The Quest for **Financial Freedom.** A Critical Choice.

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On 25 November 2000, the SMA Membership Committee, and Independent Life Planners jointly organised a talk on Personal Financial Planning. The two speakers, Joshua Ng and Augustine Lee covered two of the four key building blocks in financial planning. They are wealth protection, and retirement planning respectively. The remaining two key building blocks are wealth management, and wealth distribution.

FINANCIAL PLANNING

Everyone needs financial planning. Without financial planning, most of us will fail to achieve lifetime financial security and success. Building a capital base is therefore a pre-requisite to achieving ultimate financial independence and life long economic income security. Hence, wealth accumulation is one of the most important and challenging phases and tasks of personal financial planning.

What is financial planning?

Financial planning is more than just buying some life insurance plans and/or having some unit trusts. Financial planning in essence covers four key building blocks. They are wealth protection, wealth accumulation, wealth management, and wealth distribution. However, asset allocation planning remains key in successful financial planning.

Asset allocation is the single most important aspect of a successful investment strategy. It refers to the way you divide your investment dollars among different types of investment vehicles, e.g. cash, bonds, shares, real estate, business ventures, life insurance etc.

The type of allocation is dependent on among other things, investment goals, investment horizon, liquidity needs and risk profile/tolerance.

Six Steps in Personal Financial Planning Process

Essentially, there are six steps in personal financial planning. They are as follow:

1. Fact-finding & summary of financial data.
2. Defining financial goals and objectives.
3. Analyse current financial plan.
4. Develop a comprehensive financial plan.
5. Implementing and executing the financial plan.
6. Measure performances: review and updating.

Five components in Building a Capital Base

Building a capital base is an important part of wealth accumulation. There are five key components in building a capital base.

1. Income
2. Annual/savings
3. Return on Investments
4. Capital
5. Time

Income

The higher a person's income, the greater is his/her ability to build a capital base. For example, a person's average income per year is S$100,000/-. If he/she continues to work and earn income for the next 20 years, his/her total future income will be S$2 million.

Therefore, the most important financial asset for most working adults, such as medical officers, registrars, consultants, or even business owners and other professionals, is their economic life value. This economic life value will often have an impact on the cash flows in their overall financial plan.

Annual Savings

Annual savings refer to a person's gross income less living expenses and income taxes, and the "net savings" is what are available for investments. With savings, one can make investments. With investments, there are opportunities for wealth accumulation.

High savers will have a tendency and opportunities for high investment and accumulation. Low savers on the other hand will have fewer opportunities for investments and accumulation.

Return on Investment (ROI)

The higher the return on investment, the greater the accumulation. For example, an annual savings of S$20,000/- over 20 years with an average ROI of 5% will have an accumulated value of about S$700,000/- in 20 years. However, be aware of the risk and return trade off.

Capital

In order to invest in real estate, shares, business ventures etc., we need to accumulate sufficient "seed" money or cash reserves to be allocated for investments. For example, we need 20% as cash down payment and other legal/transactional expenses when we invest in property.

Time

Time is needed to build a capital base. That is, we need time to earn, save, invest, and accumulate. The longer the time period, the greater will be our aggregate savings, investment and accumulation values.

WEALTH PROTECTION

The goal of financial planning is to achieve financial security and success. That is, to achieve financial independence.

As mentioned earlier, the concept of economic life value is the most important financial asset anyone can have. That is, the earning potential of an individual. For example, a person who earns S$100,000/- per year will have as their total future income a sum of S$2m after 20 years. No doubt this may look overly simplified. However, the main assumption is "the ability to earn an income".

Three Major Risks

Although there are many different types of risks such as business risks, inflation risks, currency risks, political risks and so on, there are "Three Major Risks" that will adversely impact a person's ability to earn an income when either one of the three risks is experienced.

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These three major risks are:

1. Major medical crisis.
2. Long term total and permanent disability.
3. Premature death.

If a person were to experience either one or more of these three major risks, he/she will experience emotional and physical hardship let alone face tremendous financial implications. Hence, one should not take his/her ability to earn an income for granted.

The solution

No one can deny the existence of these three major risks. In view of these risks, there are essentially three possible options to counteract these risks.

1. Avoid risk: To be very careful in all his/her actions and lifestyle.
2. Assume risk: To deal with the risk as and when they appear.
3. Assign risk: To assign risk or transfer risk to companies who want it, e.g. life insurer.

Statistics have showed that 3 out of 5 individuals die because of one of the "thirty dread diseases".

How much coverage is enough?

Surveys have showed that most Singaporeans have about S$200,000 or S$300,000 coverage. Is this sufficient? The answer is, it depends on among other things, the person's economic life value.

For example, a person who earns a gross annual income of S$100,000/- would have his/her lifestyle and financial commitment based on S$100,000/-. In addition, he/she has a total coverage S$300,000/- against the three major risks. In the event that he/she suffers one of the three major risks like one of the dread diseases, he/she will receive only S$300,000/- and his/her ability to earn their "pre-existing illness" income will be in question. If assuming, he/she is unable to work, the S$300,000/- will sustain the person for about 3 years before he/she makes drastic changes in their lifestyle and financial commitment. The financial hardship will be even harder if he/she is the breadwinner with a growing family and a mortgage to repay.

In view of this, life insurance is therefore the foundation for successful financial planning. Minimum coverage is five times one's gross annual income. Ideally, ten times one's gross annual income. For example, if he/she earns a gross annual income of S$100,000/-. It will be ideal to have coverage of S$1 million.

In addition, one is cautioned against thinking endowment plans and the life insurance plans are the same. In essence, they are different. Each of these is designed for different purposes. Endowment plans are for long term savings whereas whole life insurance is designed for protection.

WEALTH ACCUMULATION AND RETIREMENT PLANNING

Given the increased life expectancy and the aging population, retirement planning becomes an important area of personal financial planning. One therefore has to be conscious of the need to be proactive in planning for retirement.

Financial Life Cycle

The financial life cycle is as follow:

1. Work creates Earnings.
2. Earnings build capital.
3. Capital produces Accumulated Income.
4. Accumulated Income increases your Capital.
5. Your Increased Capital when liquidated will produce retirement fund.

No doubt this financial life cycle may be very simplistic. It however remains fundamentally important in understanding the importance of and the need for financial planning.

As mentioned earlier, there are five basic components in building a capital base. They are Income, Annual savings, ROI, Capital and Time. Therefore, the earlier one starts to save, invest and accumulate wealth, the better he/she will be in their retirement years.

Retirement Funding

There are many options available as retirement funding. The types of sources of income/funding are largely dependent on one's needs and financial goals. For example, if one needs S$100,000/- a year for retirement, he/she may need S$1m or S$2m as their capital base during retirement years. That is, if the retiree can invest with a ROI of 5% or 10%, that will determine the capital needed for retirement. Of course, one must be reminded of the risk and return trade-off.

Annuities as a source of income

Retirement funding can be a combination of different types of instruments, such as, government bonds, rental, annuities and so on. There are two types of annuities.

1. Immediate annuity
2. Deferred annuity

First of all, annuities are a series of payments at regular intervals from a fixed date until the death of the annuitant (life assured) or some other specified time. It is the reverse of ordinary life insurance. That is, an annuity provides protection against the possibility of outliving one's income. The consideration to be paid by the annuitant is called the purchase price.

Immediate Annuity

An annuitant will begin receiving his/her first payment immediately at the beginning of the "next period" for the rest of his/her life after having paid the single premium/the purchase price. The periodic payments can be monthly, quarterly, half-yearly or yearly.

Deferred Annuity

In a deferred annuity program, the payment of the annuity installment would not begin immediately. Instead, it would begin at the end of a stipulated period of years called the "deferment period", such as 55 years or 60 years for example.

CONCLUSION

In essence, financial planning is about taking personal financial responsibilities for oneself and their loved ones. Protecting one's economic life value should be the first step in successful financial planning. One should therefore not take the ability to earn an income for granted. The quest for financial freedom begins with a critical choice. Make an informed choice today.

The SMA, together with Independent Life Planners will be holding another talk in February/March 2001. Watch out for more details in the SMA NEWS. ■