

Why is a spending plan important?

By Molly Balunek, CFP®

Senior Vice President

Preparing for upcoming expenses can make a real difference in an investor's comfort level with portfolio volatility and market declines, especially in tough times in the markets and the economy,

We believe the foundation of financial planning and portfolio investment policy is cash flow, also known as a budget or a spending plan. The amount of money a client withdraws from the portfolio on an annual basis is critical both to the financial plan and the investment policy. First, we must assess if the desired level of spending is reasonable and sustainable for that client based on his or her total investable assets, age, and risk tolerance. Once we have determined the answer to that question is "Yes," we focus on how to invest the client's portfolio to provide that cash flow and future portfolio growth to offset the effects of inflation.

It is very important for clients to have an emergency cash reserve for unexpected needs. Some clients keep those reserves in a bank account, while others keep them in their investment accounts. Wherever the reserves are held, those dollars are to be kept liquid, in cash or cash equivalents, and are not considered part of the spending plan or the investment strategy.

We begin with calculating how much money should be invested in fixed income and cash equivalents, for certainty. A minimum of five years of cash flow withdrawals should be invested in a "ladder" of bonds, CDs and/or cash. Most of our clients have at least five years of spending needs in their bond ladders. The certainty of the interest payments from those fixed income instruments is important. We invest the fixed income allocation in high quality, investment grade corporate bonds; high quality municipal bonds; high quality, FDIC insured CDs, and/or cash.

Our focus on the quality and financial strength of the bond issuer keeps the possibility of default quite small. Therefore, we are reasonably certain that the bonds will pay interest as expected and that they will mature on schedule for the face amount. We construct the ladder so that one or more bond or CD matures each year, making the proceeds available to meet our client's expected spending plan for the coming year. Interest payments throughout the year from the other bonds in the portfolio also are used to meet cash flow needs.

Since the portfolio has at least five of planned spending needs in this "ladder of certainty," our clients do not have to sell equities in times of turbulence or decline in order to pay their bills. The stock allocation in the portfolio is invested for the long-term, defined as longer than five years from today. We know that stocks will experience volatility over a five year period. We cannot know if they will be up or down on any one date in time. There is little certainty in stocks over the short-term. What stocks bring to the portfolio is long-term security. Over time periods of longer than five years, typically, the stock market has increased in value, and these increases have typically been higher than the rate of inflation. The long-term security of investing in the stock market contributes inflation protection to our clients' portfolios over their lifetimes.

We cannot control the markets, but we can control how we respond to them. Our clients' investment portfolios have been designed to provide for planned expenses through all types of markets, even the current extraordinarily volatile environment. With at least the next five years of planned living expenses provided for by the fixed income allocation of the portfolio, there is no need to sell stocks in the equity allocation. Our clients' basic living expenses will be provided for.

From 2003 through 2007, many clients were able to take additional withdrawals for discretionary activities or expenditures. Sometimes, those discretionary expenses can creep into our spending plan and become part of our basic living expenses.

Even though the investment policy anticipates the planned withdrawals from client accounts, any reduction in the level of spending prolongs the period of time the bond ladder will last, and gives the equity allocation more time to recover.

In a volatile investment environment and an uncertain economic outlook, many investors are searching for actions they can take to help themselves feel more in control of a situation that truly is completely out of their control. In challenging environments like today, when we want to take action, one action that could be helpful is to carefully review our expenses to seek ways to reduce or postpone discretionary or unexpected expenses. We have a cash

flow worksheet to help our clients categorize their expenses and distinguish between fixed and discretionary spending.

One of the most valuable assets of working with the Inverness Investment Group is our comprehensive financial planning expertise. We have three CERTIFIED FINANCIAL PLANNER™ certificants in our firm, with a cumulative 28 years of experience. Understanding a challenging investing and economic environment within the context of an overall financial plan helps our clients persevere and prepare for continuing financial success over their lifetimes.