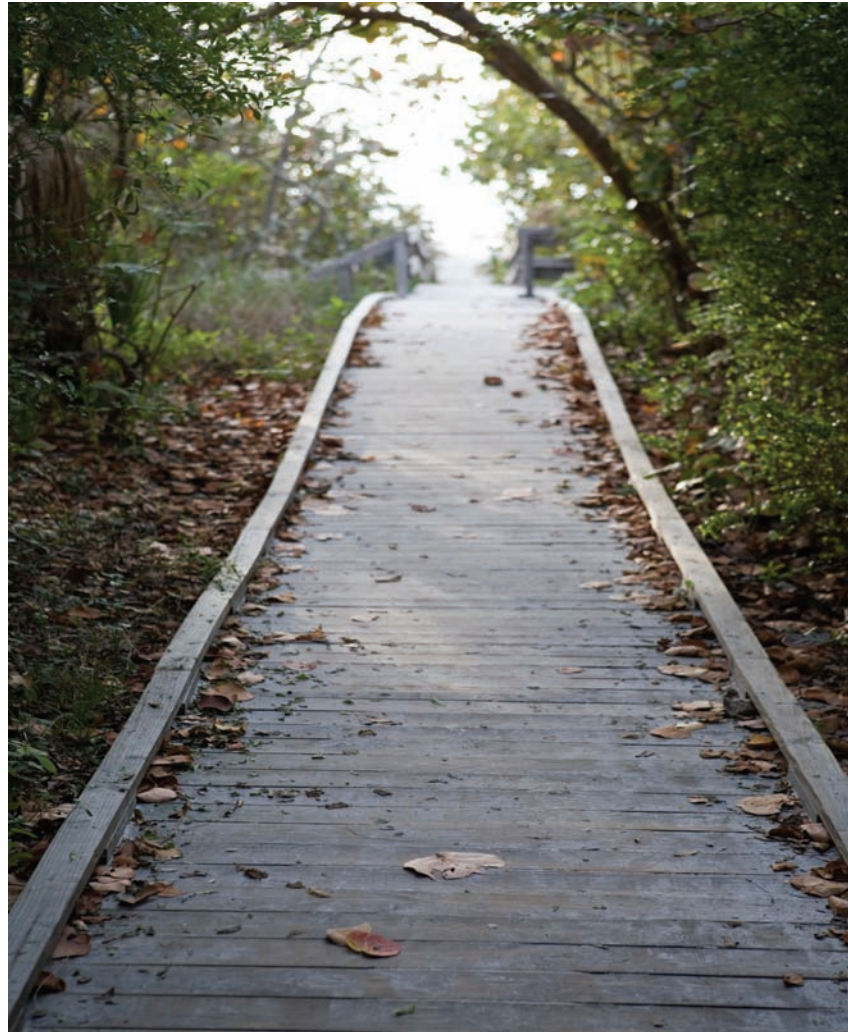




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# Financial Planning Basics



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**Prepared for:**  
Duane's Instructor Corner

## Setting Your Goals

When you set goals, you're defining your dreams for the future. Some of your goals may be things that you want soon, like paying off your credit card debt or buying a new car. Other goals may be more distant. Do you want to buy or build a new home? Start your own business? Pay for college for your child or grandchild? Retire early?

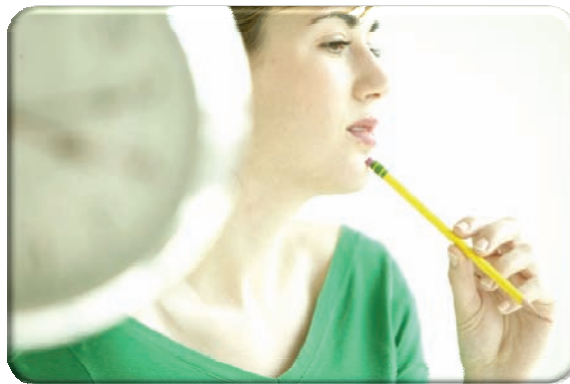
Your goals are the foundation of your financial plan because you need to know what you want to accomplish before you can begin saving or investing. Once you've identified and prioritized your financial goals, you can develop a clear-cut savings or investment strategy that can help turn your dreams into reality.



### How SMART are your goals?

To set clear-cut goals, make them SMART:

- ◆ **Specific** -- clearly defined and described in detail
- ◆ **Measurable** -- track your progress toward a definite endpoint
- ◆ **Attainable** -- realistic and reachable
- ◆ **Relevant** -- to your specific needs and values
- ◆ **Timely** -- subject to a clear deadline



**Writing down and prioritizing your goals is an essential first step toward putting a financial plan into action**

## Budgeting

The first part of putting any financial plan into action requires you to control your flow of money. A budget tracks your income and expenses, and helps you direct the flow in the way you want it to go.

To construct a budget, first account for all your income. This includes your paycheck, plus any income you might have from other sources such as rental income or government benefits, interest on money you have in the bank, or investment income.

From that, you'll need to subtract your expenses. Expenses can be broken down into two categories. Fixed expenses are those you have to pay, such as rent or a mortgage payment, car payments and insurance, utilities, groceries, and clothing. Discretionary expenses are more optional items, such as eating out, entertainment, gifts, and vacations.

Now, subtract your average expenses for a given period (a month or year) from your income for the same period. Is there a positive number left over? That's good; you're "in the black" or running a surplus. A surplus can be converted into savings or an investment for the future.



But if you get a negative number, that's bad; you're "in the red" or running a deficit. You're spending more than you're making. The only thing that's going to change that equation is either increasing your income or decreasing your expenses (and it's the discretionary expenses--the "fun stuff"--that are easiest to reduce)--or both.

So, let's look on the bright side: you're running a surplus. One of the first things you want to do with that surplus is create an emergency fund.

### INCOME

1. Paycheck
2. Rental income
3. Government benefits
4. Interest
5. Investment income

### — EXPENSES

1. Fixed expenses
2. Discretionary expenses

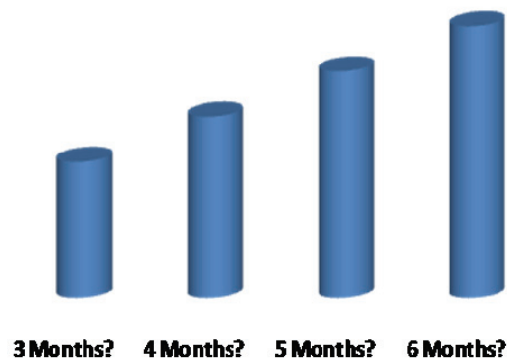
### = SURPLUS/DEFICIT

## An Emergency Fund

An emergency fund--money that's readily available to meet unexpected expenses--is really the foundation for any successful financial plan. Without money to fall back on when an unexpected expense crops up, you may be forced to tap into savings that you've earmarked for retirement, college, or another savings goal. But if you have an emergency fund, it will be much easier to handle a job loss, a temporary disability, or some other event that might prevent you from saving for the future or even tempt you to pile up debt.



### How much is enough?



A popular rule of thumb is that you should have an emergency fund equal to three to six months of your living expenses. But should you save three months, four months, five months, or six months worth of your expenses?

The amount you should have depends on many factors. How stable is your income? Do you work in an industry where layoffs are common, or are you in a growing field? Do you have adequate health and disability

insurance? Do you have other assets that you could tap without penalty in an emergency?

Where you keep your emergency fund is also important. In a jar is probably not the best idea. You'll want to keep your money in an account where it's readily available, but you'll also want to receive as high a return as possible. Rarely do you write one check equal to six months or even three months worth of expenses, so you may only need part of the fund in something as liquid as a savings or checking account. The balance of the emergency fund can be held in something with the potential to achieve a higher return, but that you can still access in a day or two.



## Risk Management with Insurance

Another important part of financial planning is identifying and managing the potential risks that can impact your finances. The value of insurance is that it's a cost-effective way to mitigate or share the potentially overwhelming cost of various risks.

- ◆ **Health Insurance** -- Most plans provide basic coverage for common medical expenses, such as doctor visits, preventive care, diagnostic tests, hospital and extended care, emergency services, and prescription drugs.
- ◆ **Auto Insurance** -- Liability insurance provides compensation to persons who would be able to sue you. Property damage insurance includes collision and comprehensive coverage.
- ◆ **Life Insurance** -- Income replacement to your survivors. It provides an income tax-free death benefit, and can be used to pay for funeral expenses and even medical expenses of a last illness.
- ◆ **Property Insurance** -- Covers a variety of risks that can cause damage to your home and personal property, medical payments for injuries to occupants and to other persons injured by accident while in your home, and loss or theft of personal property.
- ◆ **Liability Insurance** -- A last line of defense against potentially devastating claims for things over which you may have little or no control. It's often called umbrella insurance because it's carried over all other liability insurance and usually adds \$1,000,000 or more in extra coverage to your homeowners and automobile liability policies.
- ◆ **Disability Insurance** -- In the event you are out of work due to an injury or illness, disability income insurance benefits can be used to preserve your independence, maintain your lifestyle, give you time to recover, provide a chance to retrain for another job if necessary, and conserve your assets and savings for you and your family.
- ◆ **Long-Term Care Insurance** -- Private insurance that pays benefits if you need extended care, such as nursing home care. Long-term care insurance protects you against a specific financial risk--in this case, the chance that the need for long-term care will wipe out your life savings.



## The Three C's of Credit

- ✓ **Capacity**--Can you repay the credit you're granted? What's your income?
- ✓ **Character**--Will you repay the credit you're granted? What's your previous track record?
- ✓ **Collateral**--Is there tangible property that can secure the credit extended?

Your credit is determined on the basis of your:

- ◆ **Credit application**
- ◆ **Credit report**
- ◆ **Credit score**



**Caution:** Don't rely on credit to cover your normal living expenses. If you're using credit to pay for normal living expenses, it should be because it's convenient to do so--not because you don't have those expenses planned for in your budget.



## Debt

### Types of debt

- ◆ **Secured**--Backed up by a lien on collateral. Examples include a mortgage, a car loan, or a credit card secured by a bank deposit.
- ◆ **Unsecured**--Not collateralized. Examples include personal installment loans, student loans, and most credit cards.

### Important considerations

- ◆ **Amount**--The larger the amount you borrow, the larger your monthly payment.
- ◆ **Term**--The length of time you have to repay the loan. Longer terms may mean lower monthly payments but larger total interest charges.
- ◆ **Rate**--The higher the rate, the greater the total interest charge.

## Investing



Investing involves taking a certain amount of risk, and it also involves the

desire to compound your money over time. Done properly, investing is a carefully planned and prepared approach to managing your money, with the goal of accumulating the funds you need. And planning your investment strategy is about discipline and patience.

When it comes to investing, there's a direct relationship between risk and return. That is, in general, as the potential for return increases, so does the level of risk of loss. The investment plan that's right for you depends largely upon your level of comfort with risk--what's known as your risk tolerance. You can't completely avoid risk when it comes to investing, but it's possible to manage it.

### Risk tolerance: two key questions

First, how comfortable are you personally with risk? This is a subjective measure, and it depends on many factors, including your financial goals, life stage, personality, and investment experience.

The second key question is: how well is your investment plan set up to handle potential losses? The more resilient your overall plan is when faced with any potential losses, the more risk it might be able to take on. For example, time can be a powerful ally. The longer you're going to be invested, the more flexibility your investment plan might have to survive setbacks along the way.

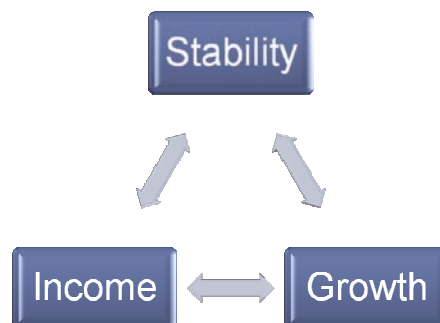
### Growth, income, stability

When it comes to investing, "growth" means that an investment has the potential to grow in value; if that happens, you might be able to sell it for more than you paid for it (of course, if an investment loses value, you could lose principal).

Income comes from regular payments of money. Interest on a savings account is income. So is interest on a certificate of deposit, interest paid by a bond, and stock dividends.

Stability, the third potential objective of an investment, refers to protecting your principal. An investment that focuses on stability concentrates less on increasing the value of that investment, and more on trying to ensure that it doesn't lose value.

As much as we might like to, we can't have it all. There is a relationship between growth, income, and the stability of our investments. The more important one of those areas becomes, the more you may have to trade off in terms of the other two. The key is to tailor your investments according to what you want them to do for you, and to balance stability, income, and growth so that you maximize your overall returns at a level of risk that you're comfortable with.



## Income Tax Considerations

Taxes can take a big bite out of your total investment returns, so it's helpful to consider tax-advantaged strategies whenever possible (keep in mind, though, that investment decisions shouldn't be driven solely by tax considerations).

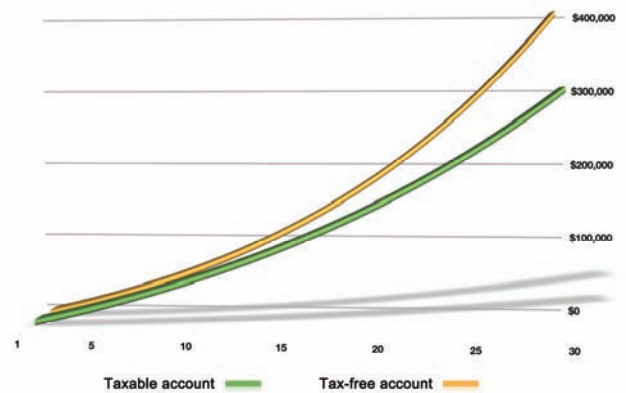
For example, retirement plans like 401(k) plans and 403(b) plans allow you to contribute a percentage of your earnings on a pretax basis, and funds in the plans aren't taxed until with-

drawn. Other savings vehicles, like Roth 401(k)s and Roth IRAs, are funded with after-tax dollars, but if certain requirements are met, withdrawals are federal income tax free. Note, however, that with all of these plans, a penalty tax applies (in addition to any ordinary income tax due) if you make a withdrawal without satisfying certain conditions (e.g., reaching a minimum age, or satisfying a holding period), unless an exception applies.

### How big an effect can income tax have?

Assume two people have \$5,000 to invest every year for a period of 30 years. One person invests in a potentially tax-free account like a Roth 401(k) that earns exactly 6% per year, and the other person invests in a taxable account that also earns exactly 6% each year, using funds from the taxable account to pay any taxes due each year.

Assuming a tax rate of 28%, in 30 years the tax-free account will be worth \$395,291, while the taxable account will be worth \$295,896. That's a difference of \$99,395.



This hypothetical example is for illustrative purposes only, and its results are not representative of any specific investment or mix of investments. Actual results will vary. The taxable account balance assumes that earnings are taxed as ordinary income and does not reflect possible lower maximum tax rates on capital gains and dividends which would make the taxable investment return more favorable thereby reducing the difference in performance between the accounts shown. Investment fees and expenses have not been deducted. If they had been, the results would have been lower. You should consider your personal investment horizon and income tax brackets, both current and anticipated, when making an investment decision as these may further impact the results of the comparison. This illustration assumes a fixed annual rate of return; the rate of return on your actual investment portfolio will be different, and will vary over time, according to actual market performance. This is particularly true for long-term investments. It is important to note that investments offering the potential for higher rates of return also involve a higher degree of risk to principal.

## Saving for College with a 529 Plan



Perhaps your potential Harvard graduate is still in diapers. But, given the high cost of college, you'd be smart to start a systematic college savings plan now. And one of the options available for saving for college is a 529 plan.

A 529 plan is a savings vehicle that is governed by the federal government but offered by states. There

are actually two types of 529 plans: college savings plans and prepaid tuition plans.

A college savings plan is an individual investment account to which you contribute. Your money is allocated to your choice of one of the plan's pre-established investment portfolios. Returns aren't guaranteed, but funds can be used at any accredited college. Almost every state offers a 529 college savings plan, and you can join any state's plan.

### College savings plans

- Individual account
- Pre-established portfolios
- Returns not guaranteed
- Can be used at any college
- Can join any state's plan

### Prepaid tuition plans

- Prepay tuition today
- Return guaranteed – in form of tuition coverage
- Limited to your state's plan
- In-state public colleges

As its name suggests, in a prepaid tuition plan you actually prepay your child's college tuition at today's prices. The contribution you make today is generally

guaranteed to cover a certain percentage of college tuition tomorrow. However, you are typically limited to your own state's plan, and your child is limited to the colleges that participate in the plan--generally in-state public colleges.

The main benefit of a 529 plan is that your contributions grow tax deferred and earnings are completely tax free at the federal level (and typically at the state level too) when they are withdrawn to pay the beneficiary's qualified education expenses. However, withdrawals that aren't used for qualified expenses are subject to federal income tax as well as a 10% penalty tax. Additionally, there are fees and expenses associated with both types of 529 plans.

**Note:** *Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans carefully before investing. More information about 529 plans is available in the issuer's official statement, which should be read carefully before investing. Also, before investing, consider whether your state offers a 529 plan that provides residents with favorable state tax benefits.*

## Saving for Retirement

### Basic considerations

- ◆ **What kind of retirement do you want?**  
To a large extent, maintaining financial independence in retirement depends upon the lifestyle you want.
- ◆ **When do you want to retire?**  
The earlier you retire, the shorter the period of time you have to accumulate funds, and the longer the period of time those dollars will need to last.
- ◆ **How long will retirement last?**  
Keep in mind that life expectancy has increased at a steady pace over the years, and is expected to continue increasing. For many of us, it's not unreasonable to plan for a retirement period that lasts for 25 years or more.
- ◆ **401(k)/403(b) plans** -- Pretax contributions reduce your current taxable income. Funds aren't taxed until withdrawn. May include employer contributions. These plans can also allow after-tax Roth contributions--there's no up-front tax benefit, but qualified distributions are federal income tax free.
- ◆ **Traditional IRAs** -- Can reduce your current taxable income if you qualify to make tax-deductible contributions, and funds in the IRA aren't taxed until withdrawn.
- ◆ **Roth IRAs** -- Your after-tax contributions provide no up-front tax benefit, but qualified withdrawals are federal income tax free.

One of the best ways to accumulate funds for your retirement is to take advantage of special tax-advantaged retirement savings vehicles, such as:

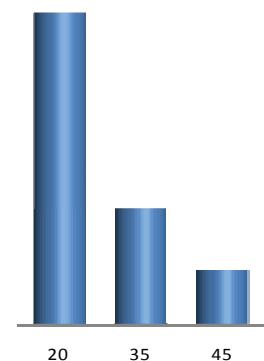
In addition to any regular income tax due, a 10% penalty tax may apply to a distribution from one of these plans made prior to age 59½ unless an exception applies.

### Start planning now

Many people assume they can hold off saving for retirement and make up the difference later. But this can be a very costly mistake. The further off your retirement is, the more time your investments have the potential to grow.

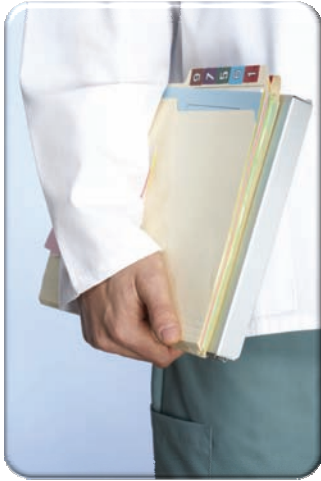
For example, invest \$3,000 every year starting when you're 20 years old. If your annual growth rate is exactly 6% per year, and you retire after age 65, you will have accumulated almost \$680,000 (assuming no tax). If you wait until age 35 and start saving \$3,000 annually, you'll accumulate only about \$254,000. And, if you wait until age 45 to start saving, you'll accumulate only about \$120,000 by the time you retire.

Of course, this is an illustration only, and assumes a fixed rate of return. The rate of return on your actual investment portfolio will be different, and will vary over time, according to actual market performance. This is particularly true for long-term investments.



## Estate Planning

### Planning for incapacity



Incapacity describes a condition in which you are legally unable to make your own decisions. What might happen if you were to become the victim of an accident that puts you in a coma for several months? How would your doctor know what medical treatments you would want or not want if you can't speak for yourself? How would your personal business be transacted if no one is authorized to sign documents for you?

Someone would have to go to court and get legal permission to do things for you. And that person, known as a guardian, would have to go back to court every time permission is needed. Further, without any prepared instructions from you, your guardian might make decisions that would be different from what you

would have decided.

Fortunately, these situations can be avoided with proper planning. Health-care directives allow you to leave instructions about the medical care you would want if conditions were such that you couldn't express your own wishes. And property management tools insure you can have your financial affairs taken care of for you in the event you become incapacitated.

### Wills

Without a will, your property at your death will be distributed according to your state's intestacy laws. Your wishes are irrelevant. A will:

- ◆ Directs how your property will be distributed
- ◆ Names an executor and a guardian of your minor children
- ◆ Can accomplish other estate planning goals, such as minimizing taxes

To be valid, your will must be in writing and signed by you. Your signature must also be witnessed.





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