A Simple Guide to
Personal Financial Management

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Updated: February 2022

INTRODUCTION

After receiving repeated inquiries from clients, family, and friends regarding the same general personal finance questions, I've decided it would be more efficient for me to write some general responses in this guidebook which can be easily shared with others.

While there are other ways to address these questions, I find the simple heuristics and rules of thumb which I demonstrate below preferrable to more complex methods for several reasons. First, the results are often similar to more complex methods. Second, the process is much more understandable to non-finance professionals. Third, more complicated approaches may give one a false sense of comprehension. At times people assume if a model is really complex, or perhaps incomprehensible to them, it must be so smart as to have considered all possible factors and somehow should then be trusted. This is simply a false conclusion. In financial markets (not to mention life in general) it is impossible to fully envision all future outcomes and to precisely quantify their implications. Thus even the most complex methods often fail in real world situations. There are usually no obvious answers to most questions in finance. Judgement, experience, and caution are required.

Hopefully you will find the following answers helpful. I recognize that general advice does not always apply to every specific situation. Therefore, I am available for further discussion as needed and happy to adapt any advice to your specific needs.

WHAT IS THE GOAL OF PERSONAL FINANCIAL MANAGEMENT?

While admittedly people have widely different goals for their finances, I suggest that the best goal for most people is financial independence. By this I mean that we should seek to have enough money so that we are not reliant on any employer, government, or benefactor to supply our basic needs. Once this goal is achieved, we could retire if desired, or at least work on our own terms. I believe working well into one's advanced years is generally healthier than retirement and I encourage others to keep working as long as they are able. But the point of financial independence is that we no longer need to work. We are then in control of if/how/when/where/why we work. This is the goal.

HOW CAN I ACHIEVE FINANCIAL INDEPENDENCE?

Having identified financial independence as our goal, how then are we to achieve it? The solution is to have enough money saved and passive income sources available to pay for all our expected needs through the end of our lives. The focus then becomes creating income producing wealth. And how does one secure income producing wealth? By saving and investing.

HOW CAN I SAVE MONEY?

This is both the simplest and also the hardest step. Much like how most of us clearly understand that the way to lose weight is to eat less junk food and exercise more, the way to save money is to spend less than you earn. All of humanity has certain basic needs. If your income is not yet sufficient to supply your basic needs, then you need find ways to increase your income. This can usually be done by working longer hours or developing a more valuable skill set through training or education. Once your income is sufficient, then you need to mind your expenses. Even people with very high incomes (movie stars and professional athletes for example), who make millions each year often go bankrupt through overspending. Not spending money requires discipline. This is probably the single most important skill that will determine your financial success. Some people are seemingly addicted to spending. Such people have very little chance of achieving financial independence. On the other hand, there are many people with average or even modest incomes that manage to accumulate vast sums by consistently saving and investing. These people are worthy of praise and emulation.

HOW CAN I CREATE A BUDGET?

The best way to save money is to carefully review and plan all your expenses. This is what a budget does. I prefer to budget using a simple spreadsheet because it requires you to review each expense each month. There are automated software tools that will make this easier, but I think part of the point of the exercise of budgeting is to see in detail what you are spending. If some software automatically performs this task for you, you lose some of the depth of understanding. Nevertheless, using software is better than not doing it at all.

Below are two example budgets for a moderate- and high-income family of four. Everyone's budget is different, but these examples are provided to show that it's possible to save money on most incomes.

EXAMPLE BUDGETS

Assuming household of two adults and two children

	Moderate Income Family			High Income Family		
	Annual	*Monthly*	*Percent*	*Annual*	*Monthly*	*Percent*
Total Income	90,000	7,500	100%	180,000	15,000	100%
Less taxes	(9,900)	(825)	-11%	(32,400)	(2,700)	-18%
Less healthcare	(10,200)	(850)	-11%	(10,200)	(850)	-6%
Less retirement savings	(5,400)	(450)	-6%	(10,800)	(900)	-6%
Take home pay	64,500	5,375	72%	126,600	10,550	70%
Housing	(22,500)	(1,875)	-25%	(36,000)	(3,000)	-20%
Utilities	(1,200)	(100)	-1%	(1,800)	(150)	-1%
Food	(12,000)	(1,000)	-13%	(18,000)	(1,500)	-10%
Transportation	(7,000)	(583)	-8%	(12,000)	(1,000)	-7%
Insurance (Home, Auto, Life, etc)	(1,200)	(100)	-1%	(2,200)	(183)	-1%
Donations	(10,350)	(863)	-12%	(27,000)	(2,250)	-15%
Other	(8,000)	(667)	-9%	(12,000)	(1,000)	-7%
Net Income	2,250	188	3%	17,600	1,467	10%
Total Retirement Contributions*	8,100	675	9%	16,200	1,350	9%
Total Savings	10,350	863	12%	33,800	2,817	19%

** Includes Employer Match*

HOW MUCH DO I NEED TO SAVE EACH MONTH?

The following two tables show the total amounts accumulated by saving over time. The first assumes annual savings of $10K which is approximately the figure from the budget with annual income of $90K. The second assumes annual savings of $30K which is approximately the figure from the budget with $180K annual income. You'll find that by steadily saving over several decades, one can amass considerable sums. You'll also notice that increasing investment returns is a great way to improve the amount saved. Though difficult to do, and impossible to guarantee, this is what I attempt to do as your financial advisor.

TOTAL PORTFOLIO AMOUNTS ($K)

Assuming annual savings of $10K

		Years of Saving			
		40	30	20	10
Annual Return	15.0%	17,791	4,347	1,024	203
	10.0%	4,426	1,645	573	159
	5.0%	1,208	664	331	126
	0.0%	400	300	200	100

Assuming annual savings of $30K

		Years of Saving			
		40	30	20	10
Annual Return	15.0%	53,373	13,042	3,073	609
	10.0%	13,278	4,935	1,718	478
	5.0%	3,624	1,993	992	377
	0.0%	1,200	900	600	300

HOW MUCH DO I NEED TO BE FINANCIALLY INDEPENDENT?

The table below shows the total amount of income producing assets required to fund a given retirement period and level of expenses. For example, using the boxed cell in each table, if you assume 20 years of retirement and monthly expenses of $10K, then you would need a total of about $1.5M. This assumes your investments earn a return of only 5%. If you could increase the rate of return on your investments to 10%, which is approximately the long-term historic average for the stock market, then you would only need slightly more than $1.0M. Your actual returns will probably be somewhere in between these amounts. I'd recommend you aim for the higher amount out of an abundance of caution, or at least aim for the average of the two numbers.

Assuming 5% returns

Monthly Expenses ($K)	Remaining Years of Life: 40	30	20	10
20	4,148	3,726	3,031	1,886
15	3,111	2,794	2,273	1,414
10	2,074	1,863	1,515	943
5	1,037	931	758	471

Assuming 10% returns

Monthly Expenses ($K)	Remaining Years of Life: 40	30	20	10
20	2,355	2,279	2,072	1,513
15	1,766	1,709	1,554	1,135
10	1,178	1,140	1,036	757
5	589	570	518	378

HOW MUCH SHOULD I GIVE TO CHARITY?

In each of the budgets above I've included significant amounts of donations. I do so because giving to others is essential to our own financial success. As a Christian, the principle of tithing has been well verified in my own experience. To tithe is to give 10% of your income to the church (or to the charitable organization of your choice). I would recommend people give at least this 10%, and more if they are able. This principle is universal, even to those who do not consider themselves believers, and I'm convinced it will improve the financial condition of all who practice it.

HOW SHOULD I ALLOCATE MY INVESTMENTS?

Once you have created a budget and are spending less than you earn, you will start to see your cash balances grow. The next question is how to allocate and invest these funds. The following are some key considerations.

- Diversification is one of the fundamental principles of investing. Do not put all your eggs in one basket. However, there is also such a thing as over diversification. I recommend that people allocate the largest portion of their net worth to businesses (stocks or private business), another large portion to income producing real estate, and a smaller allocation to cash, bonds, or other highly liquid investments. Diversification within each group is also important (i.e. don't own just one stock).
- Typically younger people should take more risk than older people. Meaning someone who is 25 years old should probably have a higher allocation to stocks and real estate, and a lower allocation to cash than an investor who is 50.
- The type of account is also important. There are several tax advantaged accounts (for US investors).
    - A 401(k) is an employer sponsored account that allows you to save on taxes by contributing pre-tax dollars, which then grow and are taxed when withdrawn.
    - A traditional IRA account also allows contributions in pre-tax dollars and requires taxes to be paid on distributions. However an IRA is not associated with an employer.
    - A Roth IRA also has tax advantages, but in this case money is taxed prior to being contributed, but all future withdrawals are not taxed.

- Tax advantaged accounts should be used first, but one can also open a normal taxable account for saving and investing.

HOW SHOULD I HANDLE INHERITANCE FOR MY CHILDREN?

Many people want to help out their children financially. The best way is to help them learn to fish, not give them fish. That means help your children out with tuition, training programs, and such that will teach them and enable them to earn their own incomes and also become financially independent. You can still give them a fish or small cash gift occasionally, but experience shows these sort of gifts should be limited. "What we obtain too cheap, we esteem too lightly" said Thomas Paine. Similarly, those to whom money comes too easily tend to spend too freely, says I. And the habit of overspending leads to poverty. Wait to give cash until your children have proven they can live within a budget, make prudent financial decisions and will be good stewards of the funds. This is different for every child. Some may be ready when they are still young. Others may never be ready. Judgement is required.

You can use the gift tax exemption to reduce your estate early and avoid estate taxes. Consider giving to 3rd and 4th generations if you are able.

SHOULD I PAY OFF MY MORTGAGE?

Eventually all debts need to be paid. Doing so early is never a bad idea, but at times may or may not be a good idea. When there are attractive opportunities to invest, it may be better to wait. Nevertheless, paying off debt always results in a more secure financial position, which is good for peace of mind, and is also a modest investment gain. And the decision is not all or nothing. A good approach would be to allocate a portion of savings to investments and another, perhaps smaller portion, to paying down debt.

Of course, any high interest debt (typically on credit cards, pay day loans, etc.) should be paid off as soon as possible.