Chapter 1

Understanding Personal Finance

# Learning objectives

1. Recognize the keys to achieving financial success.
2. Understand how the economy affects your personal financial success.
3. Think like an economist when making financial decisions.
4. Perform time value of money calculations in personal financial decision making.
5. Make smart decisions about your employee benefits.
6. Identify the professional certifications of providers of financial advice.

# Lecture outline

Introduction:

Distinguish between being financially literate and being financially responsible.

To-do-soon!

1. Get up to date on future economic conditions by going to www.conference-board.org to read their expectations for economic growth.

2. Do some time value of money calculations until you are comfortable using them.

3. Harness the power of compounding by starting early to save a consistent amount each month for a long-term goal.

4. When employed take advantage of tax sheltering through your employer’s benefits program.

5. Use marginal and opportunity costs when making an important financial decision.

1.1. Achieving personal financial success.

1.1a. The five fundamental steps in the financial planning process.

1.1b. You must plan for financial success and happiness.

1.1c. You must spend less so you can save and invest more.

1.1d. What you will accomplish studying personal finance?

>Figure 1-1 shows the building blocks to financial success

>Figure 1-2 shows how to get your financial house in order by age 30

1.1e. Replace you obsolete knowledge.

Concept Check 1.1

1. Explain the five fundamental steps in the financial planning process.

2. Distinguish among financial success financial security, and financial happiness.

3. Summarize what you will accomplish studying personal finance.

4. What are the building blocks to achieving financial success?

1.2. The economy affects your personal financial success.

1.2a. How to tell where we are in the business cycle.

1.2b. The business cycle

>The great recession

>The economic future will be expansion

>Figure 1-3 shows the phases of the business cycle

1.2c. How to tell the future direction of the economy.

>Procyclical indicators

>Countercyclical indicators

>Leading indicators

1.2d. The future direction of inflation and interest rates.

>Inflation is the typical economic condition

>How inflation is measured

>How inflation affects your income

>How inflation affects your consumption

>Deflation can be bad

>Inflation affects borrowing, saving and investing

>Track the federal funds rate

Concept Check 1.2

1. Summarize the phases of the business cycle.

2. Describe two statistics that help predict the future direction of the economy.

3. Give an example of how inflation affects income and consumption.

1.3. Think like an economist when making financial decisions.

1.3a. Consider opportunity costs.

1.3b. Identify marginal utility and costs in your decision making.

1.3c. Factor your marginal tax rate into your financial decisions.

1.3d. The very best kind of income is tax-exempt income.

1.3e. Tax-sheltered income is second best.

>Figure 1-4 shows the benefits of tax-sheltered returns

Concept Check 1.3

1. Define opportunity cost and give an example of how opportunity costs might affect your financial decision making.

2. Explain and give an example of how marginal utility and marginal cost makes some financial decisions easier.

3. Describe and give an example of how income taxes can affect financial decision making.

1.4. Perform time value of money calculations.

1.4a. There are only two common questions about money.

>Simple interest

>Compounding is the basis of all time value of money considerations

1.4b. Calculating future values.

>Future value of a lump sum

>Table 1-1 can be used to make calculations

>Figure 1-5 illustrates the future value of a lump sum

>Future value of a stream of payments (an annuity)

>Figure 1-6 illustrates the future value of a series of deposits

1.4c. Finding present values is called discounting.

>Present value of a lump sum

>Present value of a stream of payments (an annuity)

Concept Check 1.4

1. What are the two common questions about money?

2. Explain the difference between simple interest and compound interest, and describe why that difference is critical.

3. Use Table 1-1 to calculate the future value of (a) $2000 at 5 percent for four years, (b) $4500 at 9 percent for eight years, and (c) $10,000 at 6 percent for ten years.

1.5. Make smart money decisions at work.

1.5a. Open the new employee orientation package.

1.5b. Choosing tax-free cafeteria plan benefits.

1.5c. Making decisions about employer’s flexible spending accounts.

1.5d. Making decisions about employer-sponsored health care plans.

1.5e. Making decisions about participating in employer insurance plans.

1.5f. Making decisions about participating in your employer’s retirement plan.

>First advantage: Tax-deductible contributions

>Second advantage: Employer matching contributions

>Third advantage: Employer contributions are not current taxable income

>Table 1-2 shows the tax benefits of employer plans

>Fourth advantage: Tax-deferred growth

>Fifth advantage: Borrowing lets you tap your funds without income taxes

>Sixth advantage: Starting early really pays you one million dollars

Concept Check 1.5

1. What is a flexible spending account and what do pretax dollars have to do with it?

2. Summarize the benefits of participating in a high-deductible health care plan at work.

3. Create a math example of why many employees participate in a tax-sheltered

employee benefit plan, such as an HSA or 401(k) plan.

4. List two ways you can maximize the benefits from a tax-sheltered retirement

program.

1.6. Where to seek expert financial advice.

>Table 1-3 outlines the various providers of financial advice

1.6a. Not every financial advisor has your best interests in mind.

1.6b. How financial planners are compensated.

1.6c. Questions to ask a financial planner.

Concept Check 1.6

1. How does a professional financial planner differ from a local lawyer or insurance person in your community?

2. What are the four different ways financial planners may be compensated?

3. Describe two professional certification programs for financial planners.

4. List three questions that you think every person should ask a financial planner.

Conclusion:

Engaging in financial planning and implementing those plans, rather than simply earning a high income, is necessary for financial success.

What Do You Recommend Now?

Now that you have read this chapter, what do you recommend to Jing Wang regarding:

1. Participating in her employer’s 401(k) retirement plan?

2. Understanding the effects of her marginal tax rate on her financial decisions?

3. Considering the current state of the economy in her personal financial planning?

4. Using time value of money considerations to project what her IRA might be worth at age 63?

5. Using time value of money considerations to project what her 401(k) plan might be worth at age 63 if she were to participate fully?

Never ever!

1. Spend more than you earn.

2. Only think about money matters when you have a financial problem.

3.Believe and act upon financial advice from amateurs rather than trust professional sources.

# enhancing the classroom experience

In addition to the various exercises and discussion items in the text chapter, you might consider the following suggestions for improving student outcomes:

# Application Exercises

1. Allocate classroom time to have the students work in groups or individually on one or more of the end-of-chapter exercises highlighted by the “Do It In Class” icons on pages 33-34 of the Garman/Forgue text. These activities are designed to foster enhanced understanding and analytical skill. To ensure maximized outcomes you can assign reading of the pages indicated in the icons for the chosen exercise(s).

2. Engage in a classroom discussion of one or more of the “Let’s Talk About It” exercises found at the end of the chapter on page 33 of the Garman/Forgue text.

3. Assign as homework one or more of the “Be Your Own Financial Manager” exercises found at the end of the chapter on page 32 of the Garman/Forgue text.

4. Assign as homework one or more of the “Action Involvement” exercises found at the end of the chapter on page 35 of the Garman/Forgue text.

5. Explore the current state of consumer confidence at http://www.conference-board.org/.

6. Explore the current state of the economy at the BLS “Economy At a Glance” web page (www.bls.gov/eag/eag.us.htm).

7. Check the most recent report of the index of leading economic indicators at http:// https://www.conference-board.org/data/bcicountry.cfm?cid=1

8. Have students explore of the time value of money using the Excel templates available on the Garman/Forgue Website at www.cengage.com/finance/Garman. Have them play “what-if” scenarios using different rates, time periods, payments, and so on. For example, implication of saving $100 versus $150 a month in a tax-deferred account at 8 percent. See “Do the Math” exercise #3 for more examples.

9. Have the students complete Do the Math exercise #1 but substitute their own projected salary for the figures in the exercise.

10. Review the 14 examples of good financial behaviors listed on page 22 in the Garman/Forgue text. Ask the students to write a short paper on three of the examples that they already practice and three that they plan to put into practice in the next year.

11. Ask the students to write a short paper on how they would personally know that they have attained financial success.

12. Visit the Web site of the Jump$tart Coalition and explore its reality check interactive assessment of what it costs to live various life styles (http://www.jumpstart.org/reality-check.html). Work through various scenarios with your students to illustrate the costs involved.

**Video Clips**

Search YouTube, Hulu, Kiplinger.com or Bankrate.com for clips to show in class using terms from this chapter such as those below and others:

Inflation

Business cycle

Meet a financial planner

Leading economic indicators

Future value of money

Pay yourself first

Tax-sheltered retirement plan

Marginal tax bracket

Opportunity cost economics

Federal funds rate

Consumer price index

Financial literacy

**Just for Fun**

Play some music before and after class. The following songs fit this chapter:

Money by Pink Floyd

You Never Give Me Your Money by The Beatles

Money by Jerry Lee Lewis

Piggy Bank! by Denny Dey