Penguin Bitesize Guides to Better Money Management

Guide #9

Four Financial Planning Ideas Everyone Needs to Know

Learning new ideas enhances an understanding of how the financial world works, and a better understanding leads to better financial decisions. These, in turn, lead to better outcomes. There is a direct link between learning and outcomes.

When it comes to taking advice, it is possible to leave everything to the adviser, but we think this is short-sighted because with so many aspects of the financial journey things aren't as simple as right and wrong, for example the right way and the wrong way of getting from A to B.

The results that you get from your financial planning come because of discussion, planning and a series of decisions over time. The more you can collaborate with your adviser, the greater the prospects for improved results.

Here are four ideas we think will help you with a better of understanding of the financial world.

1 Cash Flow Planning

"Just about any financial planning decision will be better made once a cash flow forecast is introduced into the process."

There is no easily identifiable statistic on how many people use cash flow software in their financial planning or management. However, we know it is going to be a very low percentage.

Yet, it should be a very high percentage.

Cash flow planning is so effective just about anyone, at any stage, with any level of current wealth or financial position, can benefit from having their cash flow assessed.

Why? Because it does lots of things all at one...

First, it presents a picture of many future possible financial outcomes, that vary depending on what you assume will happen. As an example, if you want to test what your financial prospects are at different retirement ages, it will produce an accurate idea.

Second, it allows you to see where the biggest risks are to your financial position as you move forward.

Third, it can inform you on the best strategy to pursue.

Fourth, it can help you decide which financial products to use at any given time. For instance, if you are contemplating whether to invest your recently acquired windfall or to use some or all to pay off some borrowing.

Fifth, it allows you to see the value of money change over time. It's all very well knowing today you are good to live off £27,500 per year but how much will you need in 20 years?

Cash flow planning is not a panacea, but it is not far off! So, what exactly is it?

It is way of using sophisticated software to input your current financial position and from there to add assumptions about what you think may happen in the future with a range of different factors, relevant to your financial future.

This range includes salary (or other income) changes, cost of living and expenditure changes, inflation rates, investment and savings returns, cost of borrowing changes, retiring at different dates, partial retirement positions, property price changes and more.

This all leads to a picture forming which shows your lifetime cash flow moving around as you alter the assumptions.

When you see this picture, and how it moves with the assumptions. it provides a source of information and insight which you can't achieve by merely scribbling on a bit of paper or trying to figure it all out in your head.

Just about any financial planning decision will be better made once a cash flow forecast is introduced into the process.

And in a world where so many things are uncontrollable, such as the economic situation or how much return your ISA will generate, you can control your decision making.

Think of cash flow planning as a means to improve decisions and you have the idea in a nutshell.

2 Compounding returns and costs

"Money makes money. And the money that money makes, makes money."

The best way of illustrating the incredible power of compounding is to follow this story.

Two siblings receive a bequest from their grandmother, who presents them with **£25,000 each** but on the strict condition they cannot touch the money for **25 years**. In making the gift she leaves it to the grandchildren to decide where to invest it, simply saying "choose wisely".

The first grandchild decides not to bother too much about this and chooses to place it into a basic savings account, paying a little interest. Over the following 25 years they receive an interest return averaging **2.5% per year.**

The second grandchild decides to learn everything she can about investing, to make every effort to find the best growth possible and to strive to maximise the return, and she succeeds, and gets a yearly growth of **12.5% per year.**

In 25 years, grandchild number one has accumulated £40,965. Grandchild two has accumulated £263,627.

As a wise man once said, "Money makes money. And the money that money makes, makes money." The bigger you can get that figure that the money 'makes' - the greater the compounding effect.

This is why it always makes sense to work out any which way you can to eke out those extra returns, because whilst in a short period it doesn't make that much difference, over a few years or decades it can make all the difference.

There are so many areas where investors are commonly seen to ignore this basic financial concept. For instance, with old pension plans, taken out through an employer or sold by a bank or an insurance company and left to do what it will. The individual who will benefit from the pension pays no attention to how it is performing and then finds close to retirement that it has not done too well, and they could have done so much better had they paid attention or made the effort. The cost of that could be enormous.

The compounding effect – and benefit – doesn't change depending on the amount you have, it works at all levels, so if you have £20,000 or £2 million, the relative position is the same.

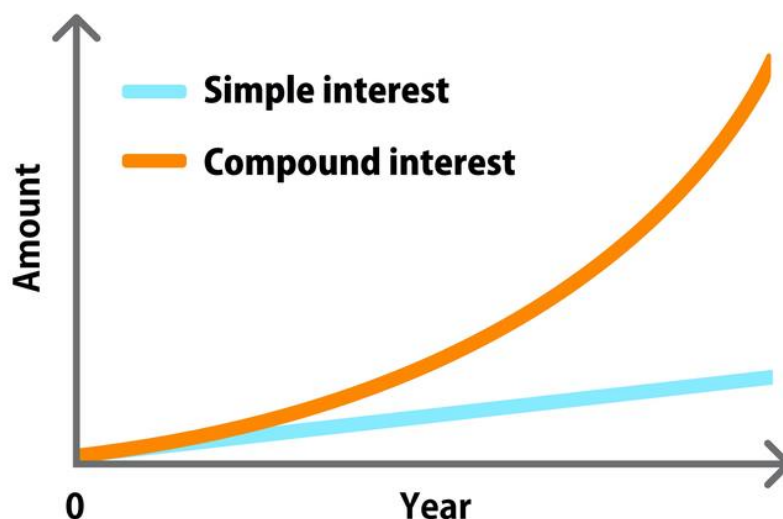
Just about any individual at any stage can use the benefits of compounding to their advantage. Whether it is within an ISA or pension, savings, or investment, it can be used to make money make money.

The same is also true for borrowers who can get badly damaged by the compounding effect when they are charged interest – if it is allowed to compound.

The most common area this applies is with credit cards. Imagine an individual who has gone on a spending spree and racked up £20,000 in card balances.

With an interest rate of 17%, if that individual makes minimum payments (assuming a 2% minimum payment) at the end of 2 years their balance is now £17,261. They have paid over £9,000 in total in minimum payments, spent £0 in new purchases and the balance has only declined just over £2,700. It's a hugely expensive position, worsened by the fact they are now paying interest on interest.

The conclusion? Understand and use compounding returns to your advantage.



3 Dynamic Planning

"When you make a financial decision, such as where to invest or what strategy to pursue, you do so based on the knowns and the unknowns"

Dynamic planning is an idea which describes an approach to managing your finances which is fluid, progressive and adjusts to ongoing and new information. The opposite of this, which too many people do (mainly by default), is rigid or static planning.

Your best chance of getting great outcomes for your finances is making great decisions.

In financial planning terms many decisions must be taken based on a wide range of unknown future factors. For example, you have no idea how long you will live, little reliable idea of how the economy will be performing in five years' time or what investment return your pension will produce.

When you make a financial decision, such as where to invest or what strategy to pursue, you do so based on the knowns and the unknowns. You will, inevitably, try to balance these out against each to reach the best decisions.

That's fine. However, fast forward a few years and some of the unknowns are now known. You will have fresh information or updated information to help you.

A great example of this is after you have retired.

On day one of your retirement, you will need to make decisions about how to structure your retirement income, where to take it from etc. You don't know if you will live for one year or thirty years after you have retired, or how the economic backdrop will change. You might not know with any accuracy your spending pattern. Leap to five years later and you now know, for sure, you have lived five years and there may be fresh economic factors to consider. You will have five years of experience of retirement to reflect on.

If you decide on day one of your retirement to pursue a certain strategy, then you are doing so with limited information in comparison to the position after five years. You are better informed five years down the line, so you should be using this ever-growing information feedback loop to continually review your decisions. This could easily lead to a change or pivot in strategy.

Far too many people box themselves into a strategy based on the earlier information, and this seems to apply at all stages.

This is highlighted in many areas, for instance the number of people who have money wasting away in under-performing pensions or who leave money in bank accounts paying no interest.

Once upon a time it may have been a good decision to put savings into these areas or with certain companies or type of plan/account. However, as time has passed and things have changed, the rigid nature of the financial planning has resulted in an error.

A dynamic financial approach wouldn't allow this to happen.

What does a dynamic financial approach look like?

It means having a strategy that incorporates regular reviews, including revised cash flow forecasts being run at each review. It means having a strategy that respects the changing nature of individuals lives and the world around them. This is supported by ensuring decisions are taken based on the updated known information.

4 Behavioural Finance

"The traits and biases we all have are hard-wired into us".

Your traits, biases, and your cognitive leanings will inevitably influence your financial decisions and, consequently, outcomes.

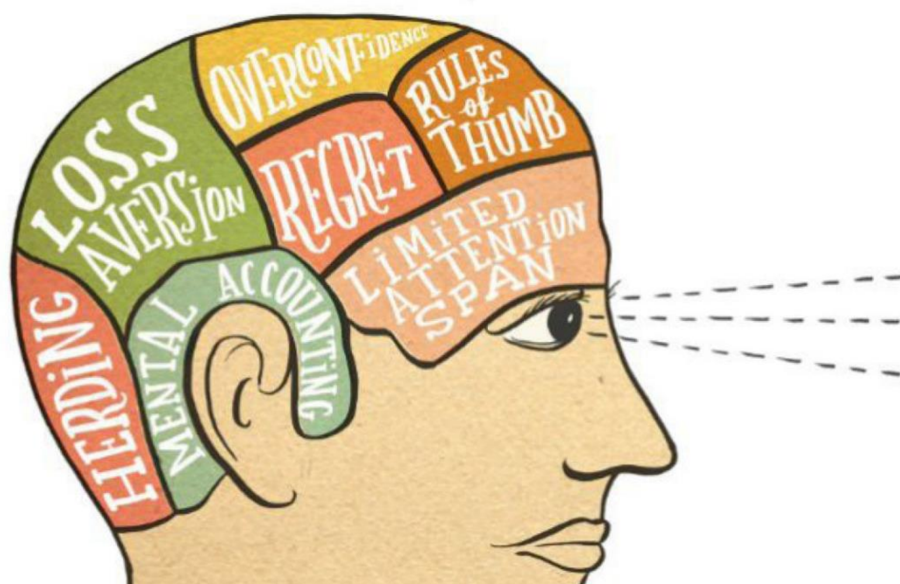
The research and academic work in this field has blossomed in the past few decades and led to a new understanding of how important this is in terms of how you approach your financial planning.

The traits and biases we all have are hard-wired into us. It's a complex position, based mainly on childhood, environment, education, personality, and genetics.

Why does this matter when it comes to financial decisions? Because your mind may steer you towards something or against something based on these ingrained positions and beliefs. That "something" may not be in your best financial interests or may lead to a poor decision.

A great example is that you may be inclined towards confirmation bias. This means you have an established belief that something is true and cannot properly perceive a counter position. For instance, that property is "an investment you cannot go wrong with". That could easily be a deep set view you hold. Confirmation bias implies that you are then seeking and finding information to back up your view, you notice and respect all the stories, articles, case studies, news, facts and figures, that confirm your view. When you make investment decisions, this belief and view is influencing your decision. You would not see or respect anything that may counter or challenge your view, and you would naturally prefer property as an option over other possible investments – regardless of any unbiased assessment.

There are many such biases. These include such things as availability bias, recency bias, loss aversion, overconfidence, herding, anchoring and hindsight bias.



Please do not think that having these biases or traits is in any way unusual or means you have anything wrong with you! All of us have these, and this includes professional money managers and investors.

What is crucial is to understand what a game changer this is when you are contemplating anything financial, especially when you take decisions and make plans. Until the recent behavioural finance research became available, Traditional Financial Theory assumed everybody was acting rationally, and produced as a consequence a map of how best to do things.

Now that it has been evidenced that most people are, at least in part, acting irrationally – because of their biases and traits – then the picture/map looks very different. It explains why bad decisions are taken regularly!

As an individual, your takeaway from this should be to (a) understand that this is a very real part of the financial landscape and affects all sorts of related matters (e.g. how investment markets move) and (b) What your own predilections are, how you view money matters, how you think about risk, what your traits are. Once you have this understanding and insight, you can then use behavioural finance to your advantage.

This will lead to better financial decision making.

About Penguin Wealth

We are a Cardiff-based Financial Planning firm formed in 2010 by a group of Financial Planners who share the same vision and love for what we do. Our processes, support team and the accreditation we have achieved all reflect our principles and prove that we are best placed to help you live the life you deserve with peace of mind.

Our Mission Statement

Helping People Live their Best Lives, by Making Smarter Financial Decisions.

Core Values

- At Penguin we Commit to our Words, Actions and Results
- Clients' Needs 1st – Always
- Communication is key
- Have Penguin Positivity

Providing the highest standard of advice is at the heart of what we do, and we are always extremely excited to see what we can help you to achieve in the future!

Contact Us

Penguin House, 2 Raleigh Walk, Brigantine Place, Cardiff CF10 4LN

T: 02920 450143
E: info@penguinwealth.com
W: penguinwealth.com