

PERSONAL FINANCE

Text Adapted by:

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Preface

This text has an attitude: that in addition to providing sources of practical information, it should introduce you to a way of thinking about your personal financial decisions. This should lead you to thinking harder and farther about the larger and longer consequences of your decisions. Many of the more practical aspects of personal finance will change over time, as practices, technologies, intermediaries, customs, and laws change, but a fundamental awareness of ways to think well about solving financial questions can always be useful. Some of the more practical ideas may be obviously and immediately relevant—and some not—but decision-making and research skills are lasting.

You may be enrolled in a traditional two- or four-year degree program or may just be taking the course for personal growth. You may be of any age and may have already done more or less academic and experiential learning. You may be a business major, with some prerequisite knowledge of economics or level of accounting or math skills, or you may be filling in an elective and have no such skills. In fact, although they enhance personal finance decisions, such skills are not necessary. Software, downloadable applications, and calculators perform ever more sophisticated functions with ever more approachable interfaces. The emphasis in this text is on understanding the fundamental relationships behind the math and being able to use that understanding to make better decisions about your personal finances.

Entire tomes, both academic texts and trade books, have been and will be written about any of the subjects featured in each chapter of this text. The idea here is to introduce you to the practical and conceptual framework for making personal financial decisions in the larger context of your life, and in the even larger context of your individual life as part of a greater economy of financial participants.

Structure

The text may be divided into five sections:

1. Learning Basic Skills, Knowledge, and Context (Chapter 1 "Personal Financial Planning"—Chapter 6 "Taxes and Tax Planning")
2. Getting What You Want (Chapter 7 "Financial Management"—Chapter 9 "Buying a Home")
3. Protecting What You've Got (Chapter 10 "Personal Risk Management: Insurance"—Chapter 11 "Personal Risk Management: Retirement and Estate Planning")
4. Building Wealth (Chapter 12 "Investing"—Chapter 17 "Investing in Mutual Funds, Commodities, Real Estate, and Collectibles")
5. How to Get Started (Chapter 18 "Career Planning")

This structure is based on the typical life cycle of personal financial decisions, which in turn is based on the premise that in a market economy, an individual participates by trading something of value: labor or capital. Most of us start with nothing to trade but labor. We hope to sustain our desired lifestyle on the earnings from labor and to gradually (or quickly) amass capital that will then provide additional earnings.

Learning Basic Skills, Knowledge, and Context (Chapter 1 "Personal Financial Planning"—Chapter 6 "Taxes and Tax Planning")

Chapter 1 "Personal Financial Planning" introduces four of its major themes:

- Financial decisions are individual-specific (Section 1.1 "Individual or "Micro" Factors That Affect Financial Thinking").
- Financial decisions are economic decisions (Section 1.2 "Systemic or "Macro" Factors That Affect Financial Thinking").
- Financial decision making is a continuous process (Section 1.3 "The Planning Process").
- Professional advisors work for financial decision makers (Section 1.4 "Financial Planning Professionals").

These themes emphasize the idiosyncratic, systemic, and continuous nature of personal finance, putting decisions within the larger contexts of an entire lifetime and an economy.

Chapter 2 "Basic Ideas of Finance" introduces the basic financial and accounting categories of revenues, expenses, assets, liabilities, and net worth as tools to understand the relationships between them as a way, in turn, of organizing financial thinking. It also introduces the concepts of opportunity costs and sunk costs as implicit but critical considerations in financial thinking.

Chapter 3 "Financial Statements" continues with the discussion of organizing financial data to help in decision making and introduces basic analytical tools that can be used to clarify the situation portrayed in financial statements.

Chapter 4 "Evaluating Choices: Time, Risk, and Value" introduces the critical relationships of time and risk to value. It demonstrates the math but focuses on the role that those relationships play in financial thinking, especially in comparing and evaluating choices in making financial decisions.

Chapter 5 "Financial Plans: Budgets" demonstrates how organized financial data can be used to create a plan, monitor progress, and adjust goals.

Chapter 6 "Taxes and Tax Planning" discusses the role of taxation in personal finance and its effects on earnings and on accumulating wealth. The chapter emphasizes the

types, purposes, and impacts of taxes; the organization of resources for information; and the areas of controversy that lead to changes in the tax rules.

Getting What You Want (Chapter 7 "Financial Management"—Chapter 9 "Buying a Home")

Chapter 7 "Financial Management" focuses on financing consumption using current earnings and/or credit, and financing longer-term assets with debt.

Chapter 8 "Consumer Strategies" discusses purchasing decisions, starting with recurring consumption, and then goes into detail on the purchase of a car, a more significant and longer-term purchase both in terms of its use and financing.

Chapter 9 "Buying a Home" applies the ideas developed in the previous chapter to what, for most people, will be the major purchase: a home. The chapter discusses its role both as a living expense and an investment, as well as the financing and financial consequences of the purchase.

Protecting What You've Got (Chapter 10 "Personal Risk Management: Insurance"—Chapter 11 "Personal Risk Management: Retirement and Estate Planning")

Chapter 10 "Personal Risk Management: Insurance" introduces the idea of incorporating risk management into financial planning. An awareness of the need for risk management often comes with age and experience. This chapter focuses on planning for the unexpected. It progresses from the more obvious risks to property to the less obvious risks, such as the possible inability to earn due to temporary ill health, permanent disability, or death.

Chapter 11 "Personal Risk Management: Retirement and Estate Planning" focuses on planning for the expected: retirement, loss of income from wages, and the subsequent distribution of assets after death. Retirement planning discusses ways to develop alternative sources of income from capital that can eventually substitute for wages. Estate planning also touches on the considerations and mechanics of distributing accumulated wealth.

Building Wealth (Chapter 12 "Investing"—Chapter 17 "Investing in Mutual Funds, Commodities, Real Estate, and Collectibles")

Chapter 12 "Investing" presents basic information about investment instruments and markets and explains the classic relationships of risk and return developed in modern portfolio theory.

Chapter 13 "Behavioral Finance and Market Behavior" then digresses from classical theory to take a look at how both personal and market behavior can deviate from the classic risk-return relationships and the consequences for personal financial planning and thinking.

Chapter 14 "The Practice of Investment" looks at the mechanics of the investment process, discussing issues of technology, the investor-broker relationship, and the differences between domestic and international investing.

Chapter 15 "Owning Stocks", Chapter 16 "Owning Bonds", and Chapter 17 "Investing in Mutual Funds, Commodities, Real Estate, and Collectibles" look at investments commonly made by individual investors and their use in and risks for building wealth as part of a diverse investment strategy.

How to Get Started (Chapter 18 "Career Planning")

Chapter 18 "Career Planning" brings the planning process full circle with a discussion on how to think about getting started, that is, deciding how to approach the process of selling your labor. The chapter introduces the idea of selling labor as a consumable commodity to employers in the labor market and explores how to search and apply for a job in light of its strategic as well as immediate potential.