



The Components Of A Quality Financial Plan



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The Components Of A Quality Financial Plan

With all of the free “quick retirement calculators” available today, many investors are asking why they need the assistance of a financial advisor to prepare a complete financial plan. Unfortunately, many people who decide to use a free calculator to plan for their retirement will find out too late that those calculators are simply not designed to be a financial plan, but merely to give a “starting point” or “wake up call”.

Consider the retirement calculator found on the website of a large financial institution. It asks only six simple questions and provides a unique “number” — or total amount you will need at retirement. However, the disclaimer reads that “this information does not serve, either directly or indirectly as legal, financial or tax advice and you should always consult a qualified professional legal, financial, and/or tax advisor when making decisions...”. In fact, after you are shown “your number”, it states that the **next step** is to share it with your financial professional to start planning. So why are so many investors substituting the calculator for a financial plan?

FYI

The effectiveness of your financial plan is 100% dependent on the quality of the information taken into account and the quality of the professional preparing the plan.

The six questions that it asks are only a fraction of the total number of variables that should be considered in a quality financial plan. The effectiveness of your financial plan is 100% dependent on the quality of the information taken into account and the quality of the professional preparing the plan.

When preparing a financial plan, there are five major areas to investigate before a plan is created and recommendations are made:

1. **Basic Information**
2. **Current Situation**
3. **Goals**
4. **Resources**
5. **Other Variables**

This report is designed to give you a basic understanding of these major areas so that you can gather and prepare the necessary data to create a quality financial plan. ❖

Basic Personal Information

Although it may seem obvious, many professionals and software packages that claim to do “planning” don’t even gather your basic personal information. Information you should expect to provide includes:

- **YOUR FULL NAME:** Including maiden name (if applicable), and nicknames.
- **MARITAL STATUS:** Not just whether you are single or married, but if you are divorced or widowed as well.
- **YOUR SPOUSE’S FULL NAME (IF APPLICABLE):** Including maiden name (if applicable), and nicknames.
- **YOUR DATE OF BIRTH:** Be careful with those professionals or software products that either ignore this information or only ask for an age. True planners know that the timing of many facets of a plan (social security, Required Minimum Distributions, and early withdrawal penalties) are affected by the month you were born.

- **YOUR SPOUSE’S DATE OF BIRTH**
 - **YOUR CITIZENSHIP STATUS:** Citizenship status can actually have a big effect on several areas of planning, including tax planning.
 - **YOUR SPOUSE’S CITIZENSHIP STATUS**
 - **YOUR MAILING ADDRESS AND PERMANENT RESIDENCE ADDRESS:** Tax planning, which is an integral part of your financial plan, often depends on the state you live in (or, more specifically, the state of your permanent residence).
 - **PREVIOUS MARRIAGES:** Many so-called professionals ignore the consequences of divorce and separation, such as beneficiary changes, alimony payments, child support, etc. There have been many cases where individuals forgot to change their beneficiary designations after a divorce, and the proceeds were paid to an ex-spouse. Social security benefits can also be affected by previous marriages.
 - **CHILDREN/DEPENDENT INFORMATION:** For proper planning, you will need to provide the names, birth dates, addresses, and information about spouses and children. If you support elderly parents, you will also need to provide information about them.
 - **EMPLOYER INFORMATION:** A true planner will look at your employer and your title or position. This is extremely critical for those who are self-employed.
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Current Situation

In order to create a roadmap to get where you want to go, you must know where you are starting from. Your current situation covers many areas of your finances and is not “optional” when creating your plan. Your current situation will cover the following areas:

- **YOUR CURRENT INCOME (BOTH SPOUSES):** You will need to provide information regarding your gross income, including salary, bonuses, and other sources. Be prepared with copies of paystubs, W-2s, and previous tax returns (2 years should be sufficient).
- **YOUR CURRENT EXPENSES:** In this area, nothing is unimportant. If you have a prepared budget, use it — if not, begin writing down a list of your expenses over the past year. Often you can look at previous bank statements to get a good idea of where your money goes. Don't forget taxes (income & property), insurance payments, pet expenses, charitable giving, and other infrequent expenditures.

- **YOUR CURRENT FINANCIAL POSITION:** Everyone should have a balance sheet or net worth statement that they update at least twice every year. On this balance sheet, you will have two categories:
 - **Assets:** Anything of value that you own, including real estate, vehicles, jewelry, art, bank accounts, investment accounts, and retirement accounts.
 - **Liabilities:** Anything that you owe, including a mortgage, credit card debt, personal loans, 401(k) loans, and margin balances in brokerage accounts. To figure your net worth, subtract your total liabilities from your total assets. Obviously, the goal is to have a positive net worth. If this isn't the case, debt reduction will be an extremely important part of your plan.

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- **CURRENT SAVINGS:** How much are you contributing to retirement plans at work? Is your employer contributing to your retirement account? Are you also depositing money into a savings account or brokerage account on a regular basis?
- **CURRENT INSURANCE:** Insurance is designed to prevent an event from causing catastrophic losses. There are many types of insurance: life, long-term care, health, property & casualty, and so on. All of these types of insurance should be considered in your plan. It is important to review your insurance

- coverage on a regular basis to make sure that your coverage is sufficient, that it is the right type, that it is the most cost-effective, and overall, that it helps you achieve your goals.
- **EMPLOYER-PAID BENEFITS:** Often insurance is thought of as the only benefit, but many employers also offer education reimbursement, paid time off, spousal benefits, discounts at various merchants, financial and personal counseling, and so on. All of these should be considered in your complete financial plan. ❖

Goals

Most people have many different goals in life, including home purchase, education, retirement, travel, and legacy goals. However, vague goals can make financial planning next to impossible. Sure you want to buy a vacation home; but what does it look like? Where is it at? Most importantly, what is the cost? Assigning a dollar value to your goals can be a difficult task, but is absolutely critical.

Defining your goals will not be something that happens overnight, and there is never a blanket answer. Many families would like to send their kids to college, but there is a huge difference in cost between an Ivy-League school and a state school. Although a state school is acceptable for the masses, if you've been dreaming of sending your child to Harvard, you must plan on the extra expense. When defining life goals, such as new cars, education, new homes, vacations, and other large purchases, keep the following in mind:

- **HOW MUCH WILL THIS COST?** Have a good idea, if not an exact dollar amount.
- **WHEN WILL THIS EXPENSE TAKE PLACE?** It is easy to determine education goals, since it is based on the age of the child. It can be much more difficult to put a date on a new home.

- **HOW OFTEN WILL THIS OCCUR?**

Do you want to take a vacation every year? Every 3 years? Be specific.

Your final goal should look something like this: In 2015, we would like to purchase a vacation home in Florida with the approximate cost being \$350,000. Or, starting in 2014, we would like to spend \$3,000 every year on a vacation to the Caribbean.

Similarly, retirement goals will vary from person to person. When you are thinking about retirement, ask yourself the following questions:

- **WHAT AGE DO I WANT TO RETIRE?**
- **WILL MY SPOUSE RETIRE AT THE SAME TIME?**
- **WHAT WILL I DO WITH MY FREE TIME?** (Remember to factor hobbies into your income needs!)
- **HOW MUCH NET, SPENDABLE INCOME WILL I NEED EVERY YEAR?** Always plan in net (of taxes) dollars. Taxes will change, so specifying a gross income need is simply not a good way to plan.

Retirement is not an easy thing to plan. For many people, the goal is so far out that it seems too difficult to envision. Start with an idea of what it will look like, and understand that things may change as you get closer to retirement.

Legacy goals can be tricky. There are many emotions involved, including denial. Death can be difficult to think about. But, we are all mortal, and in order to make sure that your loved ones are taken care of, you need to start creating legacy goals now. How much will your children need to live a comfortable life? Or would you prefer that they make it on their own? It's not easy, but it is an important part of your plan. ❖

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Resources

One of the most frustrating parts of financial calculators like the example given earlier is that they fail to take into account all of the resources available to you at retirement. Here is a partial list of resources that you may have to help you reach your goals:

- **CURRENT ASSETS:** Although this was also covered in “Current Situation”, your current assets cannot be left out of a plan. Look at retirement plans, brokerage accounts, bank accounts, real estate, and so on.
- **SOCIAL SECURITY:** Although the ability of the social security system to pay future benefits may be questionable, it is important to look at the benefits that are promised to you in the future. There are many things to take into consideration when looking at social security, such as the taxation of benefits, reductions through early benefits, and break-even points.

- **PENSIONS:** Pensions seem to be going by the wayside, but many employees still have benefits to consider. There can be a whole host of options that you will need to evaluate, including taking a full lump-sum, partial lump-sum, or income benefits. If you decide to take income benefits, do you need survivor benefits or can you maximize your pension benefits by incorporating life insurance? Do not make a decision without thoroughly evaluating each option, as it can make a huge impact on your ability to reach your goals.
- **RENTAL INCOME:** If you currently own rental properties, will you be selling those at retirement or continuing to draw the income stream? Your decision will not only be financial, but could also depend on whether you want to continue owning and/or managing the properties.
- **BUSINESS SALE/INCOME:** If you own a business, will you be selling that business when you retire or continuing to draw income? If you plan on selling the business, do you know how much you will need to net from the sale? If you plan on continuing to own the business as you draw income, do you know who will manage the business?
- **PART-TIME EMPLOYMENT:** Many retirees work part time doing things that they enjoy. Perhaps you would like to work at a library, garden nursery, or a woodworking shop. Although you may think of the income as minimal, remember to include this in your financial plan.
- **INHERITANCE:** Although it is not normally recommended to “plan” on receiving an inheritance, if it appears to be likely, you want to make sure that things pass to you tax efficiently and that you do consider the inheritance as potential assets in your financial plan. ❖

Outside Variables

There are many things beyond your control that you will want to consider in your planning. Some planners will call these “What-ifs” and a quality financial plan will address each of them.

- **INFLATION:** The old standard of using 3% inflation doesn’t seem reasonable anymore. Gas & food prices have risen substantially over the past few years, and who knows what will happen in the future? Your plan should be able to illustrate the effect of higher inflation on your ability to reach your goals.
- **TAXES:** We are currently living with some of the lowest tax rates in history. To create your plan with the assumption that these low taxes will last forever could be disastrous. This is why it is important to plan your goals on a net basis and consider the possibility of higher income taxes in the future.
- **INVESTMENT RISK AND RETURNS:** No one can predict what the market will do on a short-term basis. Although history has shown us that over a long period of time, the equity markets will rise, the past several months have proven that the markets can quickly take away the gains that were created. It is absolutely critical that you know what your risk tolerance is and invest accordingly.

However, when you prepare your plan, you may find that you need to take less risk than your maximum risk tolerance indicates. This is why it is important to prepare a quality financial plan before investing. Simply investing according to a risk-tolerance questionnaire may not be in your best interest.

- **EARLY PASSING OF YOU OR YOUR SPOUSE:** As mentioned above, death can be a tough subject to think about. However, you need to make sure that you have considered the possibility of an untimely death in your plan. Just because one spouse passes does not mean that living expenses drop by 50%, which is why often the surviving spouse’s income after an untimely death is not sufficient.
- **LONG-TERM CARE:** Although advances in medical care have increased life expectancies substantially, that can also mean increased expenses through long-term care facilities. Several years ago, a stroke may have meant certain death; today it may mean a few years’ stay in long-term care facility. Unfortunately, long-term care facilities can be quite expensive, and if there is another spouse still living at home, the long-term care costs only add to the total household expenses. ❖

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As we saw with the retirement calculator example (and many others available online), calculators simply aren't designed to make sure you achieve your goals. You need a quality financial plan, and regardless of whom you choose to help you prepare that plan, that professional needs to cover all of the above areas before they make any recommendations.

Summary

There are many more areas that may need to be covered to create your financial plan; a good financial professional will do more listening than talking, and will incorporate the “four pillars of wealth management” - investments, insurance, tax planning, and estate planning, into your plan and recommendations. This report is intended to provide you with a basic understanding of the areas your plan should cover. However, if you have special circumstances, such as owning a business, caring for a special needs child, or having a blended family, your plan will cover much more.

A quality financial plan is an intricate creation, and should be “alive”. This means that as your life changes, the plan also changes. The goals you have at age 40 will most likely change by the time you reach age 50, and change again by the time you are 60. You need to consider your values and what is most important to you, because your plan should inspire you to take action. ❖





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