Charlene K. Dolan
CERTIFIED FINANCIAL PLANNER™
978.388.3468
www.focusonfinancialfreedom.com
plan@dolanfinancialservices.com
108 Main Street, Amesbury, MA 01913-2809

DOLAN FINANCIAL SERVICES

FOCUS ON FINANCIAL FREEDOM® **SPRING 2010**

Calculating Your Financial Ratios

When reviewing the financial health of a company, it's common to look at financial ratios, such as earnings per share, price/earnings ratios, book value, and total return. The reason financial ratios are so popular is they give you a means to evaluate financial information, while allowing you to track changes over time.

Consider using the same concept to assess and track your personal financial situation. At least annually, prepare a net worth statement and then calculate various financial ratios. Comparing those ratios over time will help you assess whether you are making progress toward your financial goals.

You should start by preparing a net worth statement that lists all your assets and liabilities, with the excess representing your net worth. Assets should be valued at the price you would obtain if you sold them now, not the amount you paid for them. You'll also want to list your annual income for ease in calculating some of the ratios.

Now, ask yourself the following questions about your finances:

❍ **Has your net worth grown by more than the inflation rate?** Calculate the percentage growth in your net worth over the past year and compare that to the inflation rate. To make progress toward achieving your financial goals, your net worth should increase by more than the inflation rate. With recent declines in the stock and housing markets, you may see short-term declines, but make sure you are making progress over the long term.

❍ **What is your ratio of assets to liabilities?** A ratio of less than 1 indicates you have more liabilities than assets — a negative net worth. If that is the case, take active steps to reduce your liabilities. This ratio should increase over time, which indicates you are reducing debts.

❍ **What is the trend in your liabilities?** Review the amounts and types of debts outstanding. Mortgages are typically used to purchase a house or other items

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Cravings and Savings

Dieting and budgeting both promise a long-term benefit but require commitment and self-discipline. Both require personal goals, a strategy and a system for tracking progress. Both are intended to improve our personal circumstances and quality of life. Why, then, do these words so often elicit a negative response?

Few would argue the existence of a relationship between food and emotions. In times of emotional stress, most people are drawn to foods with higher fats and sugars and little nutritional value. These are our "comfort foods" — foods we associate with a fond memory, a feeling, or a special time or person in our lives. While the potential negative impact of such foods is clear, the need for "comfort" during times of stress will often influence our choices.

There is a similar relationship between emotions and money. Can you recall a time when stress or sadness prompted you to "splurge" on something extravagant? Most of us have at least one or two items in our basement or closets that prompt us to ask, "What was I thinking?" It is important to recognize that the "splurge" was simply a temporary distraction from the stress or sadness. In reality, we risk undermining our financial goals if we do not maintain control over spending.

Money is used to reward and punish, to control and to feel in control. Take time to consider how money has been used in your life and how you now use money. We must understand our own behaviors before we can implement effective change. Every dollar counts!

Charlene K. Dolan

Financial Ratios

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that may appreciate in value, so they are considered "good" debt, as long as the amounts aren't excessive. Credit card balances and auto loans are used to finance items that typically don't appreciate in value and should be kept to a minimum.

❍ **What percentages of your assets are liquid and nonliquid?** Nonliquid assets include items like your home, other real estate, jewelry, and works of art. Although they may increase in value over time, they can be difficult to sell quickly at full market value. Liquid assets, such as bank accounts and stocks, are more easily converted to cash. You want sufficient liquid assets to cover financial emergencies.

❍ **What is your savings-to-income ratio?** For this ratio, your savings equals all assets designated to help fund your retirement. It typically won't include your home, since you will probably live there after retirement. First, you need to decide what this ratio should equal at retirement. It is basically the amount of savings you want at retirement age, preferably determined after a careful analysis of all appropriate factors, divided by your annual income. For instance, if you want retirement assets equal to $2,000,000 when you retire and you currently earn $100,000, you would need a savings-to-income ratio of 20 when you retire. You might then develop benchmarks over your working years to help you gauge whether you are on track to achieving that goal.

❍ **What is your savings rate?** Calculate what percentage of your income you are saving on an annual basis. Typically, you'll want to save a minimum of 10% a year. This would include 401(k) contributions and individual retirement account contributions. If your employer matches your 401(k) contributions, you can include those contributions as part of your annual savings.

❍ **How have your investments performed?** Now may also be a good time to thoroughly analyze your portfolio's performance over the past year. Measure the performance of each investment, comparing it to an appropriate benchmark. Also calculate your overall rate of return and compare it to your targeted return.

Please call if you'd like help reviewing your personal financial ratios or assessing whether you are on track in pursuing your financial goals. ❍❍❍

Review Your Homeowners Insurance

Often, homeowners insurance is purchased with the home and then is not thought about again until a claim is made. But since there is little you can do at that point about your coverage, take time periodically to review your policy:

❍ **Review the adequacy of your policy limits.** Investigate how much it would cost to replace your home, and make sure your policy limit will cover that amount. Don't insure your home for its market value — it may cost more or less than that to rebuild your home. And even if your home was totally destroyed, you would still have the land. Try to obtain guaranteed replacement cost coverage, where the insurance company will rebuild your home even when the cost exceeds the policy limits. Be aware, however, that some companies no longer offer this coverage and even those that do define guaranteed replacement cost in different ways. Some companies will rebuild your home no matter what the cost, while others cap their coverage based on a certain percentage of the policy's face value. Make sure your policy has an inflation endorsement.

❍ **Obtain coverage for special risks.** Basic policies protect you from fire, smoke, windstorms, vandalism, and lightning. The most comprehensive policies cover every peril except those specifically excluded, typically floods, earthquakes, war, and nuclear accidents. If you live near a flood plain or earthquake area, obtain specific coverage for these perils. Find out if your policy will pay to rebuild your home in accordance with local zoning laws and ordinances. An existing home does not have to meet new zoning laws and ordinances; but when you rebuild, you must comply with those laws. Unless your policy specifically covers that cost, your insurance company will typically only pay to rebuild your home based on its previous condition.

❍ **Understand what other items are covered by your policy.** Your homeowners policy also typically covers personal property, other structures on your property, landscaping, loss of use when your property is destroyed, and personal liability coverage. Carefully review the limits for all of these items, since you can generally add endorsements if you need additional coverage. Typical policies cover personal property for a maximum of 50% of the coverage on the home, usually paying actual cash value, which deducts depreciation from the amount paid. Try to obtain a replacement cost endorsement, which pays to replace your property and typically raises the limit to 70% of your home's coverage. Pay special attention to limits for items like jewelry, antiques, collectibles, and works of art. ❍❍❍

Should You Pay Off Your Mortgage by Retirement?

A recent study found that 41% of homeowners between the ages of 60 and 69 still have a mortgage on their home. Of those, 51% had sufficient assets to repay their mortgage (Source: Center for Retirement Research, July 2009). The study found that most households would be better off paying their mortgage off. But is that good advice for your situation? Before making this decision, be sure to consider these factors:

- **Compare your mortgage interest rate to the rate you are earning on your investments.** If you retain your mortgage because you believe you will earn more on your investment assets, make sure that is really happening. When paying off a mortgage, you are effectively earning a pretax return equal to your mortgage interest rate, which is a guaranteed return with no risk.
- **Consider the tax benefits of the mortgage interest.** Interest paid on mortgages with balances of up to $1,000,000 and on home-equity loans up to $100,000 is deductible on your federal tax return, provided you itemize deductions. You only benefit if your total itemized deductions exceed the standard deduction amount, which in 2009 and 2010 is $11,400 for married couples filing jointly and $5,700 for single taxpayers. Even if you do itemize deductions, you are paying most of the interest.
- **Pay off consumer debt first.** Consumer debt typically carries higher interest rates than mortgage rates, and interest payments are not typically tax deductible, unless it's a home-equity loan.
- **Consider which funds you would use to pay off the mortgage.** If you are planning to use tax-deferred monies, such as those in a traditional IRA or 401(k) plan, to pay off your mortgage, those withdrawals could be subject to income taxes, which will impact your decision to pay off the mortgage. Financially, it is typically better to use taxable accounts to pay off your mortgage.
- **Retain some savings.** You don't want to use so much of your investment assets to pay off your mortgage that you have difficulty paying for unexpected expenditures.

Please call if you'd like help deciding whether you should pay off your mortgage before retirement. ❍❍❍

Segregating Your Goals

Your willingness to assume risk with your investments is not necessarily a static concept. You may be less willing to take risk with investments designated for an essential financial goal, while you may be more willing to take risk for nonessential goals. However, those varying risk levels may be difficult to assess if all your investments are commingled into one account.

For instance, assume you have three goals — to ensure you have enough funds to support yourself through retirement, to send your child to an Ivy-league college, and to purchase a vacation home. The most crucial goal is to ensure you don't run out of money during retirement. Thus, you want a high level of assurance that you'll reach that goal, devoting a substantial portion of your resources to the pursuit of it. Your investments for that goal are likely to be somewhat conservative, especially as you approach retirement age. The next important goal is sending your child to an Ivy-league college. You have more limited resources to devote to that goal, plus your children can still attend a less-expensive college or pay part of the costs themselves. For that goal, you may be willing to assume more risk with your investments to increase the likelihood of reaching that goal. Your goal for a vacation home is clearly last, so you may have few resources to devote to it. For that goal, you may be willing to use very aggressive investments, since that may be the only way you can achieve that goal.

The point is that your willingness to assume risk is not static. It will vary depending on how important each goal is to you and how much you can designate to that goal. Commingling all your investments for all goals in one account may make it difficult to analyze your investments in this manner. Thus, you might want to set up separate accounts for each goal, so you can more closely match the investments to your willingness to assume risk for that goal. Please call if you'd like to discuss this concept in more detail. ❍❍❍

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Teaching Important Financial Lessons

Even though it seems like money and financial topics are discussed everywhere, these are not concepts your children will learn automatically. Some strategies you can use to help teach these concepts include:

- **Impart money concepts along with the children's allowance.** You must decide whether to tie your children's allowance to the performance of chores. Some people feel that doing so instills the concept of working for pay, while others feel chores should be performed without pay as part of children's family responsibilities. When setting the allowance, make sure your children understand what expenses must be paid with it. The allowance should increase as your children grow older and should be large enough so children have money left over to make their own decisions.
- **Provide opportunities to earn extra money.** Offer to pay your children for additional chores around the house, so they learn the connection between effort and pay.

- **Allow your children to make their own financial decisions.** You may not agree with the choices your children make, but it is important for them to learn from their mistakes. That doesn't mean you can't discuss options with them, but the financial decisions should be theirs.
- **Encourage your children to save money.** Saving for tomorrow rather than spending today is a difficult concept for both adults and children. Thus, you may need to offer incentives to encourage saving. You may require your children to set aside a certain percentage of their allowance for long-term goals. Or you can match your children's savings, perhaps contributing 50 cents or a dollar for every dollar your children save.
- **Explain the basics of investing.** At an early age, open a bank account for your children, explaining concepts like saving and compound interest. Around age eight or so, explain how businesses operate and how investors buy and sell stocks. As their interest grows, help them purchase stocks with their savings. Since minors can't own stocks, you will need to purchase the stock as custodian for your children. Teach your children how to research a stock, follow its price, review its annual report, and decide when to sell it. Exposing your children to these concepts at a young age will hopefully make them comfortable with investing when they become adults.
- **Encourage your children to take finance courses.** Many high schools and colleges offer courses that teach stock basics and personal finance. Encourage your children to take at least one of these courses.
- **Be conscious of the money messages you send to your children.** Your children watch your actions closely, so how you treat money will be a significant influence on their views. If you make large purchases only after careful research and price comparisons, your children will learn to be careful before making a purchase. If you use your credit cards cautiously and explain how to select a card, what items to charge, and how to pay off the balance every month, your children will learn not to abuse credit cards. ❍❍❍

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Did You Know?

Approximately 44% of retirees are providing support for at least one other person. Of those providing support, 53% are doing so for children, 37% for grandchildren, and 10% for parents (Source: Charles Schwab, 2009).

Medical costs play a role in approximately 46% of all personal bankruptcies (Source: Harvard University, 2009).

In a recent survey, 78% of grandparents said that they prefer to give small financial gifts to children and grandchildren throughout their lifetime rather than leaving a larger legacy at death (Source: *Journal of Financial Planning*, September 2009).

The labor force participation rate for workers between the ages of 65 and 69 increased 44% for men and 55% for women between 1991 and 2008, reversing a century-long downward trend (Source: Urban Institute, 2009).

It is estimated that 93% of the growth in the U.S. labor force from now until 2016 will be among workers age 55 and older (Source: Pew, 2009).

Another recent study of workers who lost their jobs in 2008 found that 46% took a cash distribution from their retirement plan accounts. Younger employees were nearly twice as likely as older employees to cash out (Source: Hewitt Associates, 2009). ❍❍❍