

# Policy-Based Financial Planning

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## FI-434 Cases in Financial Planning

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# Our Session Today

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- Overview
- Client Examples
- Process for Developing Policies
- More Examples and Applications
- Q&A



# Overview

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- Uncertainty
- Chaotic World
- Financial Planning
  - Well crafted financial planning policies can serve both planners and their clients by acting as a powerful touchstone in the midst of a rapidly changing world.

## *Policy*

*A tool for making decisions  
in the face of uncertainty*



# Examples { Financial Planning Profession }

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- Investment Policies
  - Boone, Lubitz 1992, 2004
- Safe Withdrawal Rates
  - Bengen 1994, 1996, 1997, 2001
  - Guyton 2004, 2006
- CFP<sup>®</sup> Code of Ethics
- CFP<sup>®</sup> Practice Standards



# Examples { Other Professions }

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- Law
  - Ethics policies, e.g. what constitutes conflicts of interest
- Medicine
  - “First, do no harm.”
- Accounting
  - FASB/GAAP
- Military
  - Chain of Command

# Examples from Life

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- I will give 10% of my gross income to charity.
- I will only drive American cars.
- I will only do work that I love.



# What Policies Are Not

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- Beliefs or Values
- Action Items
- Implementation
- Observations
- Goals and Aspirations



# Policies vs. Values, Beliefs, Observations, Goals, Action Items

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- **Value**: A college education is imperative for a good life.
- **Goal**: To ensure my son's education is covered even if I die prematurely.
- **Policy**: I will maintain sufficient life insurance to cover my son's education costs.
- **Action Item**: I will buy \$250,000 of 20-year term life insurance.

# Policies vs. Values, Beliefs, Observations, Goals, Action Items

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- **Observation**: Our extended family looks to us to help support them.
- **Goal**: To encourage them to support themselves.
- **Policy**: We will provide financial literacy support but will not give them money.
- **Action Item**: Arrange for and pay for brother John's consumer credit counseling services.

# Policies vs. Values, Beliefs, Observations, Goals, Action Items

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- **Belief**: Too much inheritance blunts ambition.
- **Goal**: To provide for spouse without leaving too much money to our grown kids.
- **Policy**: We will own life insurance for our survivor needs only, establishing charities as contingent beneficiaries.
- **Action Item**: Buy term insurance based on capital needs analysis; coordinate beneficiary designations; monitor regularly.

# Is it a Policy?

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- When external circumstances change, does the policy return a new answer?
- If the answer returned by a policy never changes, then it's not a policy.

**Goals**

**Decisions**

**policies**

# Is it a “Good” Policy

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- Broad enough to encompass any novel event that might arise.
- Specific enough so that we are never in doubt as to what actions are required.



# Policies vs. Values, Beliefs, Observations, Goals, Action Items

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- **Value**: A college education is imperative for a good life.
- **Goal**: To ensure my son's education is covered even if I die prematurely.
- **Policy**: I will maintain sufficient life insurance to cover my son's education costs.
- **Action Item**: *I will buy \$250,000 of 20-year term life insurance.*

# Policies vs. Values, Beliefs, Observations, Goals, Action Items

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- **Value**: A college education is imperative for a good life.
- **Goal**: To ensure my son's education is covered even if I die prematurely.
- **Policy**: I will maintain sufficient life insurance to cover my son's education costs.
- **Action Item**: *I will buy an **additional** \$100,000 of 20-year term life insurance.*

# Policies vs. Values, Beliefs, Observations, Goals, Action Items

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- **Observation**: Our extended family looks to us to help support them.
- **Goal**: To encourage them to support themselves.
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# Policies vs. Values, Beliefs, Observations, Goals, Action Items

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- **Observation**: Our extended family looks to us to help support them.
- **Goal**: To encourage them to support themselves.
- **Policy**: We will provide financial literacy support but will not give them money.
- **Action Item**: *Teach Susan how to balance her checkbook and how to use Quicken to establish and follow a budget.*

# Policies vs. Values, Beliefs, Observations, Goals, Action Items

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# Policies vs. Values, Beliefs, Observations, Goals, Action Items

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- **Belief**: Too much inheritance blunts ambition.
- **Goal**: To provide for spouse without leaving too much money to our grown kids.
- **Policy**: We will own life insurance for our survivor needs only, establishing charities as contingent beneficiaries.
- **Action Item**: *Cancel insurance.*

# Financial Planning

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Client Values  
and Goals

Best Practices



Recommendations  
and

Implementation



# Policies: A Bridge

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Client Values  
and Goals

Best Practices



**POLICIES**

Recommendations  
and

Implementation



# Financial Planning Policies

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- Financial Planning Policies transcend the current situation by expressing in general terms what clients plan to do and how they are willing to do it in terms not limited to the current circumstances.

# Implicit vs. Explicit

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- We are not suggesting that financial planning policies are not implicitly present in most financial plans. We are simply suggesting that these policies made explicit can create better tools for guiding clients.



# Integral Framework

	Interior	Exterior
Individual	I	It
Collective	We	Its



# Integral Framework

<p><b><u>Individual / Interior</u></b> Who you are, who matters to you, and how you feel about things, including attitudes toward spending &amp; saving, personal risk tolerance, and your vision of “the good life.”</p>	<p><b><u>Individual / Exterior</u></b> What you own, what you owe, all the objective facts about your life, including personal resources and constraints like education, occupation, income, expenses, assets, liabilities.</p>
<p><b><u>Collective / Interior</u></b> Relationships; religious/spiritual beliefs; family, ethnic, cultural history and beliefs, including collective attitudes toward spending, debting, investing, charitable giving, education, legacy, etc.</p>	<p><b><u>Collective / Exterior</u></b> Objective facts about the external environment, including tax laws, financial market structure, state of the economy, interest rates, inflation rates, available financial instruments, etc.</p>

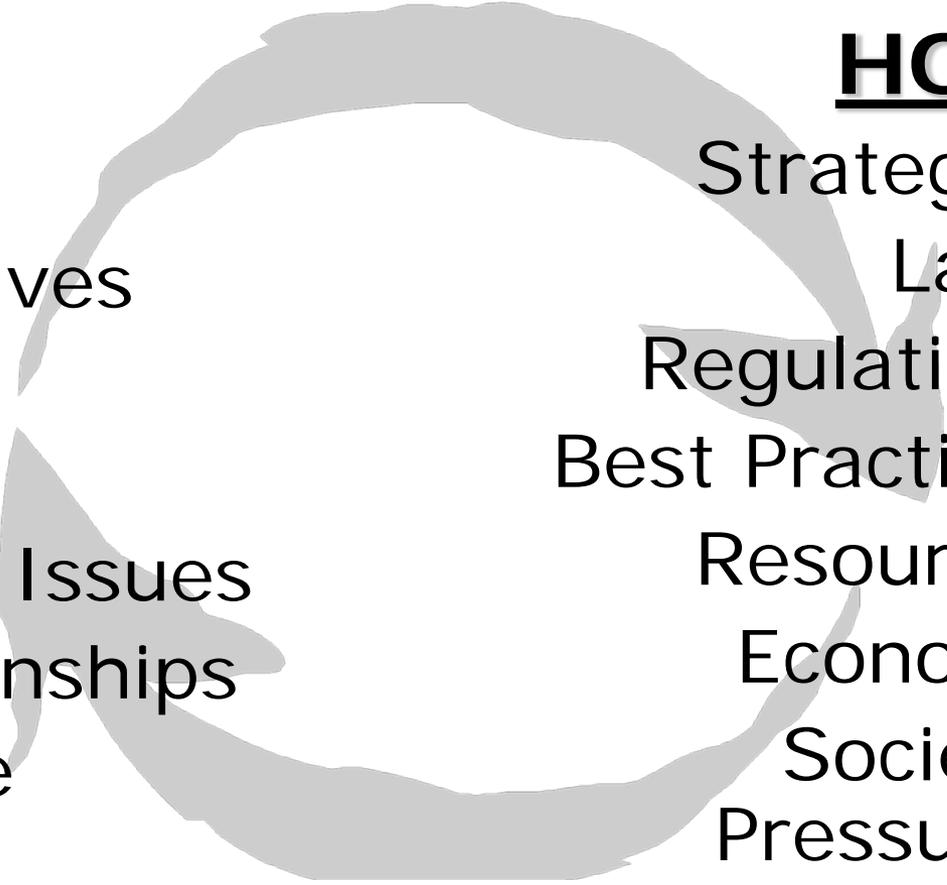


# Policies Blend the Interior and the Exterior, the Individual and the Collective

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## WHY

Goals  
Objectives  
Values  
Beliefs  
Money Issues  
Relationships  
Culture



## HOW

Strategies  
Laws  
Regulations  
Best Practices  
Resources  
Economy  
Societal Pressures



# Financial Planning Policies

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- Financial Planning Policies blend the integral quadrants by expressing in general terms what clients plan to do and how they are willing to do it in terms not limited to the current external circumstances.

# Financial Planning Policies

## Six-Step Process

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- Step 1: Discovery
  - Goals
  - Desires
  - Values
  - Attitudes
  - Data
- What really matters to them?
- What do they want?
- What do they have to work with?



# Financial Planning Policies

## Six-Step Process

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- Step 2: Identify Planning Area and Related Principles
  - What Planning Area(s) are the Policies going to need to address based on the client's circumstances?
  - What are the Best Practices in that/those Planning Area(s)?



# Financial Planning Policies

## Six-Step Process

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- Step 2:
  - Different client *structural* circumstances will dictate different planning areas that may require policies.
    - Client resources
    - Kids/No kids
    - Marital status
    - Career path
    - Etc.



# Financial Planning Policies

## Six-Step Process

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- Step 3: Combine Client Goals/Attitudes with Planning Principles
  - Draft statements that you believe reflect the client goals, values and attitudes, and the relevant planning principles.

# Financial Planning Policies

## Six-Step Process

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- Step 4: Test Policies and Develop Specific Recommendations
  - **Is it a policy?**
    - Are there external circumstances that will change and affect the decisions encompassed by this policy?
    - Does this policy enable us to make decisions as things change?
  - **Is it a “good” policy?**

Scenario Planning: Feed current and potential data through the policies to test how good they are.

    - General enough to encompass divergent circumstances.
    - Specific enough to leave one in no doubt as to the actions to be taken.

# Financial Planning Policies

## Six-Step Process

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- Step 5: Test Policies with Client
  - Formalize for discussion with client.
  - Does the wording resonate with them?
  - Do clients see their goals and values reflected in the Policies?
  - Interactive Process



# Financial Planning Policies

## Six-Step Process

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- Step 6: Periodic Review and Update
  - Policies change based on ***structural*** or ***fundamental*** triggers, ***not cyclical*** triggers
    - Laws and Regulations
    - Best Practices
    - Change in Client Values or Goals or Structural Circumstances
      - An interior shift that has changed the exterior goals
      - An exterior change that has changed the structural circumstances

# FP Policies - Applications

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- All comprehensive financial planning engagements
- Hourly or “one-time” financial planning engagements
- Young people and others with little income and few assets for whom planning issues will emerge over time



# Summary

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- A process for making financial planning policies explicit would aid both clients and advisors in making appropriate adjustments to changing circumstances without the necessity of starting from scratch.



# Some Examples

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# Debt Policy

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- We will use credit cards for convenience only for purchases that are part of the monthly budget.
- For purchases equal to 10% or less of annual after-tax earnings, we will set aside funds monthly until needed sum is accumulated.
- For purchases equal to more than 10% of annual after-tax earnings, we will use amortized debt.

# An example where policies might have helped

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- Client who could not live on \$50,000 per month, wouldn't sell employer stock and started a business.
- Policies that might have helped
  - I will maintain a portfolio that supports a 5% safe withdrawal rate
  - I will invest in the new business by liquidating employer stock



# An example where policies did help

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- Same stock, \$110,000 spending goal
- Policies that were adopted
  - Maintain portfolio of at least \$2,200,000 (increasing with inflation)
  - Make other purchases/investments out of remaining employer stock
    - New first home
    - Business with partner and brother
    - Speculative real estate investment
    - New second home (and upgraded)



# More examples: The Horse Farm

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Clients spent money they couldn't afford helping their daughter and son-in-law buy the house next door, which the daughter and son-in-law couldn't afford, prompting the clients to spend even more money they couldn't afford to subsidize the daughter's monthly living expenses.



# The Horse Farm: policies

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- We will provide financial support to our children up to the point that it does not endanger our own financial security based on Guyton's safe withdrawal rate and "guardrails"
- We will not facilitate transactions by our children that they themselves cannot afford to sustain.



# The Money Anorexic

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- Husband retired from UCSF with a pension equal to 85% of prior earnings
- Couple have \$2mm in financial assets
- Wife spent her entire life as a diligent saver
- Wife told husband when he retired that they were going to have to tighten their belts because his pension was less than his salary had been.

# The Money Anorexic: policies

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- An amount equal to the sustainable withdrawal rate will be transferred quarterly to a separate “play” account.
- The play account will be kept liquid
- All travel, vacations, and other discretionary purchases will be made from the play account
- Suspend transfers when play account exceeds 150% of annual target



# Policy, Value, Belief, Goal, Observation, or Action Item?

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## Spending/Savings Policy

- We will live within our take-home pay.
- We will spend within our means and develop healthy savings habits to meet our short- and long-term goals.
- We will track our spending with a computer based tool, develop a monthly budget, and balance our bank statements to ensure adherence to the budget. We will use the following accounts to manage our money:
  - a) Create and fund an **emergency fund** to cover 6 months of non-discretionary expenses.
  - b) Create and fund a **save/spend account** for all expenditures that are not in our monthly spending plan.
  - c) Create and fund a **save/don't spend account** for longer term goals or to transfer to investment accounts.

# Policy, Value, Belief, Goal, Observation, or Action Item?

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## ■ Spending/Savings Policy, cont.

- Any and all financial windfalls will be equally divided between the emergency fund savings and debt reduction.
- We will use cash for all budgeted expenditures. Our budget includes all nondiscretionary and discretionary expenses. We will not use credit cards for household expenses and we will save in our save/spend account for all non-budgeted expenses.
- We will allocate 10% of our gross income to long-term endeavors (e.g. education to increase our future income, retirement savings, children's education, etc.).

# Policy, Value, Belief, Goal, Observation, or Action Item?

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## Debt Management Policy

- We will use debt wisely.
- Debt is a roadblock to financial security.
- We will pay off all of our consumer debt within 30 months.
- We will ensure future debt is incurred and managed responsibly.
- We will reduce the number of credit cards we currently have.
- We will develop a payment plan to pay existing debt and adhere to our monthly spending plan to avoid creating additional debt.
- We will pay an additional \$ 500/month toward the consumer debt with the highest interest rate. As each card is paid off, the additional payment will be applied to the next highest interest rate card until all consumer debts are retired. Once the consumer debt is retired, the additional monthly amount will be re-purposed to fully fund our emergency savings.
- We will use debt only when purchasing appreciating assets.

# Policy, Value, Belief, Goal, Observation, or Action Item?

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## Policy on Family & Finances

- We will ensure that we have sufficient financial resources to meet the needs of our immediate family and to increase the financial literacy of our immediate and extended family.
- Each member of the family will have a weekly allowance to meet their personal needs.
- Each month we will discuss our monthly expenditures and our financial goals for the upcoming month.
- Our extended family should be self-sufficient.
- We will provide extended family members with emotional support and information regarding financial resources (credit counseling, budgeting support, etc.) but we will not provide financial support to family members until such time as our debt is retired, and our emergency fund is sufficient to meet our needs.
- Children need to learn financial responsibility.
- We will teach our children financial literacy. .

# Policy, Value, Belief, Goal, Observation, or Action Item?

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## Children's Vacation Policy

- We will balance our lives with a combination of work and play, ensuring that we have play time together as a couple and with our children.
- We will increase the amount of time we spend with our children by visiting local parks and museums one weekend each month. We will have one annual vacation as a family and the children will each have one week away at a camp of their choice. The maximum amount for each camp adventure will be \$350 and each child is responsible for contributing 10% to the total fee.
- We will provide our children with an experiential learning opportunity while teaching them financial responsibility. Our children will save 10% of their weekly allowance to pay a portion of all extracurricular activities.