EDGEMOOR INVESTMENT ADVISORS

Ten Fundamentals of Financial Planning

The stock and bond markets are always uncertain. Investors with sound financial planning take into account the unexpected as well as the expected, and they have peace of mind from doing so.

Here is a checklist of ten financial planning fundamentals with comments about each. These are essential components of a framework for lifetime planning.

1. Include All Assets & Income in Your Financial Plan

Create a list of every asset and income source including any financial investments, real estate, privately owned businesses, earned income from employment, Social Security, pensions, options, trust income, annuities, life insurance, future inheritance, etc. These assets and their incomes should be carefully analyzed to determine their ability to provide the lifetime funds needed personally and for loved ones.

2. Determine Investment Time Horizon and Asset Allocation

The time horizon for choosing investment allocation is critically important. Funds required for expenditure within one to two years in excess of earned income should be primarily invested in treasury bills, prime money market funds and high-quality short-term debt instruments. Stocks are volatile, and the potential risk of having to sell them at disadvantaged prices to meet known short-term needs for cash is not worth taking. Conversely, funds required for long term needs such as retirement living expenses and children's education expenses should be invested with a significant portion in equities for greater long-term returns. Bonds and other high yielding income investments also have an important stability role to play in investment portfolios. Their long-term total returns have been significantly less than for equities, but they are less volatile in price and offer higher current income yields.

For investors, time horizon is critical for the determination of asset allocation between equity and income investments. The longer the time horizon, the greater percentage of funds should be allocated to equity investments. The shorter the time horizon, the more should be allocated to income investments. Asset allocation is a dynamic process which changes with circumstances as people age and portfolios grow. A general "rule of thumb" for those at retirement age is an asset allocation of 60% in equities and 40% in income investments. Generally, the older the investor the greater the amount to be considered for investment in income securities. For those who are younger with longer investment horizons the greater the amount to be considered for equity investments.

3. Diversify Investments to Reduce Risk

Investment portfolios should be well diversified, and it is important to avoid the concentration risk of too much invested in any single investment, no matter how good it may seem to be. Too many eggs in one basket is never a good idea.

4. Maximize After-Tax Returns Consisted with Sound Investment Policy

It's what's left over after taxes that counts. For clients who have both retirement accounts and taxable accounts, high yielding interest and dividend investments should be in retirement accounts where taxes are deferred. Low dividend yielding equity investments held for appreciation should be in taxable accounts to minimize taxable dividend income and to take advantage of low long-term capital gains taxes when they are sold. Investment balances in retirement accounts should be left there to grow tax free until required minimum distributions are necessary and which should not be exceeded if possible. Tax loss harvesting in taxable accounts should be used to offset capital gain income. In taxable investment accounts large tax-deductible charitable contributions should be made with highly appreciated stocks, the full market value of which can be used for tax deduction without having to realize capital gain taxes.

Within limits, charitable contributions from IRAs can be particularly advantageous because they can be excluded from taxable income. However, distributions from IRAs for those of less than the age when minimum distributions are required should be avoided if possible to allow IRA investments to grow in value tax free before required minimum distributions become necessary.

Changes in tax law governing retirement accounts should be followed closely for tax planning purposes.

5. Assume Returns of 7% - 9% & Limit Withdrawals to 4% - 6%

Savings and investment goals should be realistically set to provide investment portfolios that meet lifetime financial needs, with reasonably expected average net returns on investments of 7% to 9% per annum and annual expected withdrawals from portfolios of 4% to 6% per annum. Limiting annual expenses to 4% to 6% withdrawals from investments should allow both investments and withdrawals from them to increase with inflation over the long run. While this is conservative and there are many other valid investment return and drawdown guidelines depending upon circumstances, the percentages above can be sound long-term standards for sustaining the lifetime purchasing power of both income and investment principal with inflation.

6. Do Not Panic & Sell Good Investments at Depressed Prices

When an investment decreases in market value, it should be re-examined for its future prospects, but not necessarily sold. Judging when to buy and when to sell investments based on short term market sentiment is impossible, and the vagaries of market timing are unfathomable. Do not panic and sell good investments at depressed prices. Consider the remorse of those who sold their stock portfolios at year-end 2008 during the Great Recession and in February and March of 2020 at the onset of Covid and missed the subsequent stock market's strong recoveries. Intrinsic investment value is far more important than the current price.

7. Cover Catastrophic Risk with Appropriate Insurance

Catastrophic risks should be covered by appropriate insurance, particularly risk exposures to loss of earned income, medical expenses and negligence liability claims. Life insurance and disability insurance to cover loss of employment earnings, comprehensive health insurance to cover medical expenses for all family members and personal liability umbrella insurance to cover potential exposure to negligence lawsuits are all essential. Long term care insurance may also be advisable, depending on affordability, capacity to self-insure, and concern about the adequacy of Medicare and other factors.

8. Keep Debt Manageable at Low Interest Rates

Borrowing must be manageable, avoiding excessive loan servicing requirements and high interest rates, especially for interest which is not tax deductible. For those who itemize income tax deductions, the interest on a mortgage loan of up to $750,000 for purchase of a home is tax deductible. New home mortgage loan rates are still high and should carefully be considered for affordability. If home mortgage loans with desirable maturities become available at lower rates than currently paid, they should be explored for refinancing. Be sure to include cost consideration of new mortgage loan arrangement and closing fees in addition to interest rate cost.

9. Carefully Prepare Life-End & Estate Documents

Everyone should have carefully and professionally prepared life-end and estate planning documents including a current Will, Advanced Medical Directive, Durable Power of Attorney and up to date IRA Beneficiaries. Revocable Trusts can avoid probate time and costs for heirs of the deceased. Loved ones should not be burdened with difficult life support, financial management and estate distribution decisions that can be determined in advance.

10. Maintain Financial Records and Work with Competent Professionals

Compile and maintain financial records for all significant assets and liabilities including investment account statements, bank account statements, real estate, insurance policies, mortgage loan statements, and other major asset and liability statements. Be sure to work with trustworthy professionals for all financial needs including your:

- Investment Advisor
- Financial Planner
- Accountant with Tax Expertise
- Estate Lawyer
- Banker
- Insurance Agent

Financial records and names of financial professionals with contact information should be made readily available to will executors and others involved in estate administration. It may also be appropriate, depending upon circumstances, for heirs to be informed about the wills and estates of which they are beneficiaries so they can prepare for future decisions and be effective and responsible in the management of their own ongoing financial plans.

Sounds simple, doesn’t it? Well, it is not as simple as it sounds, and it is surprising how many investors do not follow these fundamentals of financial planning, many to their ultimate regret. Don’t be one of them!

Timothy C. Coughlin, CFP®

November 20, 2024