless of the definition that works best for your situation, though, the means of achieving this financial success always start out the same—with a focus on and mastery of the basics. Like the building blocks of language taught in school, there are four foundational 'letters' in personal finance that will set the pace for the long-term success of any financial plan. In the spirit of this ongoing (and very unusual) school season, these letters are:

- A, for Asset Allocation
- B, for Balance Sheet
- C, for Cash Flow Statement; and
- D, for Debt Management

A is for your Asset Allocation

At a high level, your asset allocation is simply the amount of your portfolio invested in the financial markets in equities (stocks and related assets) vs. fixed income (including bonds and bond-like hybrids) and in other markets such as real estate or private equity—and even cash. Your asset allocation drives a large part of your expected return because it determines the amount of risk that your portfolio is assuming. A well-respected article published in Financial Analysts Journal about 20 years ago (Ibbotson and Kaplan) found that over 90% of the variability in returns over time was due to a portfolio's asset allocation. Generally, the higher portion of a portfolio that is invested in stocks or equity-like assets, the more volatile (risky) that portfolio will be and the higher level of average returns will be expected for the portfolio over time. It's important to note that this is not guaranteed, though. Below is a look at historical risk/return metrics from Vanguard for some selected different asset allocations over almost 100 years of real data.



From a planning perspective, your Asset Allocation decision is best made in alignment with your financial goals, risk tolerance, and investing time horizon. Further, it does not need to be a static, 'set it and forget it' decision over a lifetime. Priorities change, and with them, the 'right' asset allocation for a particular situation can and should change with them.

B is for your Balance Sheet

Your Balance Sheet is your personal list of assets, offset by your debts, for a given point in time (e.g., as of December 31, 2020). The difference between these two categories of assets and debts is your Net Worth. Why is tracking your Balance Sheet assets, debts, and Net Worth important? Quite simply, you can't improve what you don't measure! Keeping a personal score in these terms allows for comparison and deliberate decision-making. It's important to point out, though, that comparison does not mean vs. other people, as is often incorrectly assumed. Rather, the comparison you should be making in tracking your Balance Sheet is to yourself—both over time and vs. your personal goals.

After compiling a basic Balance Sheet, you can also use asset and debt categories to further refine your measurements and clarify potential actions. For instance, you can separate assets into Liquid and Illiquid or Short-Term and Long-Term categories to help you better understand where you are. The same can be done for debts, separating expected short-term liabilities such as for credit cards from longer term items like a mortgage.

C is for your Cash Flow Statement

As with your Balance Sheet, tracking your personal cash inflows and outflows allows for measurement. But while your Balance Sheet is a point-in-time statement, your Cash Flow Statement is created over a period of time. The most common unit of time here is annual, although you can create this statement for any relevant amount of time (monthly, quarterly, 5-year, etc). Essentially, your Cash Flow Statement shows what you are adding to (or subtracting from) the assets part of your Balance Sheet in each time period—your savings. You can further refine this to show various types of cash inflows and outflows as well as historical results vs. future projections, which is helpful when determining what activities to focus on or cut back on. Your savings rate (driven by the difference between inflows and outflows) is a major determinant in your future financial success, however you choose to define it.

D is for your Debt Management

Finally, your approach to any debt on your personal Balance Sheet can be either a source of stress on your financial plan or the means to achieving particular goals. Debt is commonly categorized as ‘good’ vs. ‘bad’. In this view, good debt is debt incurred to support education or purchase assets. Bad debt is usually debt associated with credit cards or personal loans used for activities with only temporary benefits. In reality, either form of debt can be detrimental to your plans if they are not properly correlated with your goals, though. Not all student loans or mortgages are ‘good’ if they are too big or not yielding enough future benefit. Similarly, debt that is used to purchase assets (i.e., leverage) can be a double-edged sword, amplifying benefits when markets are rising but also losses when they fall.

In addition, not all credit card debt is bad no matter what, if credit card payments are being managed responsibly. Credit and loans can simply be methods for smoothing out cash flows over multiple time periods, allowing for more predictable spending and savings even if cash inflows are volatile. In this sense, Debt management is a meaningful part of Cash Flow management—but also interwoven with your personal Balance Sheet and Asset Allocation.

E is for your Effort

I firmly believe that mastery of the basics in personal finance will enable long-term success, whether you are tackling your situation on your own or with the help of professionals in the field. Above all, though, having a plan will help you through the up’s and down’s of your financial life, which will rarely be a straight-line ascent. The size of the ultimate financial rewards is rarely apparent in advance for anything you do, but whether something is rewarding or not usually comes down to how well you utilize your Assets, Balance Sheet, Cash Flow, and Debt in alignment with your goals.

In the end, no plan is complete without supporting action. If you need encouragement or a friendly guide, asking for an initial (and usually free) discussion from a potential advisor to explain your situation and get the ball rolling is a great start.

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