Creating and Following a Real Financial Plan

Carl Richards is a certified financial planner, director of investor education for the BAM Alliance, and creator of the weekly Sketch Guy column at The New York Times. He spoke to AAII about the benefits of having an easy-to-follow financial plan.

Could you explain what a financial plan should be? Most people have a conceptual idea of what a financial plan is, but may not be able to correctly explain what should be in it.

Richards: What a real financial plan is is pretty simple. It's a pretty clear definition of where you are today. And I like to call it your current reality. It's factual. You could think of this as if you're going on a trip. You start mapping out your trip with where you're leaving from, where you are today. Then you make a series of guesses about where you think you want to go. You wouldn't actually leave on a trip until you decided where the destination was. Finally, it's an effort to map out how you're going to get there. It's pretty simple.

Getting clear about where you are today is called a personal balance sheet, which is just a list of your assets and your liabilities. Once you have this, you can make some guesses about where you want to go.

One of the really important parts of a financial plan that's totally overlooked and almost never talked about is why you even want to go there. Why are you doing these things? I like to think of these as a statement of values. You get clear about your values, you make some guesses about where you want to go and you clearly define where you are. Then, it's the next two or three things that you need to do in order to get yourself a couple of steps closer to that destination. We don't need to worry about a list of a hundred things, because then nothing gets done. But what are the two or three simple things you need to do in order to get yourself close to that destination?

The last step is repeated, because it is a process. When you complete those two or three steps, you say, "Okay, what should I do next to get myself close to that destination? Is that still the destination I want to hit?" Maybe that part of the repeat might be "Hey, you know what? I think those guesses I made about my goals have changed a little bit." You just sort of keep repeating that process over and over and over and get committed to the process, not the actual "plan." That, to me, is what financial planning is.

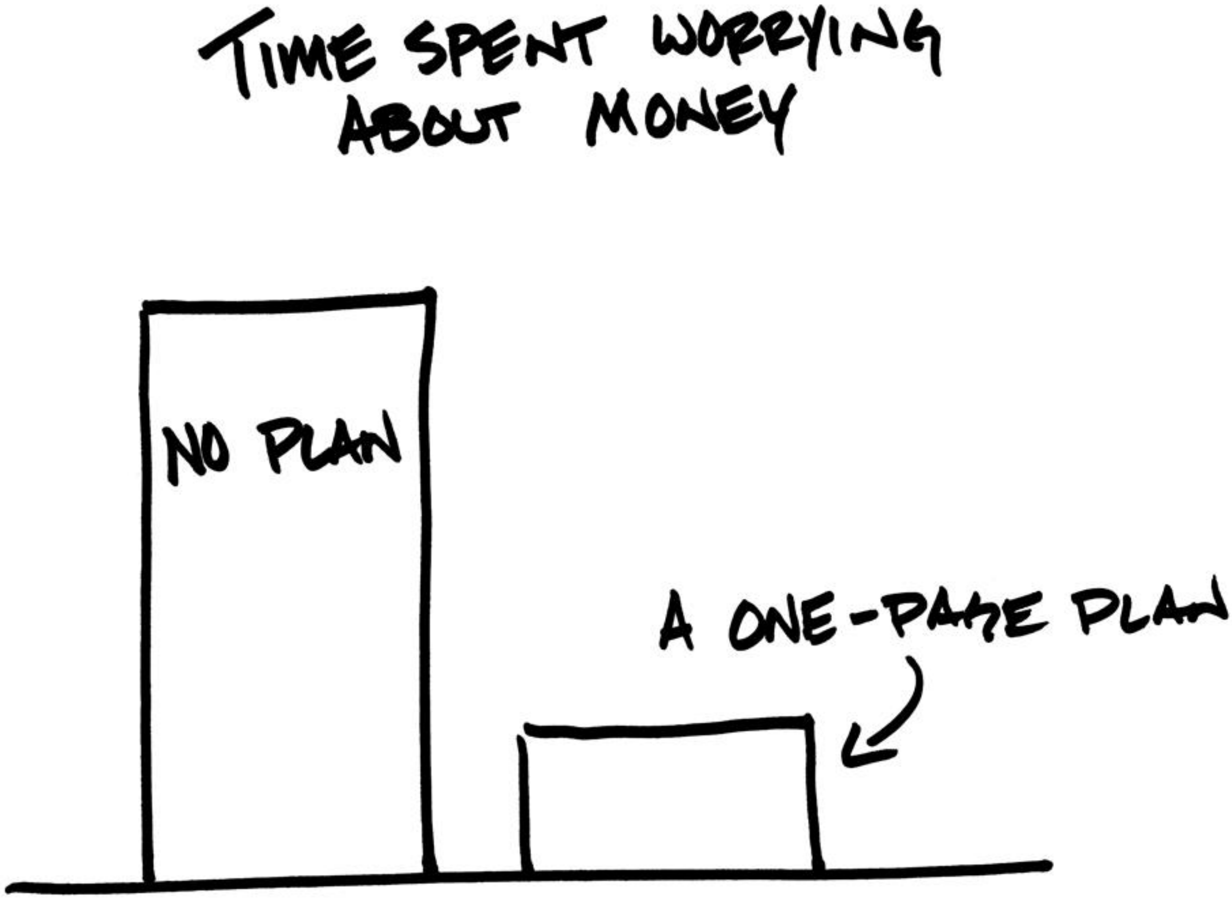

Figure 1. The Financial Plan Process

*In your book, "**The One-Page Financial Plan**" (Portfolio, 2015), you wrote about asking people why they thought money, or having a certain amount of money, was important. Could you elaborate?*

Richards: This is my favorite place to start. You start with an exploration of values and my favorite question around that is "Why?" The question I like to start with is "Why is money important to you?" I'm not looking for "to send my kids to college" necessarily, I'm looking for values. Often you'll hear people say things like "freedom" or "security" or "flexibility." As they explore it more, I'll ask "Why is freedom important to you?" The clients may respond with something like "Well, money gives us time." "Okay, that's great. Tell me why time is important to you." Then they may get to something a little closer to the heart, like "Well, we really want to serve in our community and spend time with our family. That's the most important thing."

This conversation leads to the point where we can say, "Is that the MOST important thing about money: The freedom so you can have the time to spend with your family and serve in the community?" "Yes." "Is there ANYTHING more important about money?" "No." Okay, well, that's a beautiful framework and it allows us to make these other important decisions.

Do you think having these goals will prevent behavioral errors by helping people frame money within the context of what they really want to do?

Richards: First of all, I don't know if having defined goals will help solve behavioral mistakes, because to some degree, those are hard-wired. But, I'm suggesting that this idea of starting with "why?" is a function of getting clear about where we want to go. When we're clear about where we want to go, often those behavioral mistakes don't occur to us anymore. To paraphrase Stephen Covey, "The 'why' becomes the deeper yes." That allows us to say no to all these other distractions: like a new lease on the Lexus, the hot stock you heard about in the news or what your neighbor says to you about investing in this fund. That stuff is sort of like "What?!" It just doesn't occur to you anymore, because you're focused, again, on the things you identified when you went through that process.

When you're working with clients, how do you keep them focused and remembering "This is what I said is important?"

Richards: You remind them. If you're doing this on your own…well, here's an example. Right here in my office, I can look up and see "The Richards Family One-Page Financial Plan." On the very top, it says, "Spend time with our kids, mainly outside, and serve in our community."

Recently, a friend of mine came to me and told me about a private investment opportunity. All the normal stuff would have sent me into a three-week rathole—doing the research and getting spreadsheets, talking to people and analyzing everything I could to decide if I should invest. This time, I looked up, saw my one-page plan and said to myself, "Wait a second, that doesn't have anything to do with what I said was my 'Why.'"

So, the answer to your question is we just need to either remind ourselves or have somebody in charge of reminding us of what we said was important when we were thinking clearly.

What if someone has goals in mind, but there's a mismatch between what they have saved or what they can realistically save and what they want?

Richards: Welcome to being human. For most of us, we have an unlimited list of wants or needs and a limited set of resources. In financial planning, the process of making good decisions about money becomes all about that trade-off. We can look at that thing that we say we want or we've called a goal and say to ourselves "Alright, given that I want that goal…" By doing so, we remind ourselves real quickly about what we said was MOST important to us.

The point here is: Let’s do it with awareness, instead of subconsciously just buying the stuff and then later going, “Oh, geez, I did it again.”

What if someone’s retired? Does that change things?

Richards: Well, no, the process is the same. We paint these as options to consider. Sometimes we forget that some people have no options.

It’s not a whole different discussion. It’s just that we get really clear about reality: Even though we’re retired, we really wish we had a little bit of extra money to take one trip a year. We can then think about whether there is a part-time job we could get. Ask, “What do I have control over that I could change?” If the answer’s nothing, we need to learn to let go of that. Because if you have no ability to change it, what good—and I know it’s easier said than done—is it going to do to worry? So we get sort of clear about these things.

At least there’s a framework for learning to let go of the stuff that you can’t control and make really clear decisions about your trade-off when you do have options.

Once a person is clear about his or her goals, should he or she think about how strict those steps should be?

Richards: The hard work, in the beginning, is getting really clear, sometimes painfully clear, about your current reality, and having that discussion about the why—your values—then making some guesses about where you want to go. Once that work is done, the art of financial planning is embracing uncertainty.

Life never works in a straight line. So, there’s an element of this where you’ve got to embrace uncertainty, which is why I call goals “guesses,” because they’re going to change. So, you embrace uncertainty and then once you’ve done all that, you just ask yourself, “What is to be done next? What’s the next thing I could do to get myself closer, to sort of head down that path? What’s to be done now?” I love that question. “What is to be done now?” You listen carefully to what shows up, you do it and you just keep repeating that process.

Maybe it’s like, “I’ve been thinking forever that we really need to get life insurance in place.” Okay, get the life insurance in place. “Oh, I’ve been thinking forever that we need to start saving money for the kids’ education.” Okay, can you find an extra \$50, an extra \$100 a month? Go get it figured out. Take the time to figure out where the right place to set that money aside is, get it set up as an automatic withdrawal out of your checking account and do it. Then, it’s done and maybe you get a little space, a little rest. Then the next thing shows up and you do it.

For somebody reading this and wanting specifics, you're saying, figure out what your goals are first and then what you can realistically do, versus worrying about having a checklist of a, b and c steps?

Richards: Say one of my values is my kids and I want to make sure they have money for education. And one of my other values is, sort of, freedom at some point in the future. I want to save for retirement.

Okay, let's get really specific: What can I do today? I think I could find $50 for each of my kids to save. I can set up a 529 account in the Utah Plan (which is where I happen to live), and I can have the money pulled from my checking account on the 15th of every month. That's very specific, it's got a deadline, it's going to happen, it is automated—it's everything everybody says you should do. But the problem is, should that be YOUR goal? I have no idea.

So, you back out from the values—where you are today, your goals—into very specific automated behaviors that will get you closer. Now, I may wake up in a couple of months and say, "I think we should switch that $200 a month toward paying down our mortgage, because we really want to get out of debt as fast as we can." Okay, then, I'll switch it. But, again, define very specific actions and, to the degree possible, automate the behavior, because if we don't automate it, we all know what will happen. It will never happen.

What about allocation? If someone has goals with different timelines, should they be thinking more in terms of a bucket strategy, where they're considering when they'll need the money to accomplish certain goals?

Richards: Allocation is not a smorgasbord of investments; each one is carefully picked to give a person the greatest likelihood of meeting his or her goals. Most of the time, that's linked to some time frame. Right? That's easy. We can take on the risk question, but the easy answer is yes, it's linked to some time frame.

But your investments should be there for a purpose, and the purpose should be to meet your goals. That's why everybody's investment portfolio is, to some degree, tailor-made for them. At least it should be.

In your book, you also discussed the disconnect between investors who just want simple instructions and don't realize, from the standpoint of an adviser, that there aren't simple instructions to give.

Richards: I think that's because real financial advisers are so focused on customizing a tailor-made plan, in other words, the "best" plan for each client. But, the dilemma, of course, is if you're not one of their clients and you have to make these decisions on your own, you're just looking for some guidance. Sometimes this pursuit of “the best” gets in the way of doing anything at all.

If all you did was say, “Hey, I don’t need this money for 10 years and I’ll put it in the S&P 500 index, and everything I need in less than 10 years, I’ll buy CDs,” and then you got to work figuring out how to save a little bit more each month—making a little bit more money at your job or saving a little bit on your taxes, or making smart decisions about your spending—you would be better off than 99% of your neighbors. Because they’re just busy running around trying to find the best investment in the world, and we all know that behavior, that well-intentioned behavior, often leads to disastrous results.

Finally, since you emphasize the point of simply behaving correctly for a really long time, could you give some basic suggestions on how people can accomplish this?

Richards: I think we just need to let go of this myth that finding the best investment is the job of investors. That’s not the job of investors. The data is super clear about this. If you just own a mediocre investment but behave correctly for a long time, you will be ahead of many other investors. Another way to put this is, if you find the best investment, but get scared out of it at the wrong time, you just blew up all that work.

The investment process only matters to the degree that it influences behavior. So, the best investment for you is the one you can hold on to for a long, long time. For example, I hear people say, “My house is the best investment I ever made.” We’ll go back through the records with them and we’ll see that their average rate of return has been about 2.5% or 3%. Over that same time period, the equity markets did close to 10%, so let’s just call it 8% even. How in the world was their house their best investment? Well, because it was the only investment that they behaved correctly with.

So, figure out how to just not get too concerned with what your investment is doing now, and think of it as an oak tree and leave it alone. I love Warren Buffett’s idea: Who would plant a tree and dig it up every quarter to see how the roots are doing? Just leave it alone.

That means ignoring an awful lot of noise. It means ignoring what your neighbors are doing. It means ignoring this whole giant complex that we almost think of as the financial services industry. It’s all built up on this circus that there’s something that you should be doing. The reality is you get paid incredibly well for doing absolutely nothing. Right? For being lazy. That’s amazing. Why not take advantage of it?

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firms throughout the U.S.

The full version of this article is available in the ***August 2015*** *issue of the AAII Journal.*

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