

# HOW IT'S DONE



## Fundamentals of Cash Flow

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Cash flow is one of the items that most advisors overlook, but yet it is the most revealing piece of the puzzle toward understanding the client's lifestyle and values. The cash flow conversation will be different from what you have done in the past and it will help you help your clients get where they really want to go. It is about accountability and helping your clients do the things that they intuitively know should be done.

Cash Flow is about understanding where money comes from and how it is distributed. Just like a business, cash flow is the life line of an individual's well-being. Cash flow needs to be understood and managed. Cash flow needs to be protected with savings and protection items such as life, health, disability, liability, and long-term care insurance.

Income is probably the most important element in cash flow. Expense management is the second piece. To properly manage cash flow, a certain level of liquidity must be maintained to balance out any financial problems that may arise. Savings are like a shock-absorber in a car. Most experts suggest that an amount equal to six month income be held in liquid accounts such as savings or money market accounts. At a minimum \$10,000 should be liquid at all times.

Cash flow analysis accesses a prospect or client's inflows and outflows; how much money comes in the door and where it goes after that. Cash flow can be **positive** (more inflows than outflows), **break even** (inflows match outflows) or **negative** (more outflows than inflows). 43% of households have more outflow each year than inflow. In other words they are living on more than they make.

For most people the basic cash flow management tool is the checking account. Other basic tools include savings or money market accounts. Some people are more deliberate about cash flow and maintain budgets, or track cash flows with tools such a Quicken, Moneydance, Mint, or AceMoney. These tools can be linked with checking accounts, online bill pay services and income tax reporting software.

### **The basic formula for managing cash flow is 10-20-70.**

- ✓ Save 10% of gross income in guaranteed investments and build liquidity; allocate no more than 20% of gross income to debt service excluding the home mortgage.
- ✓ To the extent that 20% is not needed to service debt the balance of the 20% can be used to create more wealth. Ultimately, when all debt is retired, you can save 30% of gross income.
- ✓ 70% of gross income is allocated to living expenses which includes taxes and the primary home mortgage. Home Equity Lines of Credit are included in the 20% category above.

## The Cash Flow Summary

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The Cash Flow Summary is designed to help you understand the sources and uses of cash flow. The worksheet is divided into four sections:

1. Income
2. Guaranteed Investments
3. Debt and Asset Accumulation
4. Living Expenses

The first step before we can apply any of the rules of thumb is to estimate the sources and uses of income. The Cash Flow Summary is designed to help you and your prospect/client analyze cash flow.

**Section 1 Gross Family Income** lists the total family income and the suggested total amount of life insurance based on the formula on Page 6. For example, a client age 35 should have life insurance coverage of between 20-to 25 times his/her income. This number is taken from a major insurance company's financial underwriting table. If your client is earning \$100,000 per year, the suggested amount of life insurance would be between \$2,000,000 and \$2,500,000. If you assume a 4% return on money, the proceeds of the life insurance would replace 80-100% of your client's income at death. By comparison, if we use the compensation amounts taken from the US Government's 9-11 Victims fund (Page 6) as a measure of human life value, a 35 year old victim's survivors received \$2,561,561. This gives you a starting point for an insurance conversation at a later date. Don't open a major discussion about life insurance at this point. You are just setting the bar for another time to talk about life insurance. Your goal at the moment is to get a handle on overall cash flow.

Note: The **Cash Flow Summary** can be used manually by printing the form for use with a prospect or client. If done manually, enter to numbers for columns E-I directly on the form. If used as an Excel file on your PC, Column E-I will self-fill as you input your data into Column C and D.

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**Section 2 - Ten percent** of gross income should be placed into **savings** to build up a cash reserve to provide security and guarantees. Included in this Section are savings accounts, permanent life insurance, salary savings plans, contributory retirement plans (guarantees) and other savings such as savings bonds. Ideally a client should have at least 6 months of liquid assets in this category. In Column C record the account balances, and in Column D, record the annual deposits or contributions to these accounts.

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**Section 3 - Twenty Percent** of gross income should be a combination of **debt service**, not including the home mortgage, and other savings. To the extent that 20% is not needed to retire debt, the balance can be put into others savings, such as qualified plans and mutual funds. In Column C record the total amount of any debt so that you have an idea as to how long the debts will last before they are paid off. If you simple divide the balance by the monthly payment, you will have a rough idea about the duration. This will give you a timeframe for repositioning cash flow once the debt is cleared. To the extent that debt service does not equal 20% of the gross income, any remaining amounts can be channeled to savings and investments. If the item is an asset rather than a debt, record the account balance in Column C. In Column D, record the monthly payments/contributions for each account.

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**Section 4 - Seventy Percent:** the balance of the cash flow is **living expenses**. Included in this category are all such things as the house payment, Federal income taxes, FICA, State income and sales taxes, local and property taxes and utilities. It also includes term life insurance. Some people may give you estimates instead of actual amounts. Accept the numbers you are given by your prospect/client. You can reconcile the accounts after you complete the spreadsheet.

You can decide how accurate you want the cash flow conversation; you may just want to get an estimate to get the conversation under way. If you want all the details you could suggest that people fill out the form before they arrive at your meeting or you could suggest that they bring their tax returns employee benefit statements, financial statements, and pay stubs to the meeting.

The spreadsheet automatically totals the columns. It will calculate the gross amount allocated to each Section, the over/under amount based on the 10-20-70 allocation and the actual percentage of income in each Section. In many cases you will find that your client will not account for all the money noted in Section 1. This is usually because of some one-time items such as a car repairs, home improvements, athletic fees, meals out, a vacation, or it may be money that just slipped away during the month.

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## Cash Flow Summary Instructions

- Section 1.** Enter the gross family income at C3 and enter the recommended gross amount of life insurance from the tables on page 6 in I3. Don't discuss the insurance amount at this time.
- Section 2** List the account balances in column C and the amount of money that is added to these accounts on an annual basis in Column D.
- Section 3** List the debt amount and/or accumulated account values in Column C. In column D, record the monthly payments amounts for each debt or the amount that is added to the other investments.
- Section 4** List the amounts for each of the monthly expenses. The spreadsheet will automatically fill in the totals for columns E-I.

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**Note:** Some items in the cash flow occur annually or quarterly; convert them to monthly mode.

## Cash Flow Summary (continued)

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Column E is the total of the actual monthly/annual allocations and will tabulate the variance in column G.

Column I will give you the actual percentage allocation of the gross income which you can then compare to the 10/20/70 Formula.

Most people do not account for all of the gross income; there are things such as vacations, repairs, allowances and other one-time expenditure that do not make it into the cash flow discussion. But with a little thought, eventually you will be able to account for everything.

By starting with cash flow instead of balance sheets, you learn more about the family, their lifestyle, obligations and values. By learning about where the money is going, you will be in a better position to help people rethink their priorities and help them do a better job of managing their cash flow and reaching their goals.

Using a sports analogy, income is like measuring the yards gained in a football game. It measures progress, but does really tell you how the game is going. The game ultimately is about putting points on the board, which is analogous to your net worth building. Ball control is a function of managing turnovers and penalties. By controlling the “turnovers” (the living expenses and debt), there is more to save and invest. By controlling the “penalties” (taxes), there will be more money available for savings and investing.

Go to the **Bureau of Labor Statistics** <http://www.bls.gov/cex/> to find tables that will help you appreciate how the average person allocates his/her income. It will help you counsel your clients and help you help them deal with their money more effectively.

Some Sample Cash Flow Tables in PDF Format:

- ✓ **By Age Group:** <http://www.bls.gov/cex/2013/combined/age.pdf>
- ✓ **By higher Income Level:** <http://www.bls.gov/cex/2013/combined/higherincome.pdf>
- ✓ Take a look at <http://www.sharesavespend.com>. You will find some great ideas there that will help you create more talking points when you are working with your clients on cash flow issues.

After completing the **Cash Flow Summary**, have a conversation to tighten up the numbers and get a more accurate picture of their cash flow. Adjust the 10-20-70 formula to reflect the prospects/clients situation so that you can help them better align it with their goals.

You can download the **Cash Flow Summary** at <http://www.addiewoods.com/handouts>.

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## Cash Flow Summary

1 Annual Family Gross Income		\$0	Total Life Insurance on Both Spouses (See Footnote 2 Below)		\$0
<b>2 Ten Percent - Savings Program (See Footnote 1 Below)</b>			\$0	Over/Under	Actual Allocation
	<b>Account Balance</b>	<b>Annualized Amount</b>			
	Savings Accounts (Passbook, CDs, Bonds)	\$0	\$0		
	Permanent Life Insurance	\$0	\$0		
	Salary Savings Plans	\$0	\$0		
	Retirement Plans - Contributory (IRAs, 401(k) etc.)	\$0	\$0		
	Other	\$0	\$0		
	<b>Total</b>	\$0	\$0	\$0	0%
<b>3 Twenty Percent - Debt Reduction and Savings Programs (See Footnote 3 Below)</b>			\$0		
	<b>Total Owed/Owned</b>	<b>Monthly Payment</b>			
	Auto Loans	\$0	\$0		
	Boat Loans	\$0	\$0		
	Home Equity Lines of Credit	\$0	\$0		
	Second Home Mortgage	\$0	\$0		
	Credit Cards	\$0	\$0		
	Consumer Loans - Credit Card	\$0	\$0		
	Mutual Funds	\$0	\$0		
	Annuities	\$0	\$0		
	Other Debt	\$0	\$0		
	Other Investments	\$0			
	<b>Total (See Footnote 3 Below)</b>		\$0	\$0	0%
<b>4 Seventy Percent - Living Expenses</b>			\$0		
		<b>Monthly Amount</b>			
	Food		\$0		
	Clothing (Business, Shoes, Coats/Jackets, Cleaning)		\$0		
	House Mortgage or Rent Payment		\$0		
	Taxes (FICA, Income and Property)		\$0		
	Home Repairs and Maintenance Items (Yard, Painting, Furnishings)		\$0		
	Utilities (Gas, Water, Electric, Cable, Phones)		\$0		
	Insurance (Home, Auto, Medical, Renters, Term, LTC and Disability)		\$0		
	Entertainment (Movies, Theater, Books, Videos, Meals out, Vacations)		\$0		
	Dues and Associations (Health Clubs, Golf Clubs, Civic Organizations)		\$0		
	Subscriptions (Newspapers, Magazines, Online Services)		\$0		
	Car Expenses (Gas, Oil, Repairs)		\$0		
	Charities (Church, United Way, Colleges, Political, Community)		\$0		
	Medical (Out-of Pocket Medical, Dental, Vision)		\$0		
	Educational Expenses (Personal Development, College, Private Schools)		\$0		
	Child Care (Sitters, Domestic Help)		\$0		
	Pets and Veterinarian Expenses		\$0		
	Other (Alimony, Allowances, Gifts, Family Support)		\$0		
	<b>Total (See Footnote 4)</b>		\$0	\$0	0%
<b>Annual Total Allocations</b>			\$0		
<b>Total Unaccounted or Overage (See Footnote 5)</b>				\$0	0%

## Footnotes

**1** Use last year's tax returns, current pay stub information and employee benefits summaries. Annualize amounts in this category.  
 Six Months income should be liquid at all times. As a general rule, one should save from their income and then invest from their savings, which creates a buffer between income and investments.  
 Amounts listed in this section are regular monthly deposits or additions to the accounts.

**2** Multiples of Income for Underwriting Purposes  
 Each spouse should be insured for 10-20 times income on average. The amount indicated in the column should reflect the coverage for both spouses.  
 Below are the guideline maximum multiples of income for insurance coverage from a major insurer. Use the low end of the range for illustrative purposes.

Age Range	Multiples of Income
20-30	25-30
31-40	20-25
41-50	15-20
51-60	10-15
61-70	7-10
71 and over Individual Consideration	

e.g. if the client is age 32 and earns \$150,000, the maximum amount of insurance that can be purchased from all companies is \$3,000,000 - \$3,750,000 ( 20-25 time income)

### 9-11 Victim's Compensation Fund Married, 2 Children

AGE	\$30,000	\$50,000	\$70,000	\$90,000	\$125,000	\$150,000
30	1,378,746	1,919,542	2,398,540	2,938,411	3,662,281	4,203,648
35	1,198,974	1,614,433	1,985,860	2,398,889	2,959,242	3,378,319
40	1,078,306	1,409,194	1,708,218	2,035,584	2,485,629	2,622,558
45	960,314	1,212,962	1,443,201	1,692,085	2,038,224	2,297,093
50	859,097	1,047,634	1,220,508	1,405,843	1,665,228	1,859,217
55	774,251	909,761	1,034,350	1,166,885	1,353,848	1,493,673
60	700,368	791,232	874,744	963,643	1,089,008	1,182,766
65	650,634	711,444	767,354	826,829	910,730	973,477

**3** Typically the maximum limit for debt service is about 20% of take-home pay. We are using 20% of gross because to the extent the debt service is not that heavy, the balance of the 20% can be invested  
 The total amount owed will allow you to estimate when the debt will be paid off thereby freeing up more cash flow for other purposes.

**4** The Monthly Total is automatically multiplied by 12 to arrive at the annual total.

**5** This number represents the amount of income that has not been accounted for in the Cash Flow Summary or if negative represents the amount of overspending.  
 (On average in the United States 43% of families spend more than a 100% of their income each year. Monthly Total is automatically multiplied by 12 to arrive at the annual total.

## Financial Rules of Thumb

Keep in mind that rules of thumb are widely used principles with broad application, but they are not totally accurate or reliable in every situation. Here are a few basic rules of thumb to help you with a more detailed conversation about money:

1. John D Rockefeller's rule was to save ten percent and give away ten percent.
2. Bankers recommend that you allocate no more than 20% of net income to debt reduction (excluding home mortgage). The home mortgage should not exceed 3 times income. The monthly payment should not exceed 28%.
3. Total debt service including home mortgage should not exceed 36% of gross monthly income.
4. Car loan payments should be under 10% of income and for no more than 4 years. Total transportation expenses should be under 15% of income.
5. Insure your life for 10 to 25 times your income depending on your age and obligations. For more information go to: <https://www.lifehappens.org/life-insurance>. The life insurance premium should be between 3 and 5% of Gross Income.
6. Liquid cash reserves should equal the larger of \$10,000 or six-month's income. Some people suggest that the number of months should match the current unemployment rate. E.g. rate is 7.2% unemployed; months liquid should equal 7.2.
7. Have at least 70-80%<sup>1</sup> of your income covered by disability insurance. For more information go to: <https://www.lifehappens.org/disability-insurance/>.
8. Purchase long-term care insurance with a daily benefit equal to the average daily rate in your community and a benefit period of at least three years. For more information go to: <https://www.lifehappens.org/long-term-care-insurance>.
9. Insure your property for 100% of replacement value. Collision deductibles should equal one week's take home pay. As you build your cash reserves, increase your other deductibles to \$1,000 or more.
10. 401 (k) contributions should be at a level that maximizes any employer contributions. If your employer has a policy to match of 50% of your contributions up to 6%, then contribute 6% of your income to take full advantage of the match. If no matching program is available, contribute at least 5% to your retirement plans.
11. Base your retirement needs on 110% of your pre-retirement expenses.
12. Expect to safely withdraw and spend 4% of your retirement fund value every year.
13. Saving for College. The sooner the better. One thought is to save \$50 per month per child and then double the amount when the first one starts college. You may not have enough to cover the entire cost, but you will minimize school loans and the amount of time it takes to pay them off entire cost, but you will minimize school loans and the amount of time it takes to pay them off. For more information on saving for college, go to <http://www.savingforcollege.com/>.

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<sup>1</sup> With a "Catastrophic" rider you can replace 100% of earned income. For example if you earn \$100,000 and have a group disability plan that pays 60% of your income, you would receive a taxable monthly benefit of \$5,000 when disabled. Additionally, you can purchase approximately \$1,400 of individual tax free disability income which brings your total coverage to 77%. With some insurance carriers, you can also add a catastrophic rider which would bring your total coverage up to 100% replacement.

14. Net worth[2] should equal ten percent of your age times your income (e.g. Age 45; 100,000 income = \$450,000 net worth) - Thomas Stanley, author of The Millionaire Next Door
15. Save from your income and invest from your savings.
16. Use 3.5% as the inflation rate per year. (The average rate since 1913 is 3.22%; [http://inflationdata.com/Inflation/Inflation\\_Rate/Long\\_Term\\_Inflation.asp](http://inflationdata.com/Inflation/Inflation_Rate/Long_Term_Inflation.asp))
17. Have X% of your portfolio invested in stocks, where X is equal to 100 minus your age. With the increase in longevity; some experts suggest that you use 110 or 120 instead of 100.
18. Invest no more than 10% of your total savings in your employer's stock.
19. To determine how long it will take an investment to double, divide 72 by the annual return.
20. Consider refinancing your home if interest rates dropped by 1-2%.

## Cash Flow Talking Points

What are some of the goals or promises people make to themselves and their families. As a true Wealth Manager your job is to help people do the things they haven't and help them keep their promises to their families. Here is a list of typical prospect/client concerns and objectives:

### Financial Concerns

- |   |   |
|---|---|
| 1. Having enough money for a comfortable retirement         | 2. Having adequate income replacement in case of disability or lose of job. |
| 3. Having adequate and affordable hospital/medical coverage | 4. Having enough life insurance to protect their family.                    |
| 5. Having enough money for their children's education       | 6. Having enough money to start a family                                    |
| 7. Paying off debt  | 8. Buying a home  |
| 9. Meeting the day to day expenses of life                  | 10. Covering an emergency   |

Make a list of your clients concerns and goals and then revisit the **Cash Flow Summary** to see what needs to be done over time to reach their goals.

The next conversation is about protecting the cash flow. This will lead you to a dialogue about life insurance – protecting the cash flow for the family in case of premature death. Use the information on Page 2 of the **Cash Flow Summary** to provide you with more talking points.

The third conversation is about protecting both assets and income in the event of incapacity with disability and long-term care insurance.

The fourth conversation is about property/liability, medical and long term care coverage to make sure that a catastrophe does not encroach on cash flow or savings/investments. This is the time to talk about basic legal documents, including wills, trusts, durable powers of attorney, and healthcare declarations, including HIPAA authorizations. Discuss the Fireproof FileBox and the items that should be kept in the box.

And the final cash flow conversation is about taxes; making sure that everything legally possible is done to keep taxes low. Withholding should be checked to make sure that the appropriate amount is paid each pay period to avoid refunds at tax time. Do you think it is patriotic to lend money to the government interest free?