MORTGAGE advisor™

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Facing Financial Dysfunction

According to veteran financial advisor and author Bert Whitehead, financial freedom is the result of strong and healthy financial habits. In "Facing Financial Dysfunction", Whitehead demystifies the difficulties that block people from achieving their financial goals and explains how to establish the mindset and habits that lead to financial freedom.

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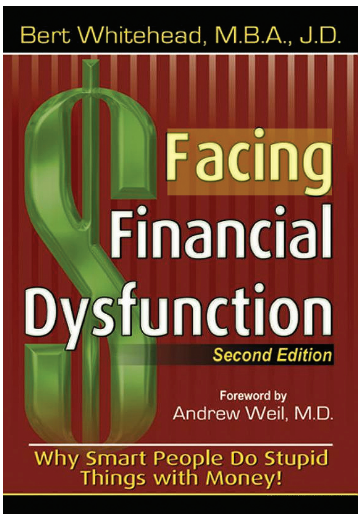

Conclusion of a three-part series

In the first two parts of this series, we highlighted key principles from Bert Whitehead's "Facing Financial Dysfunction". We addressed the strengths and weaknesses of the most common financial personalities, the roots and symptoms of financial dysfunctions, and the steps to establishing a healthier approach to finances. We also discussed adapting an endogenous approach to finances, which involves understanding that you have more control over your financial wellbeing than outside forces do.

In this final segment of the series, we'll outline some of Whitehead's final recommendations for establishing the healthy habits that lead to financial freedom.

Establish and Visualize Realistic Goals

Now that you've become more aware of your financial personality, difficulties and overall standing, it's time to establish your goals. Goals are at the heart of any financial plan, and they should be well thought out and realistic. The notion is not to establish an unattainable fantasy, but rather to find out what's important to you and develop the path to achieve that.

Start by defining your values, which may include early retirement, a new home, or paying for a child's education. After that, assess the feasibility of achieving those goals based on your current resources and financial behaviors. Keep an eye out for financial dysfunction as you're completing this activity. Poverty mentality often arises at this stage, and can impede recovery from financial dysfunction.

Once you have your goals established, take the time to visualize where you'd like to be in five years. Take the time to do this at the same time each day for 21 days. Each time you visualize, add one more detail to the picture and note it in a journal. At the end of each week, share the exercise with a visualization partner. According to Whitehead, most clients who follow through with the visualization exercise find themselves in the scenario they've imagined in less than five years.

Benchmark Yourself to Gain Clarity

Benchmarking helps to ward off financial dysfunction. When individuals don't know where they stand, they often resort to comparing themselves to others' external factors, such as the number and types of cars they own, or the frequency and destination of vacations. The issue is that these factors reflect values and priorities, not necessarily financial wellbeing.

By benchmarking yourself against a more objective measuring stick, like Whitehead's Financial Lifecycle, you'll get a clearer picture of where you stand, and therefore how you should approach your finances. The lifecycle is broken into stages that represent the natural progression in personal financial development.

When people feel stuck in a certain stage, it's often because they don't understand what it means to be financially independent and what it takes to achieve that status. The truth is, there are three basic ways to obtain money: by affiliation -- through marriage, inheritance or gifting; by earning; and by letting your money make money for you -- this is what financial freedom is all about. Wealth is created, and the goal at each stage of the Financial Lifecycle is to eventually have your money do the earning for you.

Know Where You Stand in the Financial Lifecycle

The Financial Lifecycle has four parts: the formative years, accumulation years, conservation years and distribution years. Knowing where you stand will help you to gain clarity for moving toward the next stage.

The Formative Years

The formative years occur in childhood and are important if we want to teach our children how to live healthy financial lives. During early and middle childhood, children learn the basics of money, value and waste. This is the ideal time to impart the value of saving. Children can learn to save for charity, for buying things later and for investing. During the teen years, children begin to learn how money is earned. One of the most valuable lessons you can impart to your children is that their earnings are fundamentally determined by the value they add. Get teens accustomed to saving money to invest. If they don't start early, they'll probably spend the rest of their lives trying to catch up.

The Accumulation Years

The accumulation years begin in the early 20s, or whenever individuals start to become self-supporting. The key to moving through this stage is to accomplish the five fundamentals of fiscal fitness:

1. Save at least 10 percent of your annual income
2. Have sufficient liquidity
3. Fully fund pensions (this counts toward the 10 percent savings)
4. Buy the right size house
5. Pay off credit card and consumer debt.

Sufficient liquidity is the foundation of financial freedom. Whitehead recommends that self-employed individuals have cash reserves equal to 20 percent of their annual salary, or 10 percent if someone else employs them. As for buying the right size house, Whitehead advises purchasing a home worth two to two and a half times your annual income.

Whitehead also strongly advises not to pay off your home. The practice of paying off your mortgage as quickly as possible to attain security fits the classic definition of financial dysfunction. It's a financial strategy that people think is effective, but that actually impedes financial progress. Keeping a mortgage provides positive leverage, a buffer against inflation and more financial flexibility.

Asset diversification is imperative, states Whitehead, and begins with real estate. Diversification is especially important during the early accumulation stage, which is typically between ages 30 and 40 when your net worth begins to exceed your annual salary. By the time you reach the rapid accumulation stage, usually between ages 40 and 50, when your net worth reaches three times your annual income, tax efficiency becomes a very important factor as well. Keep in mind that as important as diversification and tax efficiency are, they should never be achieved at the cost of the five fundamentals of fiscal fitness. A trustworthy and qualified advisor can assist you during the accumulation phase to help you reach the next stages in the Financial Lifecycle.

The Conservation Years

The conservation years are comprised of two stages: financial independence, where you continue to earn money but supplement that income with money from your investments to maintain your standard of living; and the conservation stage, where you rely totally on your investments for income.

To enter the financial independence stage, your portfolio should equal 7 to 10 times your annual living expenses, which Whitehead estimates at roughly four times a person's monthly house payment. In the conservation stage, your household's investment portfolio should equal 10 to 15 times your annual living costs. This is not the time to take inappropriate risks. You cannot expect to increase your standard of living meaningfully through better investments at this stage. This will put you at risk of losing a substantial part of your investment portfolio without the time to recover.

The Distribution Years

Distribution and sunset are the two final stages in the Financial Lifecycle. In order avoid having the government take your assets when you die, you'll need to structure your assets properly. Consider initiating an annual gifting program to your children. This can help them to start learning healthy financial habits in smaller increments, prior to receiving one lump sum. During the sunset stage, which occurs when we have less than 12 months to live, it's usually a mistake to sell large assets like your home. According to Whitehead, arranging a mortgage is a more sensible option. Take the steps to simplify and consolidate your assets to leave your heirs a hassle-free estate.

Invest Using a Safe and Sensible Approach

Now that you've finished your self-assessment, it's time to focus on investing. Whitehead recommends using his Functional Asset Allocation investing approach. With Functional Asset Allocation, real estate is a key aspect to your portfolio and the best protection against inflation.

The three asset categories of Functional Asset Allocation are: interest earning, which protects against deflation; real estate, which protects against inflation; and equities, which provide profits during prosperity. Real estate provides Americans the most advantageous after-tax investment vehicle in the world. In order to properly allocate real estate assets according to Functional Asset Allocation, make sure that your real estate assets comprise the appropriate percentage of your investments, have those real estate assets properly leveraged, and properly buttress real estate with liquidity.

Functional Asset Allocation calls for 25 to 40 percent of total marketable assets to be held in real estate, but real estate professionals or those owning commercial real estate may increase the percentage to 30 to 60 percent. Whitehead also recommends keeping a loan equaling 50 to 80 percent of the property's value. For liquidity, Whitehead suggests cash reserves of 10 percent of your annual income or 20 percent of your outstanding mortgage balances, whichever is higher. If you're following Functional Asset Allocation, those numbers should be roughly the same.

Take Action and Make the Commitment

Making changes may seem difficult, but embarking upon a healthy financial life is well within your power. Start by becoming aware of your financial dysfunctions and moving into action to change dysfunctional behavior. Enlist the assistance of a trusted financial advisor who is more concerned with your financial health than earning commissions. You can enjoy financial freedom beyond what you imagine, in less time than you think it will take, as long as you make a commitment, take the action and stick to your program.

For further detail on any of the principles and guidelines addressed in this series, read Bert Whitehead's Facing Financial Dysfunction.

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To arrange a mortgage planning consultation on strategies discussed in this article, please give me a call.