Hogan Financial

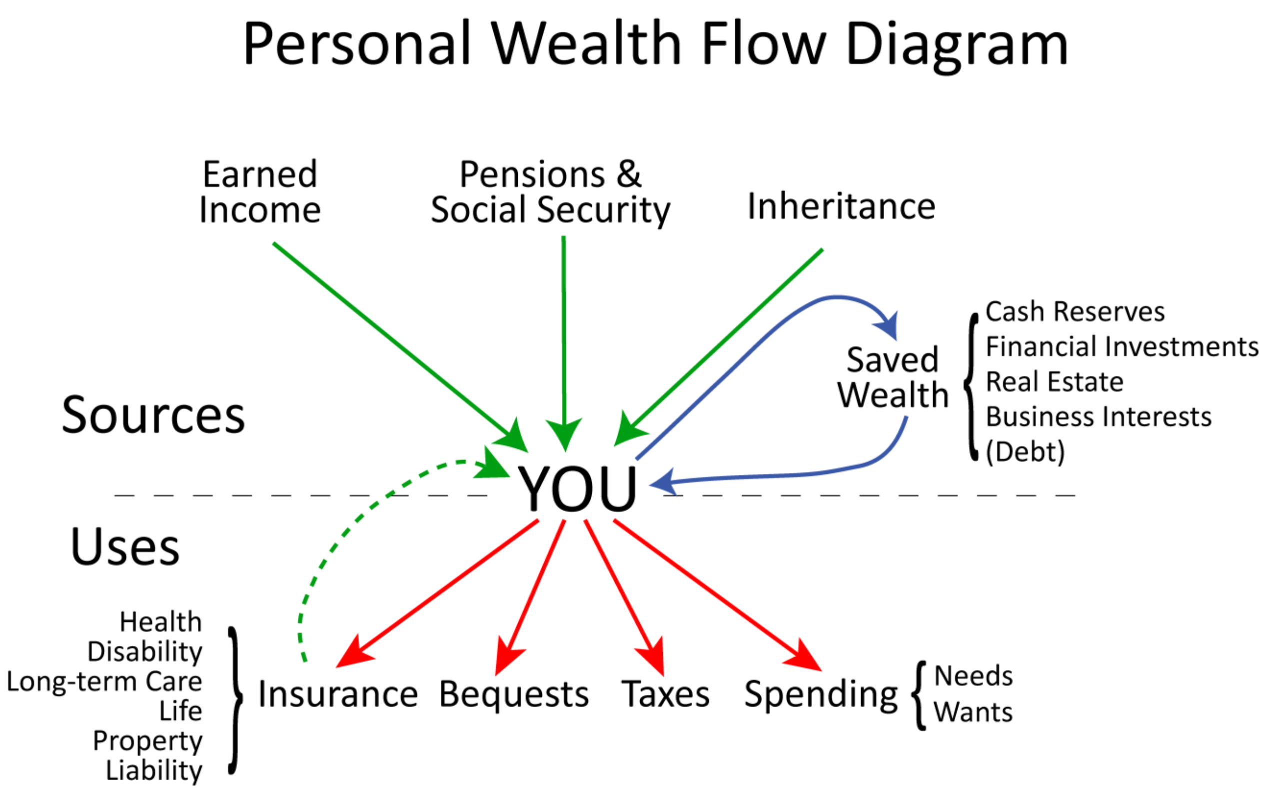
HOW WE VIEW FINANCIAL PLANNING

First, Get the Picture Right

Sometimes people picture financial planning as trying to grow the investment portfolio as large as possible. But what most people actually care about is not just the portfolio.

> **In a nutshell:** Most people care about how much they can spend both now and later in life and how they can stay financially safe regardless of what life brings.

That's how we picture financial planning as well. As your advocates for a safe, easy, and smart financial life, we use this visual image for managing the technical details of your financial planning:



250 West Coventry Ct. #202, Milwaukee, WI 53217 phone: 414.351.9111 fax: 414.352.9166 www.hoganfinancial.com

Let's take a closer look.

This picture is a little different from what you might expect. Note first that it is YOU at the center of this picture, not your portfolio. That's because it is your concerns, values, circumstances, and goals that drive the financial planning process. Financial planning starts with understanding your definition of the desired life. Everything else is then designed to support that vision.

What's awkward about financial planning is that, for each of us, income and expenses (the green and red arrows in the picture) tend to move in different rhythms. Thus, much of financial planning is about moving money from a time or state when you have it to when you need it:

- Mortgage debt moves home ownership forward to a time when you want to own a home but don't yet have the money to purchase it.
- Financial investments (savings) help move money from your working years to retirement.
- Insurance moves money from good times (good health) to bad times (poor health).

We think of Savings (the blue part of the picture) as a reservoir for getting money from when you have it to when you need it. Savings include: Cash Reserves, Financial Investments, Real Estate, Business Interests, and Debt. Understanding how to manage the flows in and out of Savings is a central focus in financial planning.

Insurance is another part of your reservoir. While insurance is usually experienced as an expense, if a problem arises it brings wealth back into the system (via the dotted green arrow). Having the right kind and amount of insurance is key to financial planning success.

Financial planning also includes the idea of implied limits: Sources (the top half of the picture) always equal uses (the bottom half of the picture). If you spend more than you have, debt will balloon up. If you don't spend as much as you have, you might end up leaving to heirs more than you had intended.

Bequests (at the bottom of the picture) have a dual nature. They include what you arrange deliberately to leave to heirs and what might go to your heirs in an unplanned manner absent more spending or legacy planning on your part. Estate planning is a routine part of what we talk about with clients every day.

As you think about this picture of financial planning, note that the areas where you have the most personal control are Earned Income—the management of your human capital and—of course!—Spending, and on a good day, understanding the difference between Needs and Wants.

Then Get the Process Right

In other words, excellence in financial planning is all about first figuring out who you are, what you care about, and where you want to go, and then arranging to spread out the consumption of your wealth over your lifetime and beyond as safely and as agreeably as possible, as your life unfolds in real time. It's that simple, and that complicated.

Our more formal definition of financial planning is:

> *The life-long process of integrating personal values with the management of both human and financial capital for the betterment of self and community.*

We see our role as facilitating this process.

That's why our advice is rooted in these ten core, academically-rigorous principles:

1. **People care most about their lifetime standard of living, not wealth.** For example, as you consider your own planning, are you targeting a specific portfolio amount in retirement, or are you thinking about a desired lifestyle? That's a key question. It matters how you define financial success.

2. **Absent a big inheritance, the most important determinant of your lifetime standard of living is your human capital, your lifetime ability and willingness to earn income.** Sobering but true; your personal abilities, and what you do with them, are the main levers for influencing your lifetime standard of living. (In technical terms, human capital is the net present value of your lifetime earnings.)

3. **Since protecting and enhancing human capital is of central importance, it is therefore critical to carefully consider education plans, career choices, work/leisure decisions, and the purchase of disability and life insurance designed to replace earned income if needed.** Does your financial plan start with a careful analysis of the vibrancy and safety of your current and future income? Does your financial plan include protection from a disruption or loss of earned income? Are you thoughtful about how to maintain and improve your personal well-being? Physical and emotional well-being can also contribute to financial well-being.

4. **Financial capital is complementary to human capital and should be tailored to it.** In general, the riskier your earned income, the less risk you will likely want to take in your financial portfolio. (The recently unemployed don't usually double up on stock exposure to 'make up the difference' in income.) The more you expect your earned income to rise and fall with the markets, the less market exposure you will likely want in your financial portfolio. Despite what you might hear in the popular media, risk tolerance, i.e., how much risk you are willing to bear, is a secondary consideration to risk capacity, i.e., how much risk you are able to take.

5. **There is an overall boundary condition to funding lifetime hopes and dreams.** Unless you die with debt, lifetime income (earned income, inheritances, Social Security, and pensions) must equal lifetime uses (taxes, insurance, bequests, personal spending). Thus, funding your personal goals requires specifying their importance to you and then funding these goals to the extent possible, subject to this lifetime income constraint. It's true, we can't have it all.

6. **Risk is goal dependent.** In general, the more strongly you care about a financial goal, the less risk you'll want to take in financing that goal. For example, your base lifetime standard of living, the lifestyle that you do not want to go below, is most appropriately funded with a safe investment that offers lifetime inflation protected income.

   If saving for your child's college education is a high value for you and you do not have an alternate means of paying college bills, you will likely want to take less risk in the college savings accounts. Goals that are more wants than needs can be funded with riskier assets.

7. **Stocks are risky, even if held for a long time, and so are not appropriate when safe financing is required.** In popular culture, there is a deeply rooted, but fundamentally incorrect belief that if you have a long time horizon you can and should own stocks because stocks aren't risky if held for the long-term.

   In the scientific world-view, that belief is a jaw dropper for the following very specific reason. Shortfall risk—the risk that the portfolio will be less than a specified level—increases with time. Think of the cone of uncertainty for where a hurricane will travel. The range of possible places where it can land increases with distance. Similarly, the range of outcomes for a stock portfolio increases with time. (Need further convincing? Try buying portfolio shortfall insurance: The longer the time period, the higher will be the premium.) What's particularly important about this principle is how often it is ignored in popular culture. Remember: If your financial plan requires excellent stock performance to succeed, is it a plan or a hope?

8. **Saving does not boost your lifetime standard of living but instead smoothes your standard of living.** Savings shift income from times of high earned income to times of lower earned income and from times of favorable life conditions to more difficult personal times such as unemployment, disability, or death of the breadwinner. Saving and insuring are strategies for resolving the reality that the rhythm of income rarely matches the rhythm of spending.

9. **Useful risk management strategies include not just precautionary saving and diversification but also hedging and insuring.** Insuring means to pay a known price to protect against the possibility of a larger loss on some risky asset while keeping the upside potential for the investment return on that asset. (An example is property insurance.) Hedging means to sell the upside potential of an asset in return for downside price protection. (An example is exchanging a portion of your investment portfolio for lifetime inflation-protected income.)

10. **Costs matter and should be transparent.** Ensuring a low and transparent cost structure is also a core principle for us. When you wring cost out of a portfolio, you put more money in your pocket. You will also likely get lower risk as well. (Higher expense producers tend to ramp up risk to compete with their lower expense peers.)

Hogan Financial

Financial planning is not just business. It’s personal.

For more information, please email us at info@hoganfinancial.com or call us at 414-352-9111.

We look forward to hearing from you.

You can follow us at:

Website: http://hoganfinancial.com
Wealthinking Blog: http://hoganfinancial.com/wealthinking/
LinkedIn: http://www.linkedin.com/company/1988215
Twitter: https://twitter.com/paulahogan
Facebook: http://www.facebook.com/hoganfinancial