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Introduction

Life is simple, but not easy. The same could be said for managing your finances. It's not easy to be financially disciplined, but that doesn't mean that it has to be complicated. A concise set of basic principles can go a long way towards helping you secure your financial freedom. Yet even for individuals who work hard to be financially sound, there is always that lagging question: Am I doing it right?

Every individual's circumstances are unique. And the more complex your situation, the more effort is required to develop a financial plan. The goal of this paper isn't to answer everyone's specific questions and concerns, but instead to lay out a brief and general blueprint that can serve as a foundation for future discussions.

The investment writer Charles Ellis calls investing a "loser's game" – like amateur tennis, the victors aren't the ones that hit the most winners, *but instead the ones that commit the least unforced errors*. The most important step to being financially smart is avoiding mistakes.

The "usual suspects" can be classified into three areas: (1) overspending your income and taking out high cost debt, (2) turning down free money, and (3) paying high fees and expenses for financial services. Avoid these errors like the plague!

The methodology outlined in this paper takes a "waterfall" approach to thinking about your personal finances – each step can be explored after the steps before it have been completed. We think that many will find the process useful, although it could be particularly helpful for young professionals. The process ranks how you should approach saving and investing decisions based on a combination of potential returns and possible risk. You want to do whatever gives you the highest expected returns, but you also want to guard against outsized and unacceptable risks.

Again, this should not be taken as advice for your own situation, which may have multiple complicating factors. But hopefully it is good food for thought.

"I do have a diversified retirement plan: 30% hopes, 30% wishes, 40% prayers."

Step 1: Stay out of debt.
Debt causes many more problems than it solves. Try as hard as you can to stay away from debt, especially high-cost debt like credit cards. Debt can make sense in some situations, primarily when used to finance the purchase of a home or an education. But even then, be careful. Owning a home usually makes financial sense only if you plan to stay in that specific residence for five years or more; otherwise, you will probably end up paying more in fees and interest than you build in home equity. If you do plan to stay in the house for five years or more, buying a house can make both financial and personal sense. And while an education is usually a great investment, certain colleges and programs have become excessively expensive. Make sure that you are getting your money's worth relative to a more affordable competing college or program.

(Note that while credit card debt is bad, credit cards can be good. They are generally regarded as more secure, can help you build your credit score and typically offer attractive cash back rewards. So use your credit card, just make sure to pay off the balance at the end of each month.)

Step 2: Consider refinancing existing debt.
Of course once you have debt, there is no magic potion to make it disappear. But refinancing existing debt at a lower interest rate can be like finding free money. Keep an eye out for opportunities to refinance your mortgage, student loans, etc. In most cases, you will have to pay some upfront fees and costs, so make sure that it's worth it. A simple way to check: will you save more from lower interest costs over the next year or two than you pay in upfront fees? If so, it may make sense to refinance.

Step 3: Spend less than you earn.
There is only one way to reach financial freedom: spend less than you earn. <u>This is the key to becoming wealthy.</u> Experts suggest that individuals should try to save at least 10-15% of their pre-tax income each year, and preferably more. Set your baseline savings target *before* you start spending money on consumption, not *after*, and try to increase your savings rate as your income rises. Only when you start to build your savings can you follow most of the subsequent steps outlined below, which detail how you should direct those savings.

Step 4: Build a cash reserve.
Before you start investing that nest egg, it makes sense to build a cash reserve in case of emergency. Experts suggest a savings account that covers three to six months of your after-tax income.

Step 5: If you have dependents, buy term life insurance.
If you have dependents that depend on your income, you need to make sure they are protected in case something happens to you. The world of insurance can be complicated, but experts agree that basic "term life" insurance policies will get the job done for most individuals. Term simply means that the policy is in place for a set period of time (meaning it doesn't last your whole life, like a whole or universal policy). Most term policies have set monthly payments for the entire term. Simple life insurance worksheets can be a useful guide for determining how much coverage you should purchase; please feel free to reach out to us if you'd like a copy of one. (Disability insurance may also be worth considering depending upon your specific circumstances and career choice.)

Step 6: Establish a will, a power of attorney and a healthcare power of attorney.
Although this step sounds scary, it is a relatively simple process that further ensures that your family is protected in case anything happens to you.

Step 7: Participate in your company's retirement plan and make sure you get the full match.
Most workers are eligible to participate in their company's retirement plan, and most plans include a company match. Companies structure their matches differently, but they typically agree to match a certain percentage of your contributions up to given threshold. Failing to take advantage of this match is the same thing as burning free money! Consider this: if your company matches 50-100% of your next dollar of contributions, you can earn a rate of return on your contribution of 50-100%. Who turns down an investment that offers a 50-100% rate of return?

There is another "free money" benefit to saving through your company's retirement plan – the money isn't taxed until you take it out in retirement. You don't pay taxes on the front-end (lowering this year's tax bill), and the investments are shielded from taxes while they grow in value.

Step 8: Pay down high cost debt as fast as you can!

High cost debt can include credit cards, private student loans, and other loans. After getting your company's retirement match, use excess savings to pay these high cost loans down as fast as you can. (Lower cost debt may not be as immediate of a concern versus saving more for retirement.)

Step 9: If you plan to fund your children's education, consider establishing a 529 plan and taking full advantage of your state's benefits.

Whether or not you wish to fund some or all of your children's college education is a personal choice. If you are set on making this sacrifice, then a 529 plan may help you get the government to chip in. The rules of each state differ – some are quite advantageous, others less so. Indiana has a nice package – taxpayers get a 20% credit for every dollar they put into 529 plans up to $5,000. This means that if you put $5,000 in this year, you will get $1,000 back on your taxes – that's a 20% rate of return (assuming you pay enough in state tax)! Further, the money is never taxed – not while it grows and not when you take it out (as long as it is used for qualified educational expenses). For more information, please see the white paper on the subject posted on our website. If funding someone's college education is only a secondary goal, you may want to move this step down one spot.

Step 10: Direct additional savings to tax-advantaged accounts.

Hopefully, you can still save additional money after you've maxed out the benefits from previous steps. Then keep saving. The simplest thing to do is just direct a larger contribution to your company's retirement plan. This works for most people and keeps things simple.

There are a few wrinkles, however, that could yield additional benefits. If you or your spouse are in a high deductible health plan, you should be eligible for a health savings account (HSA). HSA's are excellent *retirement* accounts, because if utilized correctly, you never get taxed on the money – not on the front-end, not while the money is in the account, and not on the back-end when you take it out (as long as it's used for qualifying medical expenses, which will likely be material later in your life). In order to maximize this benefit, you need to open an HSA with a provider that allows you to invest within the account, and then treat the account like a retirement account, not a health spending account. For more information, see our white paper on the subject, posted on our website.

Some individuals may also consider a Roth Individual Retirement Account (Roth IRA). A Roth IRA is a lot like your company's retirement account, except you are taxed on the front-end and not the back-end (a typical company retirement account is the opposite – you are taxed on the back-end, not the front-end). A Roth IRA makes sense for someone if they believe that their tax rate will be *higher* when they take the money out in retirement than it is now. You can only participate if your income is below a defined threshold. Some company retirement accounts allow you to utilize a Roth feature as well. Individuals who are near their peak earnings may not need to worry about a Roth. But young professionals or individuals who are in low tax brackets may find that Roth IRAs are excellent savings vehicles.

If you are not eligible for a company-sponsored investment plan, then you can simply utilize one of the accounts listed above or establish a traditional Individual Retirement Account (IRA).

Keep in mind that all of these accounts have maximum annual contributions set by the IRS. Because the benefits are material, the government limits how much you can put into these accounts. Most young professionals, however, won't hit these limits. If an individual does hit the limits, they can then open up a regular taxable investment account for additional savings.

Step 11: Avoid bad investment decisions.

Okay, so you are diligently saving all of this money in these intelligent, tax-advantaged accounts – how do you invest it? We are not going to delve into investment theory here, and the right answer likely depends on your own unique situation. But the theme is the same – avoid bad mistakes! Three common investment errors get people into trouble:

1. Paying excessive fees and expenses
2. Investing in things they don't understand, especially tips and fads
3. Trying to time the stock market by jumping in and out of it, especially buying high and selling low

If you stay away from these three mistakes, you are highly likely to have a good investment experience over the long-haul. And thankfully, most investment plans include an autopilot option that essentially guarantees that you will avoid these mistakes: low-cost, target-date funds. These funds invest based on your expected retirement date (or the date that your child is planning to attend college), utilizing a low-cost, diversified portfolio of stocks and bonds. They gradually get more conservative as you near your retirement date (or your child nears college age). They don't jump into and out of the stock market but focus on the long haul. If you choose the right fund, and just keep adding to it, you should do fine. Just make sure your selection is both low-cost and well diversified.

By the way, we aren't fans of complicated, high-cost annuity products. That doesn't mean all of them are terrible or that they can't make sense for certain individuals. But we've looked at a lot of them over our careers (we've never recommended them and none of us own one), and we've seldom been impressed. Our advice would be to stay away.

Conclusion

Again, this is a general blueprint, and it may need tweaked based upon your own individual circumstances. If you feel unsure about carrying out this plan, establishing the right accounts, or sticking to the plan, it may help to consult a financial advisor. A trusted advisor can add value by helping you put together a plan, execute that plan and ensure that you avoid any costly mistakes. Try to find someone you trust who charges reasonable and aligned fees (be leery of commissions), eats their own cooking (follows their own advice and invests in what they recommend), and is focused on providing financial and investment advice (not on selling ancillary services or products). And make sure that they operate as a fiduciary, meaning they are required to put your interests first. It's hard to believe, but some advisors operate under a "suitability" standard, where they don't have to recommend what is in your best interest, but simply what can be deemed suitable. Use the blueprint outlined in this paper as a template to walk through potential strategies with the advisor.

This 11-point plan isn't rocket science. *It's simple, but not easy*. But getting it right is vitally important, especially in today's world, where individuals are living longer, health care costs are rising faster than inflation, and Medicare and Social Security are financially challenged.

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