Policy-Based Financial Planning Provides Touchstone in a Turbulent World

by David B. Yeske, CFP®, and Elissa Buie, CFP®

David B. Yeske, CFP®, and Elissa Buie, CFP®, who describe themselves as financial planning evangelists, are past chairs of the Financial Planning Association and co-founders of Esprit Financial Planning Corp.

Executive Summary

- Although planning policies are often implicit in the recommendations that financial planners provide their clients, taking the next step and transforming these into formal written statements can better help clients stay the course in an uncertain world. This article advances a framework for how planners might formulate such written policies.
- The ideal policy will be broad enough to encompass new or unexpected events, yet specific enough to minimize doubt as to what action to take in response to changing events.
- Using the integral framework, within which clients are viewed from the four-fold perspective of individual/interior, individual/exterior, collective/interior, and collective/exterior, can be very helpful when developing formal planning policies.
- The article provides several examples of financial planning policies developed using the integral framework.
- A six-step process is suggested for formulating policies that bridge interior client goals and values to concrete exterior actions. The steps include identifying planning areas relevant to each objective, crafting statements that capture the client goals and planning principles, using scenario planning to test the policies, and updating the policies.
- An extended case study shows an initial policy, a revised policy five years later as client circumstances change, and how the policy keeps the clients on course.
- In addition to giving clients a sense of control amidst the daily barrage of "noise," this policy-based approach can be very helpful to clients who use planners only on an as needed basis, and to young people whose biggest planning decisions have yet to come.

When it comes to financial planning, clients struggle to stay the course. They find themselves buffeted by a steady stream of news and gossip, with little to anchor them to a consistent course of action. This is why they need financial planners and why financial planning works best when applied as a continuous process. But even planners can struggle to keep clients on the straight and narrow planning path. It's time-consuming to prepare an updated plan every time a client is nervous or confused, and it's not always easy to remember all the subtle factors that colored your last set of recommendations. This is where 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.

The intersection of a client's facts and circumstances with his or her goals and objectives rarely, if ever, gives rise to one unique solution. One of our challenges as planners is to choose, from among the set of possible solutions, the one that is best matched to our client's personality, experience, and values—that is, to choose not just a technically feasible solution, but one that will actually be implemented because it reflects who the client is as a human being. We believe that this qualitative assessment by which we select specific actions and strategies can be formulated as a planning policy and that such policies make it easier for clients to understand and embrace the planning process. When clients can see how the plan recommendations relate not just to their assets and liabilities but to their beliefs and values, the probability of effective action is enhanced. And just as investment policies help clients stay the course during turbulent times in the markets, planning policies can help keep clients grounded during turbulent times in their lives.

We are not suggesting that policies are not implicitly present in most financial plans. We are suggesting, however, that these implicit policies are not often made explicit and used as a tool for guiding clients. And while Hallman and Rosenbloom (1987) introduced the concept of "personal financial policies" nearly 20 years ago, there has been little or no subsequent development of the concept. It is the purpose of this article to suggest a framework for how one might go about formulating financial planning policies, a framework that will describe both the characteristics of a "good" or effective policy, and a formal six-step process by which these policies might be uncovered and articulated. This article also presents an extensive case study to illustrate the application of such a framework.

Characteristics of an Effective Policy

Among the necessary characteristics of an effective planning policy, two stand out. First, the policy should be broad enough to encompass new or unexpected events as they arise. Second, it should be specific enough so that we are rarely in doubt as to what action to take in response to changing events.

In satisfying these dual criteria, the policy acts as a bridge between a client's core values and aspirations and the specific, concrete steps that should be taken at any given time to sustain progress toward achieving those aspirations. Policies embody clients' core values and goals as well as best practices of the profession. And while specific actions to be taken by the client will vary based on circumstances, the policies themselves will rarely change. Policies will become outmoded only when there is a fundamental shift in client goals or values, the profession's best practices, or assumptions regarding the workings of the external environment. Furthermore, when new circumstances trigger a change in specific strategies, the policies set boundaries around the specific actions that might be taken to keep the plan on track. Financial planning policies help financial planners keep their clients on the path to progress.

An Integral Framework

Applying an integral framework (Wilbur 2001, Wagner 2002) to the financial planning process helps clarify the role of policies in effectively guiding clients toward their goals over time. The integral framework divides the planning process into four quadrants representing different aspects of the client's circumstances that must be accounted for if the planning process is to be complete. These quadrants (see Table 1) encompass the *interior* dimension on the left, the *exterior* dimension on the right, the *individual* dimension along the top, and the *collective* dimension along the bottom.

The upper-left quadrant represents the individual interior aspect of the client, which includes individual attitudes toward spending and saving, personal risk tolerance, and the client's personal notion of "the good life." The lower-left quadrant represents the collective interior dimension, which includes such things as family, ethnic, and cultural attitudes toward money or the image of the good life. The upper-right "individual exterior" quadrant includes all the objective facts relevant to the individual client, such as personal income and expenses, assets and liabilities, skills, and future earning power. The lower-right "collective exterior" quadrant stands for those objective facts that apply to the world at large, things like the state of the economy, financial markets, current tax laws, and available financial instruments.

The left-hand quadrants—the interior elements—represent answers to the "why" questions. This is the realm of client goals and the personal values that determine what they are willing to do to achieve them. The right-hand quadrants—the exterior elements—answer the "how" questions. This realm helps identify the most appropriate strategies based on the material resources at the client's disposal and the economic and governmental framework within which those resources will be put to work. Financial planning policies are the tools that keep the whys of the left-hand quadrants connected to the hows of the right-hand quadrants. They bridge the four quadrants by expressing in general terms what clients plan to do and how they're willing to do it in terms not limited to the current external circumstances.

Examples of Financial Planning Policies

A few examples of what we mean by financial planning policies might be helpful at this point. Note that the policy itself is neither a statement of the client's interior motivation, nor a statement of the specific exterior actions that will be taken, but a bridge between those two.

Policy for prioritizing savings. *Interior motivation:* The client wants to provide his or her children with at least the basic tools for success. This might be the corresponding policy: Funding the cost of a public

Table 1: Quadrant Framework for Client's Circumstances

Individual/Interior	Individual/Exterior
Who you are inside, your intentions, and how you feel about things, including attitudes toward spending and saving, personal risk tolerance, and your vision of "the good life"	What you own, what you owe, all the objective facts about your life, including personal resources and realities such as education, occupation, income, expenses, assets, and liabilities
Collective/Interior	**Collective/Exterior**
Relationships, family, ethnic, cultural history and beliefs, including collective attitudes toward spending, borrowing, investing, charitable giving, education, and legacy	Objective facts about the external environment, including tax laws, financial market structure, state of the economy, inflation rates, and available financial instruments

education will take priority over saving for retirement, but the additional cost of a private education will be funded only after retirement savings targets have been met.

Policy on the uses of debt. *Interior motivation:* The client has an aversion to debt (might be based on family history and attitudes or a negative personal experience involving too much debt). The corresponding policy follows:

- For convenience, we will use credit cards when buying items that are part of the monthly budget.
- For purchases representing 10 percent or less of annual earnings, we will set aside funds monthly until we've accumulated the purchase price.
- For purchases costing more than 10 percent of annual earnings, such as cars or homes, we will use amortized debt, not to exceed a debt service equal to 30 percent of gross income.

With this policy as a guide, the client can always figure out the appropriate action to take when faced with a buying decision, even if the specific item to be bought was never previously contemplated. Example: Save $500 a month toward purchase of new living room furniture.

Policy regarding legacy or estate planning. *Interior motivation:* The client believes children and grandchildren should be given the tools to live productive and happy lives, but also believes that inherited wealth blunts ambition and often results in lives that do not serve larger societal needs. Here's the resulting policy:

- We will provide, by lifetime gifting or through our wills and trusts, funds sufficient to pay for the education of our children and grandchildren.
- We will provide to our children, through lifetime gifting or through our wills and trusts, funds to help make the down payment on a first home.
- The balance of our estate will go to charity.
- We will document and regularly review our desires in a formal estate plan.

Again, while the specific implementation will depend on how many children or grandchildren the clients have at any one time, not to mention the cost of higher education and real estate, they have the tools to make specific concrete decisions at any given time. Example of a specific action: Gift $48,000 to John and Susie (son and daughter-in-law) this year for a down payment on their first home.

Policy regarding retirement/financial independence. *Interior motivation:* Would like to be retired or financially independent by age 50 in order to realize dream of creating a nonprofit mentoring program for inner-city youth. In this case, financial independence means a standard of living comparable to the one available from earned income during the working years. This might be the resulting policy:

- We will save 20 percent out of current earnings.
- We will invest savings for growth and diversify across at least four distinct asset classes.
- We will insure income against loss to guarantee continuation of savings.

Extended Example of Implementation

Scenario A (exterior conditions). The client is working for an employer paying him $80,000 a year and providing a group long-term disability (LTD) plan but no 401(k).

He will save $16,000 this year:
- $4,000 to an IRA
- $12,000 to a brokerage account

He will invest as follows:
- $4,000 ABC Bond Index fund
- $4,000 ABC Large Cap Index fund
- $4,000 ABC Small Cap Index fund
- $4,000 ABC International Index fund

He will enroll in the company LTD plan in an amount sufficient to replace what he spends plus his targeted savings per year (to the extent available).

Scenario B (change in exterior conditions). Client changes jobs and is now earning $100,000 a year with an employer who provides a 401(k) plan but no disability benefits.

He will save $20,000 this year:
- $15,000 to his 401(k)
- $5,000 to a brokerage account

He will invest as follows:
- $5,000 ABC Bond Index fund
- $5,000 ABC Large Cap Index fund
- $5,000 ABC Small Cap Index fund
- $5,000 ABC International Index fund

He will secure an individual disability income policy equivalent to what he spends plus his targeted savings per year (to the extent available).

Process for Uncovering and Formulating Policies

Step 1: Discovery. Because policies are the bridge that connects a client's goals and values with concrete actions, we need to begin by finding out more about those goals and values. Many planners do so in an intuitive way, engaging the client in informal conversation until they feel they have learned enough about the client's needs and attitudes to proceed with their analysis. Others employ some of the many discovery tools that have been developed in recent years, such as George Kinder's Seven Stages of Money Maturity, Carol Anderson's Money Quotient, and Mitch Anthony's Financial Life Planning. These formal tools help the planner probe more deeply and uncover a client's life goals and values—the interior dimension of the integral matrix—things that are unlikely to show up on a standard planning questionnaire. In many cases, the exercises will help clients themselves gain greater clarity regarding their life goals. Whatever approach one takes, the goal is to determine clients' aims (intentions, goals, desires) and what they are willing to do in pursuit of those aims (values, attitudes).

Step 2: Identify planning areas and related principles. Which planning areas are relevant to each objective? Is it financial independence, legacy, retirement, or cash flow and debt planning? Whichever area applies, there will be certain principles, or "best practices," that we as planners will bring to the process.

For example, notwithstanding client attitudes toward investment risk, we as planners would never endorse a policy of putting all savings into the stock of a single company, since best practice requires us to diversify investments. Likewise, we would not ignore the risks to client success arising from lost income due to disability or premature death, nor would we support the inappropriate use of debt or reliance on a windfall to provide for retirement or any other concept that goes against the accepted best practices in the profession.

Step 3: Combine client goals/attitudes with planning principles. This is where we actually begin to craft statements that capture both the client goals and the planning principles relevant to the attainment of those goals. Note that at this stage we are not developing specific strategies or recommendations, but broad statements that encompass client aims, the values and attitudes that surround those aims, and the relevant planning principles that we would apply under all circumstances.

For example, the client who doesn't believe in inherited wealth would have a policy, as captured in the earlier example, of providing for education or the down payment on a first home, but passing all else to charities. One of the planning principles that would come into play is that these desires must actually be documented in a legal estate plan, as the absence of such a plan would result in the laws of intestate succession circumventing client goals and passing all wealth to children and grandchildren.

Step 4: Testing policies and developing specific recommendations. At this stage, we employ a little scenario planning to test whether our policies are satisfying the twin requirement that they be general enough to encompass wildly divergent circumstances, yet specific enough to leave us in little doubt as to the specific actions to be taken. The first step is to develop specific recommendations based on our assessment of current conditions and then to generate several alternative scenarios to see if the policy continues to provide clear guidance. Such alternative scenarios might include factors like inflation rates and market performance, changes to the tax code (for example, do the income and estate tax provisions of the 2001 Tax Act sunset in 2011 or not?), changes in the housing market or school costs, or changes in personal circumstances such as the birth of another child or grandchild, a change in jobs, or a job relocation.

Step 5: Test policies with clients. If the policies survive scenario testing, they are then ready to be formalized and discussed with clients. Because part of the purpose for developing such policies is to provide guidance and comfort to clients in the face of change, it is important that the wording resonate with them and that the process of formalizing the policies be a collaborative one. If clients do not see themselves reflected in the policies, then a new formulation is called for.

Step 6: Periodic review and update. While policies are meant to be durable tools that allow clients to make continuous progress toward their goals in an ever-shifting world, there are, nonetheless, circumstances under which they might need to be rewritten. Such triggers would tend to be structural or fundamental, as opposed to cyclical, in nature. For example, significant tax law changes might require a modification to policies related to the use of debt or the allocation of retirement savings. A change in the profession's best practices regarding a particular planning area would require that some policies be modified. Examples of such changes in best practices might include the shift from building portfolios based on the investment pyramid to the use of mean-variance optimizers, or the progression from simple linear retirement projections to the use of Monte Carlo simulation. Fundamental shifts in a client's exterior circumstances, such as divorce, birth of a child, or significant career change, could also trigger a change in policies.

On the interior side, we might find that a client's values or goals have evolved over time and are no longer served by existing policies. A client may discover something about themselves heretofore unknown—an emotional pull to helping disadvantaged children, a previously unrealized fear that has made it impossible for them to agree to some recommended policy in the past but now is less influential, or a shift in feelings about their child's education or inheritance. Such changes represent a deep interior shift, a new discovery about oneself that may change everything about how one wishes to use money. All of a sudden, leaving money to the kids, buying a bigger house, changing jobs, moving to Florida for retirement—all those things that had manifested on the right-hand side of the integral grid—have lost their luster. The interior shift has changed all the exterior goals. In all of these circumstances, the shift, whether interior or exterior in origin, represents a change in the fundamental assumptions that underlie the original policies and will trigger a new round of formulation and testing.

Case Study: The Smiths

To illustrate the application of a formalized policy, and how the policy might be revised over time, the following case study is provided.

John and Jane Smith have been married for four years. John is 32 years old, Jane is 31. John earns $110,000 a year as an engineer, Jane earns $110,000 as an accountant. They have no estate arrangements.

Expenses:
- $6,000 a month (rent, insurance, auto lease, food, and so on)

Assets:
- $12,000 in John's 401(k); currently contributing 3 percent, the company match limit
- $16,000 in Jane's 401(k); currently contributing 4 percent, the company match limit
- $29,000 in ABC Emerging Market Fund (joint)
- $2,000 in money market checking (joint)

Liabilities:
- $8,000 credit card debt (making the minimum payments)

Insurance:

- $100,000 term life for John
- $110,000 term life for Jane

Their goals:

- Buy a house in a nicer area where the schools are good
- Have children, beginning in the next two years
- Jane to stay home with the children after the first is born
- Retire at age 60
- Protect the family and each other in the event of disability or death

What really matters to them:

- Their children having a stay-at-home mom
- Keeping their debt reasonable
- Managing their cash flow to maximize their lifestyle
- Spending time with family (both have family nearby) and helping family out, if possible, within the scope of other goals
- Supporting their church

The Smiths' Financial Planning Policies

Cash flow and tax:

- (1) Use credit cards for purchases that are part of the monthly budget; (2) for large purchases equal to 10 percent or less of annual after-tax earnings, set aside funds monthly until needed sum is accumulated; (3) for purchases equal to more than 10 percent of annual after-tax earnings, use amortized debt
- Keep budget, including debt service, within one salary
- Provide emotional support to family freely; provide financial support only as it does not infringe on other goals

Risk management:

- Maintain an emergency fund equal to six months of fixed expenses
- (1) Use insurance to cover potential losses that exceed emergency fund; (2) choose the highest deductibles consistent with emergency fund
- Insure John's earning power and, upon arrival of children, Jane's work in the home

Retirement/financial independence:

- Save at least 10 percent of gross income
- Save first to company retirement plans, then to after-tax accounts

Investments:

- Funds earmarked for short-term goals (less than 18 months) must be in cash
- Investments will be diversified across at least five distinct asset classes
- Wherever possible, investments will be chosen that are tax-efficient and have the lowest expenses consistent with the objective
- Asset classes will be rebalanced at least annually
- Portfolio performance will be measured and reviewed periodically

Estate planning:

- Each year, the Smiths will discuss their desire regarding the ultimate disposition of their assets, and maintain accurate documentation of those desires within the appropriate estate documents

Current recommendations:

- Accumulate another $34,000 in the money market checking as an emergency fund
- Buy a house with no more than a $2,000 monthly mortgage ($330,000 total purchase price?)
- Liquidate ABC Emerging Market Fund immediately, as this is the only apparent source for home down payment and has therefore become "short-term" money
- Increase 401(k) contributions to 10 percent of gross pay for each
- Buy a family-size car and get it paid off before Jane quits working
- Obtain $1.3 million, 30-year term insurance on John
- Obtain $600,000, 20-year term insurance on Jane
- Obtain $6,000-a-month (after-tax) disability benefit on John
- Execute valid will or living trust detailing estate distribution desires

The Smiths Five Years Later

John and Jane Smith have two children: little John is three years old and little Jane is one year old. John Sr. now earns $160,000 a year as an engineer. John and Jane's estate arrangements now consist of simple wills.

Expenses:

- $9,000 per month (mortgage, property taxes, insurance, food, and so on)

Assets:

- $85,000 in John's 401(k); he's currently contributing $15,000 a year
- $50,000 in Jane's rollover IRA
- $9,000 in ABC Emerging Market Fund (joint)
- $12,000 in money market checking (joint)

Liabilities:

- $300,000 mortgage

Insurance:

- $1.3 million term life for John
- $600,000 term life for Jane
  $6,000 a month disability income for John

Their goals:

- Move to a bigger house
- Take the kids to Disney World in three summers
- Retire at age 60
- Protect the family and each other in the event of death or disability
- Pay for four years of in-state college education for each child
- Help John's brother with his credit card problems, if possible

What really matters to them:

- Jane continuing to stay home with both kids through high school
- Keeping their debt reasonable
- Managing their cash flow to maximize their lifestyle
- Providing for the support and education of their kids, but not "making them rich" through inheritance (they believe it builds character to earn and save to meet life goals)
- Spending time with family (both have family nearby) and helping family out—if possible, within the scope of other goals
- Supporting their church and the work of Greenpeace (after having kids, they found themselves increasingly concerned with issues of sustainability and environmental degradation)

The Smiths' Financial Planning Policies

Cash flow and tax:

- (1) Use credit cards for purchases that are part of the monthly budget; (2) for large purchases equal to 10 percent or less of annual after-tax earnings, set aside funds monthly until needed sum is accumulated; (3) for purchases equal to more than 10 percent of annual after-tax earnings, use amortized debt
- Keep budget, including debt service, within one salary
- Freely provide emotional support to family; provide financial support only as it does not infringe on other goals

Risk management:

- Maintain an emergency fund equal to six months of fixed expenses
- (1) Use insurance to cover potential losses that exceed emergency fund; (2) choose the highest deductibles consistent with emergency fund
- Insure John's earning power and Jane's work in the home
- Maintain sufficient life insurance to meet the future costs of college

Retirement/financial independence:

- Save at least 10 percent of gross income
- Save first to company retirement plans, then to after-tax accounts

Investments:

- Funds earmarked for short-term goals (less than 18 months) must be in cash
- Investments will be diversified across at least five distinct asset classes
- Wherever possible, investments will be chosen that are tax-efficient and have the lowest expenses consistent with the objective
- Asset classes will be rebalanced at least annually
- Portfolio performance will be measured and reviewed periodically

Estate planning:

- The Smiths will annually discuss their desire regarding the ultimate disposition of their assets, and maintain accurate documentation of those desires within the appropriate estate documents.
- They will provide for children's basic support and education needs without creating a significant legacy for them.

Recommendations:

- Accumulate another $42,000 in money market checking account as emergency fund (bringing it to six months of living expenses)
- Buy a house with no more than a $3,000-a-month mortgage
- Maintain $15,000 annual contribution to 401(k) and save $1,000 additional in nonqualified account toward retire-

ment (for a total of 10 percent of gross earned income).

- To the extent cash flow permits, save $1,000 a year toward the Disney World vacation
- Increase life insurance on John to $1.8 million, reflecting higher income and education expenses
- Maintain $600,000 20-year term (15 years to go) insurance on Jane
- Increase John's disability benefit to $8,000 a month (after-tax), reflecting his increased salary
- Save $3,000 a year in each of two 529 plans
- Sell ABC Emerging Market Fund (which they didn't sell five years ago despite a recommendation to do so) and reallocate to the XYZ Target Allocation Fund, which invests in bonds, large stocks, small stocks, real estate securities, and foreign stocks and bonds. Supplemental retirement savings also can be added to this fund.
- Implement revocable living trusts that leave money in trust for the kids, with the family as trustee (advised professionally). Provide for living expenses through college with balance going to Greenpeace and church.
- Refer John's brother, who has asked them to help bail him out of debt, to credit counseling service and pay first month's fee, if that helps.

Epilogue: 18 Months Later

John's brother has gone into the insurance business and told them that they are woefully underinsured and need to double the amount of life insurance on both John and Jane and convert to some type of "permanent" policy.

Their planner points out that doing so would be inconsistent with their risk management policy, which is to replace only enough of John's income to meet basic living expenses and the children's college, and to fund Jane's work in the home. Increasing the amount and converting to a permanent type of coverage would also violate their legacy policy by potentially creating excess wealth for the children. It may also be inconsistent with their cash-flow policy of maintaining their lifestyle.

Being reminded of this, John and Jane felt comfortable telling John's brother that his suggestions weren't appropriate for their circumstances.

Behavioral Dimension

One of the greatest benefits of formal financial planning policies is in giving clients a sense of control when confronted by the daily barrage of factual "noise" delivered by the print and broadcast media. Likewise, when solicited for charitable contributions, loans to family members, insurance purchases, or investment products, those who have embraced a grounded set of planning policies will be able to respond with confidence. The overall financial plan, after all, like the investment strategies embedded within it, requires a degree of stability and discipline over time that is normally hard to sustain. But when clients are armed with clear formulations for how they will operate in the world—statements that clearly express both their goals and values—they stand the best chance of staying the course and achieving their aims.

Other Applications

There are two other instances where a policy-based approach might be particularly effective. The first is where the planning model is based on hourly engagements, with no ongoing relationship between planner and client. Clients are generally expected to operate more autonomously in these situations and would no doubt be aided greatly by policies that returned clear answers whenever the client was faced with financial questions or changing circumstances. While the majority of those receiving financial planning advice benefit from the steady influence and objectivity of an ongoing engagement, those who prefer "as needed" counsel should at least be given tools that can guide them through changing circumstances.

The other area where a policy-based approach could be useful is with young people just starting out, or others with little income and few assets. For many such people, the most important planning issues are not immediately present, but will emerge over months and years. Basic financial planning policies will help these people make good decisions along the way.

Conclusion

While policies are implicit in most financial plans, a process for making them explicit would guide both clients and advisors in making appropriate adjustments to changing circumstances without needing to start from scratch. Such policies must clearly connect clients' values and goals with the specific actions to reach those goals. To be effective, policies must satisfy the dual condition of being general enough to encompass any change in circumstances and specific enough to leave no doubt of the actions required. To be effective in formulating policies that will resonate with clients, planners must focus significant time and energy on the discovery process.

Finally, policies are meant to be enduring guides in an uncertain world. But changes to our underlying assumptions about the structure of the external environment or the client's values and desires, as well as changes in best practices for financial planners, will trigger the need to adopt new policies that better reflect these changes.

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