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THESIS

FINANCIAL PLANNING FOR THE
NAVAL OFFICER

BY

ALVIN R. SMITH

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This study was undertaken to assist the interested Naval Officer understand and navigate through the maze of personal finance. Specifically, it examines how Naval Officers can plan, save and budget their limited financial resources. The ultimate goal of this study is to encourage the Naval Officer to take control of his/her finances through the steps provided herein. It is believed that the Naval Officer who masters his/her own financial situation is better prepared to counsel his/her subordinates concerning finances. Further, they will be better prepared financially to deal with anxieties unique to the Naval Service. Keywords,

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FINANCIAL PLANNING FOR THE NAVAL OFFICER

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ABSTRACT

This study was undertaken to assist the interested Naval Officer understand and navigate through the maze of personal finance. Specifically, it examines how Naval Officers can plan, save and budget their limited financial resources. The ultimate goal of this study is to encourage the Naval Officer to take control of his/her finances through the steps provided herein. It is believed that the Naval Officer who masters his/her own financial situation is better prepared to counsel his/her subordinates concerning finances. Further, they will be better prepared financially to deal with anxieties unique to the Naval Service.

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I. INTRODUCTION

A. WHY PLAN?

Many junior Naval Officers fail to recognize the importance of financial planning. Satisfied with existing from month to month and dodging financial bullets they seem to be unconcerned with long run financial planning.

This lack of understanding begins in our youth and is perpetuated by our educational and professional institutions. This study is aimed at helping interested Naval Officers understand and navigate through the maze of financial alternatives.

Furthermore, the personal demands placed upon an officer after commissioning, the frequency of moves which precludes putting down roots, and extended periods of family separation contribute to the inability to learn and implement financial knowledge. The security of benefits and guaranteed compensation further exacerbate this problem. Eventually one quickly realizes that the Military Retirement System may not support them and their family as well as earlier anticipated.

This study is not all inclusive, for the world of finances is as dynamic as life itself. It should help an individual begin his/her journey of financial awareness and lay a foundation from which to build a life-long plan.

This thesis should help a Naval Officer understand the importance of and be able to initiate a personal financial plan. In particular he/she should be able to:

(1) Assemble and organize important financial data

(2) Compute net worth

(3) Understand the barriers to implementing a financial plan

(4) Design a realistic budget

(5) Develop financial goals and strategies to attain those goals

(6) Project future financial needs and

(7) Understand that time is the biggest ally in building wealth.

B. SCOPE, LIMITATIONS AND ASSUMPTIONS

The 1980's ushered in an era of personal financial complexity never experienced before in U. S. history. Major changes in tax laws, deregulation, "mergia mania", and the longest stock market rally on record are but a few of the factors in recent years affecting American lives. Our money conscience has been peaked to the point where money is often a major topic of conversation.

The competition between banks, savings and loans, Wall Street and the Federal government for inflows of capital has lead to an exponential increase in the types of investments available to investors. This leads to the first limitation of this work in that these "new" products are too numerous to detail in a study of this size. Fortunately, little substance will be lost due to this omission since many of these investments are based on prevalent financial themes containing only minor changes for marketing purposes.

The passage of the 1986 tax law, more comically known as the "Tax Simplification Act", has caused an increasing number of Americans to seek professional assistance when filing their tax returns. As the 1988 tax season comes to a close, the Congress and Internal Revenue Service still have not clarified some parts of the law. This has lead to many personal and business tax returns being filed based on interpretations that may be changed in future years. To go into an in depth discussion on taxes would be akin to the way many filed this tax season, on a wing and a prayer. Some tax considerations will be discussed though, but only as they affect the building of an effective financial plan.

Although general in nature, this study is biased toward those Naval Officers who are married, with, or planning to have children. Yet, in view of its generality, it is hoped that any Naval Officer seeking financial guidance can gleam some knowledge from its contents.

The last limitation of this study deals with the future, for which certain assumptions must be made. These assumptions about the future are the weak link in any study of this kind. Unanticipated future events could undermine the foundation on which these assumptions are based.

In light of the changing faces of world finance, the heart remains pure. This analogy leads to the main assumption of this study, that the engine of free enterprise will remain **basically** unchanged in the future, even though the outer body may change significantly. Simply put, we will still invest capital in hopes of increasing our wealth, even if the investment vehicles change. We will purchase goods even if in a cashless manner. These changes on the surface will have their impact no doubt, but the engine of free enterprise will continue with very few interruptions.

Since no one can accurately predict the underlying factors that will be influencing the world in the 21st century, today's assumptions about the world, the economy, and the monetary system may only partially resemble tomorrow's reality. It is believed though, as with the many "**new**" financial products available today, the "financial" look of the future will be supported by most of today's customary themes.

Statistically, short of a nuclear war, most Americans can expect to live to see retirement age. Therefore, even though the customary assumptions about what we expect life to resemble in the future may change dramatically, financial planning has to begin somewhere and make some assumptions.

II. HURDLES TO FINANCIAL GROWTH

A. DUTY

Along with the natural hurdles one must clear in developing an effective financial plan, Naval Officers must contend with additional hurdles inherent in their job. The most common job obstacles are family separation and relocation.

First, many officers will spend considerable time away from home and family while in the Navy. Some families will be separated for as long as six months when spouses deploy while assigned to sea duty. Typically though, a combination of long work days, duty days, and cruises leave little time to monitor a financial plan, let alone develop one.

The possibility or the actual eruption of hostilities could lead to long physical separations. If there is not a financial plan in effect in your household during these trying times, it can be reasonably assumed none will be started. At this point in time other considerations and worries will loom much greater than planning a budget.

Second, Naval Officers are required to make permanent change of station (PCS) moves at various times throughout their career. These moves lead to continuous disruptions in the family budget and an increased frequency in unexpected expenses. Further, some officers are required to make PCS moves to overseas locations or on to certain ships where the tour of duty is "unaccompanied"[1].

Naval Officers may relocate for one of three reasons or a combination thereof. The first and foremost reason for having officers move, is to fill a "**need**" of the service. This type of move could be due to normal sea-shore rotation, sub-specialty utilization, educational or training related, or to fill one of many requirements needed to manage this massive organization.

The second reason for moving officers is to enhance their acumen, in hopes of developing the necessary professional and managerial skills required to handle more senior positions. Some experiences or training can only be received in certain places, such as a tour of duty at a major command in the Washington D.C. area.

The third reason, normally used in conjunction with one of the other two reasons, is the officer's desires. There are as many reasons for desiring to relocate as there are officers in the outfit.

Since all moves are government directed and paid, most are executed in order to fill a service need and/or enhance experience levels. An officer's circumstances will

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[1]An unaccompanied tour means family members are not transferred, at government expense, to the officer's new duty station. The duration of an unaccompanied tour is generally one year.

determine the relative weight of his desires among the other competing reasons for relocating.

Recent surveys indicate that military members utilize more out-of-pocket money than they are reimbursed for making PCS moves.

A 1983 survey of 3,261 Air Force members showed that approximately 60 percent had to borrow money to finance their government-directed move. These results are considered typical for all military travelers, since all services reimburse members at the same rate. [Ref. 1:p. 37]

The survey requested information on meal costs, lodging, transportation, car shipment, household goods, house hunting, auto expenses, and other costs experienced before, during and immediately after the PCS move, exclusive of home-ownership costs. The respondents consisted of 47 percent officers and 53 percent enlisted personnel. [Ref. 1:pp. 37-38]

The survey revealed that military members were reimbursed one dollar for every four dollars spent on moving. Married respondents spent an average $1,991 dollars out-of-pocket, while singles averaged $767 dollars. [Ref. 1:p. 38]

A joint-service study sent to Congress calls unreimbursed moving expenses "one of the most significant elements of negative compensation associated with duty in the uniformed services." The study specifically stated that:

"Service members are not only at a distinct financial disadvantage, but the financial penalties are repetitive due to the frequency of PCS moves over the course of a career. These financial difficulties are compounded because, in many cases, military members are faced with the prospects of having to reenter the house market at inopportune times and quite frequently at higher interest rates.... Since service members receive no financial assistance to help them enter or leave the housing market, the end result is less disposable income for the service member and his or her family". [Ref. 1:pp. 38-39]

Relocations and separations provide very strong tests of a family's financial plan. An effective financial plan can help to significantly reduce the family stress these uncertainties nurture.

B. PERSONAL

Since financial planning is a personal undertaking, it is only natural that some of the major hurdles to implementation are personal in nature. Since financial temperament, prejudices, attitudes and knowledge are different from person to person, so will be their attitude concerning financial planning. The following is a partial list of reasons why many have failed to develop/execute a plan:

1. Procrastination

Procrastination can probably be classified as the greatest personal deterrent to financial independence. The longer you wait to begin exercising a financial fitness program, the greater the amount of money needed to achieve your long-term goals. Time could be your greatest ally, being the one resource that is truly divided equally among us. Other than death at an early age, no one is given a greater share of it than someone else. Some people will go through life waiting for the "time to be right" to start developing a financial plan. Unfortunately, the time never seems to be "just right" and some people never start on the journey down the road to financial independence." [Ref. 2:p. 11]

The importance of time is illustrated by a conversation I recently had with a civil service employee whose specialty was financial management. He acknowledged that many financial management curriculums do not touch on personal financial planning at the undergraduate and graduate levels.

I have recounted several points of our conversation below.

First, concerning retirement, he had recently calculated a retirement income necessary to maintain his standard of living. He went on to state that he should have planned for retirement earlier in his career, since he was now "furiously saving" in hopes that he will not be forced to work longer than necessary.

He went further and admitted that his personal financial knowledge was self taught, as with most people, and maybe there was some merit in individual financial planning as part of a financial management curriculum.

This individual provides a good example of how personal finances are not really "simple". Unfortunately, time is now his biggest enemy, whereas if properly used earlier in life it could have been his biggest ally.

2. <u>Lack of Goal Setting</u>

If you do not know where you want to go financially, chances are you will never arrive at any desirable destination. The establishment of some financial goals is the first step to developing an effective plan. A financial plan should contain specific actions to be taken in order to realize those goals, not a straitjacket laden with restrictions that discourages compliance.

Goal setting is an elusive concept for people to grasp. Setting a goal requires making a decision and making financial decisions generally require that something be forsaken to attain your goals. In economic terms, this is called opportunity costs. Basically this means by choosing item "A", you forsake the opportunity to have chosen item "B".

One of the problems with goal setting appears to be that people have trouble distinguishing between their wants and desires from the necessities of life. Transportation, food, clothing, and shelter are necessities. Private school, domestic help, a gardener, dining out, and cars such as a Porsche, BMW or Mercedes are wants and desires. Necessities could be classified as "A" items, while wants could be classified as "B" items. The only problem most of us want "A" and "B" and we want them, now!

Fulfilling wants and desires have put many in the vicious cycle of "paycheck-to-paycheck connoisseur". This individual's financial gas tank is typically dry several days before payday, waiting to be refilled so they can continue satisfying his/her wants and desires. This individual typically invests in wasting assets vice assets that grow in value.

Just as an aviator would not fly without a flight plan, nor a Captain sail without charts, you should not wonder through life without a financial road map. It is essential to have a road map to guide your financial journey or you will surely find yourself running into detour after detour. [Ref. 3:p. 8]

3. Failure to Understand Money

Money is the raw material to be used to build toward your financial independence. The tool for molding and shaping your money is your financial plan. How skillfully your money is employed during your life will determine how long you may have to remain employed later in life. The problem with understanding money is not yours alone to bear, it's a national and professional problem.

In the educational process of our nation, courses in personal finances are not given a voice in the classroom. This attitude is perpetuated throughout our college systems and into our professional training. For some people, it is not until they embark upon some type of graduate education that they are provided the tools for understanding the intricacies of money.

Many officers deal with monetary problems immediately upon entering active service in their capacity as a division officer. These are not generally their own monetary problems. Instead they are often required to counsel a subordinate concerning their finances. Unfortunately, an officer's professional training only provides the ability to offer superficial attempts at dealing with such situations.

At the United States Naval Academy there is no formal classroom training given on finances. Some training is given by Company Officers during professional sessions, but who educates the Company Officer? Naval Reserve Officers Training Corps (NROTC) course requirements, as set down by the Naval Education Training Command, do not call for any training in personal finance. Both of these accession programs are four years in length.

At the Officer Candidate School, potential officers undergo 17 weeks of intense training in which three hours of class time are devoted to personal finances. Two hours are dedicated to pay and allowances and one hour to personal finance and insurance. Realizing this professional and educational void the prudent officer has no other choice but to seek outside assistance in attempting to understand the complex world of finances.

4. **Failure to Learn and Apply the Tax Laws**

The "Tax Simplification Act of 1986" was designed to reduce the importance of taxes as a major concern when making financial decisions. The truth is, taxes are still and will continue to be a major force in the financial game. The fact that this major change in the tax laws has Congress, the Internal Revenue Service, and tax professionals confused, should provide some insight into how important taxes are when implementing a financial plan. Learn what you can and apply the laws as best you can.

5. **Failure to Keep Accurate and Updated Records**

Let me ask two simple questions to illustrate this point. The first, where is your child's birth certificate? The second, what is or where can you locate your spouse's Social Security number? Being in the military, I'm sure you have been asked to supply these data on more than one occasion.

6. **Failure to Stay Abreast of Current Investment Alternatives**

A sure sign of a good financial plan is one that exhibits some degree of flexibility. But the ability to adjust your plans due to changing circumstances is of little use if you do not monitor current opportunities. [Ref. 4:pp. 3-4]

7. Lack of Self-discipline

The lack of self-discipline probably ranks a close second behind procrastination as a deterrent to reaching financial goals. "The secret of financial independence is not brilliance or luck, but the discipline to save a part of all you earn and put it to work...." [Ref. 2:p. 19]

C. HURDLING TOGETHER

Couples can, but often do not, bring the wisdom of two minds to the finance game. Much too often, couples discover that their spouse "...can be irrational, totally unpredictable or even utterly careless when money comes into the picture." This is "because many of our views about money are determined more by psychological factors like fear, desire, jealousy and even guilt than by logic..." or objectivity. [Ref. 5:p. 144]

Because it's such a personal and private matter, money is rarely discussed in great detail between couples before they marry. That's a strange paradox since monetary disharmony is an underlying cause of many divorces. Some of the reasons given for the absence of fiscal discussions during courtship are as follows:

(1) Individuals want to hold onto their fiscal autonomy as long as possible

(2) Embarrassed to inquire about their loved ones finances

(3) Being that money is not the most romantic topic, couples tend to find better ways of spending their time together. [Ref. 5:p. 143]

Eventually the honeymoon ends and couples must face fiscal reality by making some financial decisions, such as who pays what bills? Should we maintain separate or joint checking accounts? What type and how much life insurance should we have? Do we file joint or separate tax returns and what happens to the refund if any? How should property be divided or should it be jointly held? [Ref. 5:p. 144]

The usual "fodder for connubial discord", about how one spouse uses money as a source of power and the other spends too much are still alive and well. But, more powerful deterrents or opportunities, depending on your view, have come into light in the 1980's. Today wives may earn as much if not more than their husbands. This changing role in the financial arena "particularly for women...has become a place to sort out issues of independence--a negotiation that begins with deciding who pays for dinner on the first date and continues well beyond the trip to the altar." Further, "women have learned to define their freedom and autonomy through money...." [Ref. 6:p. 69]

Another major change for couples, is that people are waiting longer to marry and start families. This leads to the complicated process of combining two developed financial attitudes. To keep money in its proper place in a marriage, not above it, here are some possible actions couples can take:

(1) Discuss with your spouse some short, medium and long range financial goals. This will help to sort out and inform each other of what is important to each of you.

(2) Discuss finances regularly, preferably when money problems are not pressing.

(3) Both partners should know how the money is spent. By placing all the cards on the table one partner's anxieties may be relieved and a monetary bond can begin to develop, just as the bond between a mother and her new born.

(4) Both partners should have some discretionary funds that they are not required to account for, more passionately known as "mad money".

(5) Remember, personal, often differing monetary attitudes are involved, which means negotiating is generally the key to solving most problems. [Ref. 6:p. 69]

(6) If you have a debt averse personality with regard to money, surely you should have a heart to heart discussion with your spouse concerning the use of credit. Couples can make their first major investment together through the reduction and elimination of credit card debt. The average credit card charges 18 percent interest on outstanding balances; there aren't too many places one could invest and realize a return as high as this.

III. BENEFITS AND COMPENSATION PACKAGE

A. COMPENSATION PACKAGE

In developing a financial plan Naval Officers should be thoroughly aware of their total compensation package. Military compensation is divided into two main classifications, direct and indirect. Direct compensation is further divided into military pay and incentive/special pay items. Incentive/special pay items can comprise a significant portion of an officers total compensation package.

B. DIRECT COMPENSATION--MILITARY PAY

Military pay is comprised of the most basic elements of compensation paid to military members. These elements are basic pay, basic allowance for quarters, basic allowance for subsistence and the Federal tax advantage.

1. Basic Pay

A Naval Officer's basic pay is akin to a civilian's salary. It is considered basic, because if a member were not entitled to any other monetary compensation, he/she would receive this basic payment.

Basic pay is determined by an officer's rank and years of service. It increases when a member is promoted, remains on active duty (longevity pay), and when Congress authorizes a pay raise.

2. Basic Allowance for Quarters

Basic allowance for quarters is a housing allowance paid to military members not living in government quarters. This monthly allowance is based on the members rank and whether they have dependents.[2] In 1981 Congress allowed those members who are single, without dependents in pay-grades E-7 and above to receive full BAQ.

In a typical situation an officer forfeits his/her BAQ when living in government quarters, this is synonymous with making monthly rent payments. If an officer is living in government quarters deemed "below standard" for the officers rank, they may receive full BAQ and pay rent less than the BAQ received. The difference between BAQ and the amount of rent is compensation to the officer for living in below standard quarters. [Ref. 1:p. 21]

The Variable housing allowance is not an item of direct compensation, but is closely tied to the type of BAQ an officer receives. VHA is an extra housing allowance paid to those members receiving BAQ and not living in government quarters. The amount of VHA is based on an officers rank, the type of BAQ being received, and annual surveys that are based on housing cost in a geographical area. Housing costs are determined by averaging rental/mortgage payments and homeowners/renters insurance premiums.

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[2] If your spouse is on active duty, he/she is not considered a dependent for any entitlements.

Qualification for VHA among members married to military spouses or sharing housing expenses with other service members, is determined by splitting housing costs equally among the members in residence. Depending on how much housing costs exceed BAQ payments, each member is entitled to receive some or all of this allowance.

3. <u>Basic Allowance for Subsistence (BAS)</u>

The Basic Allowance for Subsistence is designed to defray some of the costs officers must pay for meals. Officers presently receive $114.90 dollars per month and, unlike enlisted personnel, there are no qualifying conditions attached.

4. <u>Federal Tax Advantage</u>

The Federal tax advantage is a category of compensation received indirectly. This "phantom" payment, is the lack of federal taxes an officer would have to pay if BAQ, BAS and VHA were taxable items. Further savings are realized depending on what state taxes, if any, would have to be paid on these non-taxed payments.

Whether a member feels this is a direct compensation or not, Congress, the controller of the military's purse strings, considers it as such.

C. DIRECT COMPENSATION--INCENTIVE AND SPECIAL PAY

Incentive and special pay items are composed of certain monetary allowances that are paid to military members because of their type of work, location, or because they possess certain skills that the Navy deems critical to its readiness. Generally, there are numerous requirements that must be met in order to qualify for one or more of these special/incentive pay categories.

Here is a sampling of some of the more common classifications in this category:

(1) Family Separation Allowance--paid to members who have been separated from their families for thirty days or longer due to shipboard assignment, out of area assignment, or an unaccompanied tour assignment.

(2) Flight Pay--paid to personnel who perform flying duties. This classification is further divided into three pay categories, Officer, Enlisted, and Warrant Officer.

(3) Hostile Fire Pay--paid when performing duties in or near an area designated as a hostile fire zone.

(4) Dislocation Allowance--equal to one month's Basic Allowance for Quarters paid to those members with dependents who are executing PCS orders.

(5) Nuclear Power Pay--paid to those members who are qualified in the field of naval nuclear power.

(6) Sea Pay--paid when assigned to shipboard duty. An officer is required to be on sea duty a minimum of 36 months before he/she qualifies for this pay. [Ref. 7:pp. 12-13]

Since incentive/special pay items are used by the Navy to fine tune personnel needs, be aware that this category of compensation is continuously under review and can change at any time. Further, since the rules governing this category are so numerous and detailed, be aware an entitlement may stop when you change jobs, designator or execute PCS orders.

In addition to these monthly payments, officers possessing certain critical skills may receive annual bonuses. Typically, officers in the following category receive this additional compensation:

(1) aviators

(2) nuclear qualified officers

(3) medical and dental officers.

D. INDIRECT COMPENSATION

Indirect compensation is supplemental to direct compensation. These extra benefits are not paid in cash, but have a cash value determined by what an officer would have to spend out-of-pocket to obtain similar services in the civilian sector. Retirement benefits, medical coverage, and life insurance are a few examples of indirect compensation. [Ref. 8:p. 2]

1. Retirement

Officers are normally eligible for retirement benefits upon completion of 20 years of active service, of which ten years had to be served in a commissioned status. If an officer desires to retire before completing the necessary ten years commissioned service, a member will normally be required to revert back to the highest enlisted rank held and retire in an enlisted status.

Calculating retirement pay used to be a straight-forward task. Two major changes to the laws governing the retirement system since 1980 created three different retirement plans under which an officer may fall. Computations use to be based on how many years an officer served on active duty, but now take into consideration when active service was started.

Under the Final Pay plan, which covers the majority of military members today, to determine one's retirement pay, you first calculate your retirement factor. This factor is determined by multiplying the number of years of active service by 2.5 percent. So, if an officer retires after 20 years, his/her retirement pay factor is 50 percent, 2.5 percent x 20 years. You would then multiply the retirement factor by your basic pay at the time of retirement, rounding down to the nearest dollar, thus yielding the amount of monthly retirement pay. Under the Final Pay plan, the maximum retirement factor an officer can accumulate is 75 percent which correlates to thirty years active service. This plan was terminated for those officers beginning active duty on or after 8 September 1980.

Officers beginning active duty between 8 September 1980 and 31 July 1986 will retire under the High-3 plan. Under this plan the retirement factor is calculated as under the Final Pay plan, again reaching a maximum at 75 percent for thirty years active service.

The major difference between the two plans is that the amount of retirement pay is determined by an officer's "average monthly basic pay received during your highest three years (36 months) of active duty." [Ref. 7:p. 15] An officers last three years of service will typically be the highest paid years and hence are used for figuring this average.

Next, as under the Final Pay plan, multiply the retirement factor by the average monthly basic pay, round down to the nearest dollar, again revealing your monthly retirement pay.

The Military Retirement Reform Act of 1986 created yet another retirement plan affecting those officers who started active service after 1 August 1986. There are two exceptions to whom the law applies; officers with prior active service who returned to active duty after 1 August 1986 and service academy cadets/midshipmen serving when the new law went into effect. The Military Retirement Reform Act was designed to encourage military members to remain on active duty longer than 20 years. This is accomplished by significantly reducing the retirement factor for members who retire with the minimum 20 year requirement. As seen in Table I a member must serve at least 23 years before receiving a 50 percent retirement factor. [Ref. 7:p. 16]

As can be seen from Table I, officers who retire under the new system with 20 years active service receive only a 40 percent retirement factor. This 10 percent reduction from previous retirement plans amounts to a one percent retirement factor penalty for each year retired before thirty years of service.

TABLE I

RETIREMENT FACTOR TABLE

Retirement Factors (Prior to 1986)		Retirement Factors (Post 1986)	
Years of service	Factor	Years of service	Factor
20	50.0%	20	40.0%
21	52.5%	21	43.5%
22	55.0%	22	47.0%
23	57.5%	23	50.5%
24	60.0%	24	54.0%
25	62.5%	25	57.5%
26	65.0%	26	61.0%
27	67.5%	27	64.5%
28	70.0%	28	68.0%
29	72.5%	29	71.5%
30	75.0%	30	75.0%

Source: Meyer & Yohey

Under this plan, after reaching age 62, an officer's retirement pay is recalculated using the retirement factor that would have applied under the other systems at the time of retirement. This "catch-up" feature only applies if an officer retires with less than thirty years active service, because as in previous plans, the retirement factor peaks at 75 percent for this amount of active service.

If you fall under the post August 1986 retirement plan, your retirement pay is computed as follows:

(1) Determine the retirement factor for your years of service by referring to the "new retirement factors" in Table 1, or multiply the first 20 years of active service by 2.0 percent and each successive year by 3.5 percent.

(2) Determine your average monthly basic pay received during your highest three years (36 months) of commissioned service.

(3) Multiply the "new retirement factor" by your monthly average, then round down to the nearest dollar.

(4) To calculate the amount of retirement pay you will receive after age 62, recompute by multiplying your average monthly Basic Pay by the "old retirement factors", or those factors that apply under the Final Pay or High-3 retirement plans. [Ref. 7:p. 16]

Over the past few years, the Federal government has reduced transfer payments to the American people in the form of social security, welfare, and medicare. These changes in the retirement system have been consistent with the signals the Federal government has been sending to the American people, and that is to expect to carry more of your financial weight in your "golden years".

Therefore, it is essential to understand your retirement income. It has been estimated that officers who retire under the High-3 plan before thirty years will receive approximately 13 percent less retirement pay than under the Final Pay plan. Further, officers retiring under the Military Retirement Reform Act of 1986 will receive approximately 28 percent less retirement pay than under the Final Pay plan. [Ref. 7:p. 16]

The Navy estimates that an officer would have to pay 7 percent of his/her basic pay to receive the same benefits under the Final Pay plan. By not having to pay this cost out-of-pocket the Federal government estimates it saves an officer several thousand dollars annually, depending on rank and time in service. [Ref. 8:p. 2]

2. Medical Care

The individual worth of medical care is variable in nature, directly linked with how often this benefit is used and the perception of the quality of care received. The Navy determines the individual worth of medical care based on the cost of an insurance plan available to Civil Service personnel. This plan provides approximately the same medical coverage as CHAMPUS does for military dependents.

The cost associated with the Civil Service plan is $69 a month for singles and $186 a month for families. Depending on your category, the Navy figures it saves you either $828 (single) or $2,232 (family) in health insurance costs each year. [Ref. 8:p. 2]

3. Death and Survivor Programs

Death and survivor programs provide certain monetary allowances for dependents if an officer dies on active duty. If the member was fully insured under the Service Group Life Insurance[3] (SGLI) plan, the spouse receives the maximum payment of $50,000 dollars. Further, as an immediate

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[3] Service members can elect to have reduced coverage under SGLI, thereby reducing his $4.00 a month premium, if he/she states such in writing.

cushion to the sudden loss of income, the spouse receives an additional $3,000 dollars in death gratuity.

If there are dependents involved[4], they are eligible for Dependence and Indemnity Compensation (DIC) payments from the Veterans Administration. The spouse remains eligible to receive DIC payments as long as he/she does not re-marry, and the children are eligible through age 18, or through age 22 if still in school. The amount of these payments are determined by the deceased members rate/rank, years of active service, and the ages and number of the children.

It is estimated that an officer would have to pay 2.4 percent of his/her basic pay in extra insurance to receive equivalent coverage. [Ref. 8:p. 2]

4. Social Security Coverage

Military members are eligible for Social Security benefits on the same basis as their civilian counterparts. The Federal government matches dollar for dollar payments made by members into the system as required by law. At present, members pay 7.51 percent of basic pay into the Social Security system, with an eligible salary cap of $45,000. [Ref. 8:p. 2]

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[4]Remember, if a service member is married to a service member, he/she is not considered a dependent.

5. Other Considerations

In adding up the total worth of your military compensation package, officers should also consider the different programs and privileges provided by the government for their use. The worth of these extra benefits listed below will vary from person to person depending on utilization. The following are additional considerations taken from the Personal Statement of Military Compensation for 1988:

a. State/Local Tax Advantages

BAQ,BAS, and VHA are not only exempt from Federal taxes, but state and local taxes as well. For a California resident, paying the state income tax rate of 9.3 percent in 1988, an officer receiving BAQ at the dependents rate, BAS and VHA based on Monterey Peninsula housing costs, saves in extra state taxes over $700 dollars per year. Of course this benefit depends on the amount of your BAQ, BAS, VHA and the tax rate of your state of residence.

b. Commissary and Exchange Privileges

Because Congress allocates funds to cover employees salaries, commissaries and exchanges are able to sell their wares at prices slightly above costs. On average it is estimated that a savings of $.25 is realized for each dollar spent in the commissary. The following table provides some estimates of cost savings if you shop at the commissary:

MONTHLY PURCHASE	MONTHLY SAVINGS
$200	$ 50
300	75
400	100
500	125

c. **Leave and Holidays**

Military members' are alloted 30 days of leave plus ten holidays annually. In the case of illness, members are alloted an unlimited number of sick days. During periods of annual leave or sick leave members receive full pay and benefits.

To Quantify this benefit, 30 days of leave is equal to one month's basic pay, BAQ, BAS, and VHA and the ten authorized holidays equal one-third of those same payments just mentioned.

d. **Retired Pay Increases**

Military retirement pay is normally adjusted annually based on the amount of increase in the Consumer Price Index (CPI). These increases are referred to as Cost of Living Adjustments (COLA) and are usually computed as of 1 December of each year. COLA is designed to protect the purchasing power of retirement pay from the erosion that can result from inflation.

The personal worth of this benefit is directly proportional to the career aspirations of each individual. Most people realize that if they stay on active duty long enough to retire, they are not going to maintain their standard of living on monthly retirement pay alone.

Further, the inconsistent signals emanating from the Federal government concerning military compensation, especially retirement, continue to concern many military personnel. The changing perceptions of the value of a military retirement have developed as military members witness annual Congressional discussion concerning retirement and COLA increases. These discussions/actions have only added to the anxiety of military personnel as members have watched COLA's deferred, delayed, or eliminated in certain years and the introduction of two less generous retirement plans.

At present, under the Final Pay or High-3 retirement plans, COLA adjustments are supposed to match increases in the CPI.

Members who will eventually retire under the "new" retirement plan have a permanent cap on the size of COLA increases they will receive. The annual adjustment is scheduled to be held to one percentage point less than the increase in the CPI. [Ref. 7:p. 16] A member who retires after 20 years active service and lives another 35 years will witness a significant erosion of his/her real retirement income because of this cap.

e. **Survivor Benefit Plan**

If a member dies on active duty and has the requisite number of years to retire (20 years or more active service), his/her spouse will receive an annuity under SBP. This annuity is equal to 55 percent of whatever the member's retirement pay would had been. This payment is offset (reduced) by any Dependency and Indemnity Compensation the spouse receives. This coverage is of no cost while a member is on active duty. SBP is normally associated with post retirement and will be discussed in more detail later in this study.

f. **Educational Assistance**

Members who desire to continue their education while on active duty may be eligible to receive Navy Tuition Assistance (TA). The Navy, if the educational program qualifies, will pay 75 percent of tuition costs. Further, certain members may qualify for other educational assistance depending on when they started active duty, and if required, actively participated in the program. These newer programs typically require the member to contribute to an educational fund in which the Federal government matches donations on a two to one ratio.

g. **Morale, Welfare, and Recreation Activities**

Typically on base entertainment, such as bowling alleys, theaters, golf courses, hobby shops, child care, gyms, clubs, etc., are provided at costs lower than most off-base facilities.

h. Counseling and Assistance Programs

This form of benefit pertains to available legal counsel and assistance, educational counseling and assistance and financial management assistance normally provided through the Navy Relief Society. Navy Relief also provides emergency loans/grants depending on the nature of an individual's case.

i. Space Available Travel

Members and their dependents[5] may travel on Military Airlift Command (MAC) aircraft while in a leave status. A $10 fee is charged for trips outside the country. If utilized, travel by MAC provides substantial savings over commercial airfares.

As mentioned earlier, each officer will have to determine the personal worth of these privileges. No matter the personal worth, be assured that Congress places a high value on these privileges, taking them into account when determining other aspects of military compensation.

Figures 3.1, 3.2, 3.3, and 3.4 provide a summary of the value placed on the compensation package for a Lieutenant with eight years service with dependents who receives no type of incentive or special pay. Figure 3.1 depicts elements of direct compensation, Figure 3.2 illustrates

[5]Dependents may travel via MAC if overseas.

indirect compensation and Figure 3.3 covers additional compensations. Figure 3.4 provides a summary, revealing the total compensation that the military wishes you to use when considering other employment possibilities.

As can be seen by Figures 3.1 through 3.4, individual figures may differ from those the Navy regards as the value of your personal compensation package.

BASIC PAY $2,439.00

DIRECT COMPENSATION	MONTHLY RATE	ANNUAL RATE
Basic Pay	$2,439.00	$29,268.00
BAQ	$ 455.40	$ 5,464.80
BAS	$ 114.90	$ 1,378.80
Federal Tax Advantage	$ 121.66	$ 1,459.92
Expense Allowance (VHA)*	$ 306.76	$ 3,681.12
TOTAL	$3,437.72	$41,252.64

Figure 3.1 Direct Compensation

INDIRECT COMPENSATION	MONTHLY RATE	ANNUAL RATE
Retirement		
7% X $2,439.00	$170.73	$2,048.76
Death and Survivor Programs		
2.4% X $2,439.00	$ 58.54	$ 702.48
Social Security Benefits	$183.17	$2,198.04
Medical Care	$186.00	$2,232.00
TOTAL	$598.44	$7,181.28

Figure 3.2 Indirect Compensation

ADDITIONAL CONSIDERATIONS	MONTHLY RATE	ANNUAL RATE
State/Local Tax Advantage**	$ 52.67	$ 632.00
Commissary	$100.00	$1,200.00
Morale, Welfare and Recreation	$100.00	$1,200.00
TOTAL	$252.67	$3,032.04

Figure 3.3 Additional Considerations

* Monterey Peninsula rate
** From Leave and Earnings Statement

SUMMARY OF COMPENSATION	MONTHLY RATE	ANNUAL RATE
Direct Compensation	$3,437.72	$41,252.64
Indirect Compensation	$ 598.44	$ 7,181.28
Additional Considerations	$ 252.67	$ 3,032.04
TOTAL COMPENSATION PACKAGE	$4,288.83	$51,465.96

Figure 3.4 Summary of Compensation

IV. FINANCIAL PLANNING

A. WHAT IS FINANCIAL PLANNING?

In its simplest form, financial planning is the determination of a set of goals and a strategy to attain those goals. Viewed from a broader perspective, financial planning is the theme of a theatrical play consisting of several supporting scenes. In other words, a financial plan is a master plan with several interacting and continuously evolving mini-plans. These mini-plans consist of:

(1) Personal Planning

(2) Insurance Planning

(3) Tax Planning

(4) Investment Planning

(5) Retirement Planning and

(6) Estate Planning.

No matter what analogies you draw about financial planning the importance of starting as <u>early</u> as possible cannot be over-emphasized. Therefore, lets begin with an overview of these mini-plans.

1. Personal Planning

Personal planning involves the establishment of your personal financial goals. Those financial goals should be divided into immediate, short, medium, and long range objectives. These four time perspectives could correlate to time periods of one, five, 10-20 years, and ultimately retirement. Obviously adjustments are required depending on your age and personal income at the time you implement your plan. Some common financial goals include:

(1) Reducing credit card/revolving credit debt (Immediate)

(2) Saving for a down payment on a home (Short-Medium)

(3) Saving to cover future college tuition (Medium)

(4) Vacation savings (Immediate-Short)

(5) Financially independent retirement years (Long)

Whatever your goals, they should not be determined in a vacuum. Family members should be as much a part of the financial decision making process as they are when it comes to planning for a vacation. By involving the children, you can begin their financial education with some basic concepts about money they will probably receive nowhere else.

Setting goals and priorities is a beginning that forces you to make some realistic decisions. Further priority selection provides a forum for family communication as the process allows each family member to indicate what is important to them. How this situation is handled will determine if your family puts forth a unified effort in achieving those goals.

2. Insurance Planning

There are only two[6] main reasons for you to buy insurance-protection of assets (liability) and to provide support to your dependents in the case of premature death. The main types of insurance the Naval Officer should be concerned about are life and liability. Disability and health insurance are non-factors since they are provided by the Navy.

On the other hand, dental coverage is one area where military benefits are lacking. Since the present plan only covers routine examinations for dependents, major dental work could carry with it some negative financial consequences. Such work could be a few dollars for fillings to several thousand dollars for braces or corrective surgery.

Liability insurance is usually associated with auto or home/renters insurance. These are two areas where an officer might expect to be set back financially through a lawsuit. Liability coverage is generally included in your auto and home/renters policy. One may consider raising the liability portion of this coverage to match their lifestyle. Additional coverage may be required if you are a pool owner,

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[6]Some individuals consider estate planning as a third reason to buy insurance. In this case insurance proceeds, which are non-taxed, would be utilized to pay any estate taxes on transferred assets.

a hunter, or engage in any activity that increases the probability of injury to others.

Although liability insurance is an important protection against financial loss, it is usually taken for granted until needed. Do not wait for the filing of a lawsuit to discover your coverage is insufficient.

A good financial plan will carry solid auto and home/renter's policies that cover liability requirements. It will also contain a solid life insurance policy to cover the possibility of premature death.[7]

Even though there are basically two types of life insurance, term and whole life, the plethora of variations rival the tax code in complexity. Therefore, it is much easier to let an insurance salesman baffle us with colorful charts and talks about cash build-up, low interest loans, etc., than to sort through the various policies available. Unless you learn the basics about insurance, at a minimum you may end up being talked into signing a policy that is not ideal for your needs. To understand the maze of insurance, let us examine the two basic policies from which all others are derived--term and whole life.

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[7]Some people who have lived long and prosperous lives will feel that when death arrives it is premature no matter their age. As used in this context premature death implies a person dies before he/she is able to accumulate the necessary resources to meet the future needs of their dependents.

Term insurance is a contract between you and the insurance company providing protection for a specific period of time. Your protection against the risk of death is constant over the time period (term) and so are your premiums. There is no cash build-up or any other feature, therefore your premium covers only the cost[8] of the policy plus some profit for the company. With term insurance, each time you renew your policy, your rates will increase. This is understandable, since rates are based on mortality tables and each year of life brings you closer to death.

In the earlier years of an officer's life, his/her insurance needs are generally the greatest and term insurance is generally one-third to one-fifth the cost of a whole life policy. Maybe this fact prompted the saying, "buy term and invest the difference". To get a feel for a term policy, the officer has only to think about the coverage provided under the Servicemen's Group Life Insurance (SGLI) program and its costs. This policy remains in effect for as long as you remain on active duty. The cost is $48 dollars per year for the maximum coverage of $50,000 dollars.

A whole life (permanent life) insurance policy provides protection over your entire lifetime, hence its name. There is one thing you can be sure of--your heirs

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[8]Based on the probability of death occurring during that time period.

will eventually collect something. These policies usually have some frills, such as cash build-up or attractive borrowing terms.

There are two main selling points for this type of policy. The first is that your premiums remain constant over the life of the policy. The second point is that after a certain number of years of paying premiums, the cash value of your policy reaches a level such that your premiums are significantly reduced or no longer paid. It sounds like a really great idea, and why millions of Americans have been so "grossly abused" through the purchase of these policies.

Of all the articles, studies and books consulted for this work, not <u>one</u> advocated the purchase of a whole life policy or one of its derivatives. There are two reasons I can conclude from this anomaly.

First, during the course of your life your insurance needs will vary. Before marriage and children, there is generally little reason to purchase extra insurance coverage above that provided by SGLI. Between marriage and the children leaving home is the time of maximum insurance need.

Early in life, as your family begins to accumulate wealth, your family's lifestyle is vulnerable to a sudden loss of income due to the death of the major income earner. When the kids have departed (graduated from college) and are on their own, your insurance needs begin to decline. The need for insurance is still present but greatly reduced, since fewer people are dependent on your support and hopefully you are knocking on the door to financial independence. Once you have a self-sustaining nest egg, your need for insurance virtually disappears. So why spend money on something when it is not needed?

The next reason is bluntly stated by Charles Schwab in his book, How To Be Your Own Stockbroker, when he implies that whole life policies are a rip-off. He asserts that the selling of these policies overly compensate the insurance salesperson with bigger commissions and insurance companies with fatter profits. [Ref. 9:p. 68]

He also states that a whole life policy is basically a "low-interest savings account" built around a decreasing term policy. This means that each year your life insurance protection (money the company contributes to cover the face value of your policy) goes down as your cash value (money you have paid in excess premiums) goes up. [Ref. 9:p. 68] In other words, after paying enough in premiums, the policy's cash value equals the face value of the policy. So when death finally arrives, it is your own money that your heirs will be getting back! [Ref. 9:p. 69]

The first question an officer should ask when considering insurance, is why buy life insurance at all? The **only** reason is to provide enough "financial protection in the event that you die before accumulating the resources required to meet the future needs of your dependents."

[Ref. 4:p. 20] This reasoning covers any argument for buying life insurance; the other reasons may be for convenience, reactions to personal fears, or the old Madison Avenue shuffle causing you to reach for your wallet.

After deciding to purchase life insurance an officer must ultimately decide on how much coverage to purchase? There are several rules of thumb for determining the amount of insurance you should purchase. The most popular being to purchase enough coverage to equal approximately five times your annual earnings. Unfortunately, rules of thumb do not always lend themselves to dynamic situations or intuitive insight and certainly should not be relied on in determining your financial plans.

By answering the following questions, you will at least have given some reasonable thought concerning your personal insurance needs. Who and how many people are dependent upon my income? What needs will they have and what resources will be available to them to meet those needs? What proceeds from insurance will be needed to maintain my family's standard of living? How much debt is outstanding? (Mortgage, credit card, car, etc.) How much income can my spouse be reasonably expected to earn given the number and ages of the children? The answer to these questions should help you reach a reasonable decision. [Ref. 4:p. 21]

Insuring the children is another area where millions of dollars are wasted each year. Remember, the reason to purchase insurance is to protect those who are dependent on the income of the deceased. Unless your child provides significant income to the family, it is reasonable to assume that no coverage is needed. "You may shun such a somber thought, but a child's funeral expenses will be defrayed by the decrease in the cost of caring for the child, while the loss of a wage earner may be a near economic disaster to the family." [Ref. 2:p. 447]

3. Tax Planning

The goal behind tax planning is to legally minimize the taxes you must pay the IRS. There are several ways to shelter income from taxes, but unless you learn and properly apply the tax laws, your tax bill may be a continued source of financial agony. Unfortunately, the tax laws have become so complicated that to become proficient in their application will require a significant investment of time and effort.

If discussions about avoiding taxes makes you feel unpatriotic or uneasy, you may be confusing tax avoidance with tax evasion. Venita VanCaspel clarifies this dilemma when she states in her book, Money Dynamics For The 1980s, that "tax avoidance is using your intelligence. Tax evasion is illegal and severely punishable." [Ref. 2:pp. 344-345]

Because the tax codes are subject to change at the whim of Congress, tax planning is one of the more dynamic aspects of financial planning. Constant vigilance and agility are required in order to properly reduce your tax bill. This is becoming more difficult each year as Congress tightens/closes certain tax avoiding methods allowed by law and creates new hurdles to overcome to qualify for others.

Although complicated in nature, the tax laws must be learned as their effects should be taken into account when making decisions among competing investments. The expected rate of return may differ considerably than the actual return once tax considerations are taken into account. Further, certain investments allow you to avoid or delay taxes through exemptions or deferments.

So, contrary to the desires of Congress to reduce the influence of taxes on those decisions affecting investments through the passage of the 1986 Tax Simplification Act, taxes are still a major factor to consider when making an investment decision.

4. <u>Investment Planning</u>

Investment planning entails the decision process by which you decide on which financial instruments you are going to entrust your money. In reaching investment decisions, an officer will have to determine his/her comfort level with regard to risk, and understand the risk associated with each type of investment. Your over-all goal is to choose the best investment vehicles to increase your personal wealth with minimum risk.[9]

a. Personal Risk

Personal risk can be defined as how well a person handles the probability of monetary loss in the future; either a loss of your invested capital (principal), or loss through a decline in purchasing power. [Ref. 4:p. 79] Personal risk is usually exhibited through the types of investment a person makes.

An aggressive investor is a person trying to achieve the maximum return on his/her investments in the shortest time possible. Usually people making aggressive investments can handle high levels of risk and uncertainty. These investors resemble "a Porsche owner who has his radar detector turned on as he hurtles along at 85 mph." [Ref. 10:p. 70]

A conservative investor on the other hand assumes low levels of risk in his/her investment philosophy. The return on these investments are generally low by historical standards, because the risk of future monetary loss is low. Conservative methods of investing can eventually help you realize your financial goals, and is better than doing nothing, but expect to take longer reaching your destination. Conservative investors "resemble

[9]Minimum risk is relative to your capacity to handle the personal risk concerning investing and the market risk associated with a particular investment.

defensive drivers who hug the right-hand lane in second gear. The trip may take them longer, but chances of a smashup are lower." [Ref. 10:p. 70]

The moderate investor falls on the spectrum between aggressive and conservative.

Choosing where to invest your money is another extremely personal aspect of financial planning. Again, psychological factors such as fear and desire are very much in evidence. These factors are prevalent because, as with most personal decisions, they are major determinants of the level of risk a person is willing to handle.

Some financial experts correlate age with the level of risk that one should bear in their investment strategy. Between 30-55 years of age an individual should follow a more aggressive investment strategy, along with its relative risk levels. The goal during these years is wealth accumulation. Also, since these are the peak earning years where income is rising its fastest, a financial setback can more easily be handled through a re-adjustment in your financial plans.

Between the ages of 55-62 your investments should be geared toward financial instruments exhibiting moderate levels of risk. Earnings have typically peaked and may be exhibiting a slight decline through a reduction in purchasing power because of the effects of inflation. The financial strategy during this time period is to continue accumulating wealth while protecting what you already have.

From age 62 and onward through retirement the preservation of wealth should be your main goal. Your investments should be designed for continued growth even as you are using some of your cash. In other words, receipts from your investments should be used to supplement any other income you may be receiving. The ultimate objective is not to outlive your sources of income.

b. Investment Risk

Besides the psychological factors that make up our risk avoidance mechanism, there is a level of risk inherent to each type of investment due to market conditions. Generally the higher the level of investment risk (possibility of capital loss), the higher the expected rate of return[10] should be on these investments.

This risk/rate of return relationship deserves some special consideration. Their levels are set by market conditions and depend heavily on the characteristics of the investment. The basic characteristics of safety of principal, liquidity[11] of investment and expected yield

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[10]Rate of return is the monies returned to you for the use of your capital, it is usually represented as a percentage of your invested capital.

[11]Liquidity is the ease at which an investment can be converted into its underlying cash value. For example, a house is not considered very liquid since it may take months to sell.

(rate of return) are offsetting in nature. Typically, to obtain a high rate of return necessitates a reduction in safety and liquidity. Similarly, low yielding investments offer safety and liquidity, but generally their yields are below average. [Ref. 4:p. 79]

The four types of investment risk are closely intertwined with the risk/rate of return relationship. They are financial risk, market risk, interest rate risk, and inflation risk.

Financial risk is the probability of a declining investment (loss of principal) or receiving less than the expected rate of return on your investment. These events could happen because of changing market conditions, the company's product or services are no longer competitive, or from perceived or real problems internal to the company. Financial risk is closely associated with stock investments.

Market risk deals with the price fluctuations caused by changing market psychology. Events such as wars, change of political power, Congressional legislation, growing trade deficits, or growing budget deficits could significantly affect your investment.

Interest rate risk is best illustrated by investments that have a fixed rate of return, such as bonds. Depending on which way interest rates go affects the value of the underlying investment. As interest rates rise principal value falls and vice versa.

Inflation risk deals with the impact inflation has upon the purchasing power of money. This risk is again most closely associated with fixed return investments. As inflation, or the thought of inflation (inflation psychology), heats up, there is a tendency to expect that future payments from these investments will be paid with an insufficient amount of dollars to cover the expected loss in purchasing power due to inflation. This will result in an erosion of principal, whereas in deflationary times, the principal value of the investment increases. Again bond values are particularly affected by inflation. [Ref. 4:pp. 79-81]

The aforementioned paragraphs illustrate that no one investment is superior to all others. Each investment, while it may be considered relatively safe, is vulnerable to at least one aspect of investment risk.

This section should also make the officer more aware of the personal nature of risk and the risks involved when putting one's money to work. Furthermore, officers should have a deeper appreciation of the psychological factors their spouses will be exhibiting while making investment decisions. Not only will you have to gauge your own risk comfort zone, but also that of your spouse. Table II lists selected investments and the effects of investment risk.

TABLE II

INVESTMENTS AND INVESTMENT RISK

INVESTMENT	FINANCIAL	MARKET RATE	INTEREST RATE	INFLATION
Savings Acct.	Low	Very Low	Low	High
Bonds	Low	Moderate	High	High
Common Stock	Low	High	Moderate	Low
House (own)	Very low	Low	Moderate	Low

Source: Parrish

c. Prerequisites To Investing

There are several preliminary actions an officer should take to ensure that his/her financial plans are built on a solid foundation. Two areas, insurance and wills have been mentioned earlier, and hopefully any deficiencies in these areas will be quickly corrected. The next important area is to build an emergency fund. This fund is designed to handle those unforeseen situations which could have adverse financial effects if monies were not set aside to supplement regular earnings.

There is no formula for determining the amount of money that should be in your fund. One favorite rule of thumb is that your emergency fund should approximate 3-6 months earnings. Since this idea is offered by civilians, it does not fully recognize an officer's dynamic environment.

Typically, an officer is not concerned with the sudden loss of income, other than death, therefore he/she may be able to maintain a lower cash level in their emergency fund. The normal concerns of civilians with regard to firings, disability, bankruptcy, take-overs or periods of long hospitalization are not major concerns of the Naval Officer. Bankruptcy and take-overs are not really concerns at all, but for the other adversities mentioned, an officer's normal pay and compensation are still given until a final decision is made in each case.[12]

An officer's emergency fund should contain enough cash to handle unforeseen contingencies, although the timing of such action is not normally knowable. Illness or death in the family requiring immediate travel, unexpected expenses encountered when executing PCS orders (initial deposit requirements for renters, utility connection cost and deposits, etc.) are examples of some difficulties an officer can expect to encounter.

Whatever level of funding you settle on should provide you with the comfort and peace of mind by knowing that theoretically you should be able to handle those minor storms when they arrive without going in debt.

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[12]Involuntary separations, firings, usually takes 3-6 months to finalize and a severance payment of $35,000 dollars is made. Depending on the severity of the illness, disability determinations could, and often do, take over a year to determine permanency and degree of impairment during which full compensation is received. For hospitalizations there is no interruption in compensation.

After deciding on the size of your emergency fund, the next logical question is where to invest it. The reason for having an emergency fund is to have immediate access to your cash, so that if needed you will not have to interrupt your regular financial activities. You should quickly realize that safety and liquidity, not growth, are your major concerns in managing this fund. Table III lists some of the more common investment vehicles for satisfying your fund requirements.

TABLE III

COMMON SHORT TERM CASH ACCOUNTS

INVESTMENT VEHICLE	LIQUIDITY	SAFETY	YIELD
Bank Savings Account	Good	Excellent	Good
Bank Checking Account	Excellent	Excellent	Fair
Money Market Funds	Excellent	Good	Good
Cask Management Funds	Excellent	Good	Good
Certificate of Deposit	Poor	Excellent	Excellent
Treasury Bills	Excellent	Excellent	GOOD

Source: Parrish

You should investigate each of these options and decide on the one which provides the service and level of comfort you desire. A money market fund with check writing privileges or a separate checking account tend to fill these needs for many people.

Although I preference this section as a prerequisite to investing, there is one investment couples can make while building their emergency fund, and that is the reduction or elimination of credit card debt. This is not to say that credit is not a useful tool at times, but we tend to use it for purchases that should be paid for with cash.

It is easy to see why some people succumb to the ease of credit. Throughout our lives we have been sold the idea that credit is as American as baseball and apple pie. It seems that every other week some company is sending us a pre-approved credit application. Retailers prefer plastic, vice worrying about checks bouncing. This is evident by the fact that there are not too many services or goods that cannot be purchased with a credit card. [Ref. 11:p. 98]

The trappings of credit come about because it is very easy to become accustomed to the higher living standards, if only temporarily, that credit allows. But what most credit junkies fail to realize is that they are borrowing against their future earnings. Eventually they are in a vicious cycle where the use of credit is the only way to maintain a lifestyle above their income.

As with any borrowing, some interest has to be paid the lender. Credit card interest rates range from 12 to 22 percent. The effective cost of carrying credit card debt is even higher now, since deductions for interest on consumer loans are being phased out.

5. Retirement Planning

Retirement planning should be designed to save (invest) a portion of all you earn in the hope of making your retirement years financially comfortable. Even though you may elect not to work does not mean your standard of living must drop. Therefore, your goal should be to develop an investment portfolio that generates cash flow to supplement your retirement and Social Security income. Unfortunately it is estimated that only two percent of individuals 65 years and older have such portfolios established; while 23 percent continue to work[13] and 75 percent are dependent upon relatives, friends, or charity. [Ref. 2:p. 4]

We already know, through the changes instituted in the retirement system, that it is unwise to rely upon past promises from the military. Bulging deficits and increasing social demands has Congress scrutinizing the budget for possible "cost" savings. As witnessed over the past few years, the military budget is an extremely popular place to begin these cost saving exercises. Another chilling event that should cause you to be concerned about future

[13]Not all must continue to work past 65. Some senior citizens have discovered jobs, tasks or hobbies they enjoy that are also financially beneficial.

government funding is the enactment into law of the Gramm-Rudman Balanced Budget Act. This act, among other things, "temporarily" ceased cost of living adjustments (COLA) increases for military retirement pay. [Ref. 4:pp. 141-142]

The major question to answer concerning retirement is to determine how much is needed? This amount will vary from person to person depending on their standard of living desired, inflation, taxes, and how long a person lives. A full 75 percent of these unknowns are unpredictable, therefore let us begin with where we are today.

As can be seen in Table IV, your monthly retirement pay is not actually 50 percent of final pay and allowances, but closer to 35-40 percent because allowances such as BAQ, BAS, VHA, flight pay, etc., terminate upon retirement. [Ref. 4:p. 141] Further you should realize that retirement pay will not provide the income flows necessary to maintain the standard of living to which you have become accustomed while on active duty. Therefore your retirement portfolio should take into account ways to supplement this income.

TABLE IV

FINAL PAY RETIREMENT PLAN
EFFECTIVE 1 JANUARY 1988

Years	Grade					
	0-4	0-5	0-6	0-7	0-8	0-9
20	$1598	$1846	$2041	$2666	$2948	$3020
22	1758	2102	2375	2932	3322[14]	3322
24	1917	2293	2591	3199	3625	3625
26	2077	2484	3045	3466	3927	3927
28	2237	2675	3279	3732	4229	4229
30	2397	2866	3513	3999	4531	4531

Source: PAY TABLES

Further, if COLA adjustments continue their downward spiral, your investments will also have to overcome more of the effects of inflation. As an example, lets assume an annual rate of inflation of three percent. In ten years it would take $1,340 dollars; in 15 years $1,625 dollars; and in 20 years $2,080 dollars to maintain the purchasing power of $1,000 dollars. I do not believe a three percent inflation rate is outrageous to assume through the reminder of the 20th century. This example illustrates the debilitating effects of inflation your portfolio must be designed to overcome.

Although no one can predict the future, you can probably bet on having an annual tax bill. In its

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[14]Monthly pay is capped at $6,041.70 dollars by level V of the executive schedule, therefore retirement pay tops out.

desperation to increase cash receipts, Congress may impose more burdensome tax requirements on the elderly as a source of revenue. This is already evidenced by the loss of the Federal tax exemption for Americans aged 65 or older.

Back to the question of how much to set aside for retirement? To try and get a handle on this amount, let us assume you know how much income you would need if you were to retire today. Then we will adjust your figure by what you feel the future rate of inflation will be. Table V shows multiples corresponding to inflation rates of between 5 and 15 percent.

To make a calculation, subtract your age from the age at which you expect to retire. Read across the top and find the rate of inflation you feel safe to assume over these years until you retire. The intersection of years to retire and inflation rate will provide a multiple that, when multiplied by your base figure, will give you the future value of dollars needed to maintain the purchasing power of your base figure. [Ref. 8:p. 21]

TABLE V

INCOME ADJUSTMENT FACTORS FOR ANNUAL RATES OF INFLATION

YEARS UNTIL RETIREMENT	5%	8%	10%	12%	15%
10	1.63	2.16	2.59	3.11	4.05
11	1.71	2.33	2.85	3.48	4.65
12	1.80	2.52	3.14	3.90	5.35
13	1.89	2.72	3.45	4.36	6.15
14	1.98	2.94	3.80	4.89	7.08
15	2.08	3.17	4.18	5.47	8.14
16	2.18	3.43	4.60	6.13	9.36
17	2.29	3.70	5.05	6.87	10.77
18	2.41	4.00	5.56	7.69	12.38
19	2.53	4.32	6.12	8.61	14.23
20	2.65	4.66	6.73	9.65	16.37
21	2.79	5.03	7.40	10.80	18.82
22	2.93	5.44	8.14	12.10	21.64
23	3.07	5.87	8.95	13.55	24.89
24	3.23	6.34	9.85	15.18	28.63
25	3.39	6.85	10.83	17.00	32.92
26	3.56	7.40	11.92	19.04	37.86
27	3.73	7.99	13.11	21.32	43.54
28	3.92	8.63	14.42	23.88	50.07
29	4.12	9.32	15.86	26.75	57.58
30	4.32	10.06	17.45	29.96	66.22
31	4.54	10.87	19.19	33.56	76.14
32	4.76	11.74	21.11	37.58	87.57
33	5.00	12.68	23.23	42.09	100.70
34	5.25	13.69	25.55	47.14	115.80
35	5.52	14.79	28.10	52.80	133.18

Source: Vancaspel

For example, you figure you need $3,000 dollars a month to retire comfortably today. But you are not actually retiring today, but plan to in 15 years; you are comfortable assuming a 5 percent inflation rate over those years. As you can see from Table V your multiple of future value is 2.08. Now, multiply the multiple from Table V by the $3,000 dollars a month cash flow that would have sufficed today. Your answer, $6,240 dollars is the amount of cash you will need 15 years from now to maintain the same purchasing power as $3,000 dollars today.

So you need $6,240 dollars per month and you wonder where it is going to come from. Let us assume an investment with a rate of return of 6 percent. A fund the size of $1,248,000 dollars would be needed to provide a monthly income of $6,240 dollars without a draw down in principal, but remember you have fifteen years to get there. At an eight percent rate of return you would need $936,000 dollars, and at higher returns the funds required shrinks even further.[15]

Further, if you draw down some of the principal each month, you will need even less money. There is nothing sacred against drawing down your principal. The only thing you must be sure of is that "you and it come out together!" [Ref. 2:p. 22]

Now lets examine how much money you would need to invest on a monthly basis to build this fund. Table VI provides some answers for an investment with a rate of return of 6 percent, compounded annually. Six percent is a conservative rate of return to strive for, but this table clearly illustrates the affect <u>time</u> has on building a nest egg.

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[15]These assumptions are after accounting for taxes.

TABLE VI

MONTHLY SAVINGS NEEDED AT SIX PERCENT INTEREST (COMPOUNDED ANNUALLY) TO ATTAIN A PREDETERMINED AMOUNT OF CAPITAL

AGE NOW	YEARS TO RETIREMENT	MONTHS TO RETIREMENT	DESIRED AMOUNT			
			$200,000	$300,000	$500,000	$1,000,000
25	40	480	$102	$153	$255	$510
30	35	420	140	210	350	700
35	30	360	198	297	495	990
40	25	300	286	429	715	1430
45	20	240	426	639	1065	2130
50	15	180	674	1011	1685	3370
55	10	120	1192	1788	2980	5960

Source: Vancaspel

The powerful effects of time and compounding are your strongest ally as you build your fund. The magic of interest rate compounding has been called by some "the eighth wonder of the world". But compounding is only as effective as the time you allow for it to work its magic. So again, I urge you to start early.

I hope this section has given you an appreciation for the time value of money. Of its three ingredients, time, money, and interest rate (rate of return), I hope you realize that time is the most powerful ingredient. Because even a few dollars invested at a conservative rate of return will grow if given time.

Table VII provides some lump sum retirement figures provided by the Department of Defense (DOD). These figures represent how much money DOD feels it needs on hand to cover the cost of one retiree in the various categories. Basically, its a capitalization of your future expense as a retiree to DOD. Obviously a chart of this nature will contain many assumptions, some of which you may not agree with. The interesting point of this chart is to show how much monetary compensation DOD feels it expends on you during your retirement years. Unfortunately, lump sum payments are not an option to the retiring officer, at least not yet.

TABLE VII

LUMP SUM VALUE OF MILITARY RETIRED PAY AT THE TIME OF RETIREMENT

YEARS OF SERVICE	GRADE					
	0-4	0-5	0-6	0-7	0-8	0-9
20	$512789	592370	654945	855503	945995	969100
21	527565	609624	673762	880009	973072	996966
22	541203	647104	731147	902620	1022682	1022682
23	553393	661842	747999	923627	1046234	1046234
24	564739	675507	763296	942410	1067908	1067908
25	574947	687805	777056	959300	1087130	1087130
26	584006	698446	856187	974562	1104185	1104185
27	591920	707999	867711	987632	1119078	1119078
28	598691	715914	877563	998800	1131813	1131813
29	604312	722723	885734	1008317	1142377	1142377
30	608796	727914	892241	1015677	1150795	1150795

Source: Navy Times 9 May 1988

As you can see in Table VII, the feeling that these payments were too "generous" prompted Congress to introduce two less generous retirement plans. This attitude of holding down expenses, thus "reducing" the deficit, is reaching such a fervor some estimate that the most powerful lobbying group on Capitol Hill, senior citizens, will not be able to staunch future legislation reducing Social Security benefits. Already, the legal age for retirement begins to rise from 65 to 67 years starting with the turn of the century.

This bit of legislation is targeted at the fearful budget busting "baby boomers", those born between 1945-1962. In the next 20 years, as this group of Americans begin to retire, they will begin a massive onslaught on the Social Security System. By the year 2025 it is estimated that there will be 70 million Americans aged 65 and over. In hyperbolic terms we are headed for a system overload; in realistic terms we are headed for at least a reduction in benefits. Enough about lifelong government promises.

It would be unfair to leave you with such a cloudy picture about Social Security. Actually, the system is expected to have an $11.8 trillion dollar surplus by 2030. But in just 18 years, by the year 2048, the "baby boomers" are expected to completely deplete the fund. [Ref. 12:p. 28] Further, the system is meeting its over-all objective of preventing mass destitution. It was never designed to ensure complete financial security for the elderly.

No matter how you view the future, even the most optimistic officer should realize that his/her financial fitness will depend heavily on actions taken today.

6. Estate Planning

Estate planning entails the successful transfer of your assets to your heirs while paying the least amount of taxes. These various Federal and State taxes are generally applicable to estates valued at $600,000 dollars or more.

The most important element of estate planning is your will. As military members it is possible that death may call at any moment, it is inherent in the job. Therefore the need for a will should be apparent. If not, consider your hard earned assets being dissipated by lawyers' fees and court costs in the event you die intestate. Those few unpleasant moments it takes to plan for death is certainly the lesser of potential evils after you are gone. [Ref. 3:pp. 120-122]

For the Naval Officer there is really no excuse for not having a will. This is one of the many benefits available to you and your family free of charge.

Survivor's Benefit Plan (SBP) provides a means for military personnel to provide an annuity to their dependents after their death. A retiree pays into the program a portion of his/her retirement pay. The cost of participation depends on your level of participation and the amount of your retirement pay.

At the maximum level of participation, your beneficiary receives a monthly payment equal to 55 percent of your retirement pay. SBP can be beneficial in the case of premature death. But if a 40 year old retiree lives most, all, or more than his/her life expectancy, the amount of money paid into the plan will probably be more than what will be realized. Table VIII provides some cost figures to participate in SBP for a spouse only program.

TABLE VIII

SURVIVOR'S BENEFIT PLAN
(Spouse Only)

BASE AMOUNT RETIRED PAY	MONTHLY PAYMENT TO SPOUSE	MONTHLY COST TO MEMBER
$2,000	$1,100	$176.15
2,400	1,320	216.15
2,800	1,540	256.15
3,200	1,760	296.15
3,600	1,980	336.15
4,000	2,200	376.15
4,200	2,310	396.15
4,400	2,420	416.15
4,600	2,530	456.15
5,000	2,750	476.15

Source: Meyer & Yohey

The rules governing SBP are numerous and too complicated to detail here. But there are some complaints expressed by prior retirees that deserve mention. First, the cost of participating relative to the benefits received seem slightly askew. This feeling is especially prevalent now that SBP annuities are reduced, under the new "two-tier" system, when the receiving beneficiary becomes eligible for social security.

The two-tier system involves simultaneous payments of social security and/or Dependency and Indemnity Compensation. If the surviving spouse becomes eligible for one of these payments, the payments are offset against their SBP payments. So at age 62, when your spouse becomes eligible for social security due to your service contribution, her total monthly intake may or may not increase. In any instance, her monthly payments will not increase by her total social security payments. Thus, if social security is reduced, your spouse does not receive full credit for your contributions to the system; and if SBP is reduced you are getting in full what you paid for!

The final irritant is that a retiree must receive permission from their spouse if he/she elects not to participate in the program. Also this holds true if they chose to participate at less than the maximum level available. If the spouse refuses to sign a release, the retiree is automatically enrolled at the maximum level and the payments are automatically deducted from his/her retirement pay. [Ref. 7:p. 25]

Meyer and Yohey provides a detailed analysis of SBP in their book, 1987 Financial Planning Guide for Military Personnel.

B. GETTING STARTED

It seems the most difficult part of financial planning is actually getting started. Since it is not a hard fact of life, as are taxes and death, financial planning is one of those aspects of life that tend to be put off until tomorrow. Unfortunately for too many, tomorrow never comes.

As with most plans, it is best to proceed incrementally towards your goal. Executing your financial plan in steps helps to alleviate the psychological factors of fear and failure, plus allowing you to get a better grasp on the big financial picture. The following is a list of recommended steps in the order you should proceed:

(1) Develop a list of personal data on you and your family. Information such as names, ages, social security numbers, dates and places of birth of the children, and their present location if they are not living at home. This first step serves two purposes. First, it gets you started and the necessary information is easy to get a handle on. Second, it provides a starting point for someone trying to settle your estate.

(2) Next, create another list of identifying information on individuals having a significant role in your personal affairs. This could be your lawyer, stockbroker, insurance agent, tax preparer, and the guardians of your children.

(3) Step three entails accessing your present financial situation, your net worth. This is the process of adding up the value of all that you own and subtract all that you owe. The resulting figure is your net worth. (This figure could be negative) Become conscious of this number! Because annually at a time of your choosing, usually tax time is best, you should execute this exercise to see how much you have increased it over the previous year.

(4) Budgeting or the infamous "B" word is next. This examination of your monthly cash flows will allow you to see <u>where</u> all that money, the Navy says you make, goes! It also allows you to get a better handle on expenses and lets you see how much money you have to invest.

(5) Next is determining what you would like to achieve with your money, or goal-setting. As discussed earlier, there is no secret formula for setting your goals. The important points to remember are to be honest to yourself and realistic.

(6) Finally the plan, the financial plan that is! All the necessary aspects of financial planning have been mentioned previously. As a refresher and to help tie them together in your mind, I will list them again:

- Personal Planning
- Insurance Planning
- Tax Planning
- Investment Planning
- Retirement Planning
- Estate Planning.

(7) Put your plans into action! [Ref. 7:pp. 3-4]

Steps one and two are self explanatory and will not be discussed further. Steps five and six have been mentioned earlier and other than the main wealth building tactic of investing, will not be expanded upon. Step seven is the will and determination you personally possess and no one can determine that other than by the actions you take.

1. Net Worth

In order to determine if your future financial goals are realistic, you must first become aware of your starting point by analyzing your current financial health. This is done by balancing your assets against outstanding liabilities, thus revealing your family's net worth. Determining your net worth will provide you with "a candid appraisal of whether you can realistically hope to achieve your financial objectives." [Ref. 13:p. 37]

First, let us determine the value of your assets. Assets are generally divided into liquid or illiquid. Liquid assets are those that can be converted to cash with relative ease. Bank accounts, money market accounts, and investments such as widely traded stocks, bonds, and mutual fund shares are considered liquid because they can be quickly converted to cash.

Illiquid assets generally require more time to convert to cash. Also, these assets may be harder to evaluate as to their underlying cash value. Items such as your house, car, antiques, and collectibles fall into this category. Newspapers, trade journals or magazines can help you with determining the present value of these items.

Liabilities, claims against your assets and future earnings, are also divided into two categories. These categories are associated with the time period these liabilities are expected to expire, current and long-term.

Current liabilities include items as charge accounts, credit cards, and short term loans. Long-term liabilities include mortgages, bank loans or any loan with a repayment schedule longer than one year. Table IX gives you an idea of some common assets and liabilities.

After you have determined the value of your assets and outstanding liabilities, subtract the latter to determine your family's net worth.

TABLE IX

NET WORTH

LIQUID ASSETS	**CURRENT LIABILITIES**
Cash and Checking Account(s) Savings Account(s) Money Market Funds Life Insurance Funds Common Stocks Mutual Fund Shares Certificate of Deposits	Charge Accounts and Credit Card Charges Installment Credit and Other Short-Term Loans
ILLIQUID ASSETS	**LONG-TERM LIABILITIES**
Primary Residence Vacation/Rental House Raw Land Auto(s) Boat(s) Furs and Jewelry Collections, Hobbies, etc. Furniture and Household Accessories	Mortgage(s) on Personal Real Estate Mortgage(s) on Investment Real Estate Bank Loan Life Insurance Policy Loans
TOTAL ASSETS	**TOTAL LIABILITIES**
NOTE: Total Assets less Total Liabilities = Net Worth	

Source: Gordon

Now that you have established a starting point and a standard of measure through your net worth calculations, lets look at raising cash to be used to increase your personal wealth. Generally, a military lifestyle does not afford the opportunity of raising cash through a second earned income. A possibility is having your spouse seek employment, if he/she is not already working. Whether or not your spouse works will not generally alleviate bad spending habits, which is usually the source of most individual monetary problems.

For many military families, an examination of cash flows usually unveils some cash that could be made available for savings or investment plans. Since we are concerned with cash flows, a copy of your Leave and Earning Statement (LES) would be helpful. Although the military's benefit package saves you several hundred dollars annually in extra expenses, you can not walk down to your local bank and deposit the money. Granted your cash flow is increased by not paying for certain expenses, but that cash cannot be counted on unless it is uncommitted to paying other expenses.

Income items listed on your LES are basic pay, BAQ, VHA, BAS, and bonuses or additional allowances. Outside income could be rents, interest, alimony, etc.; basically any income not generated through your normal occupation.

Typically, most people realize where their income is coming from, but have a difficult time getting a handle on where it is going! The best way to approach your family's spending habits is to examine the prior year's expenses. The previous years tax return and checkbook registers should suffice in providing most of this information.

Those expense items considered fixed, meaning fairly constant from one month to the next, are easy to reconstruct. These costs include mortgage payments or rents, utility expenses, car payments, other consumer loan and insurance premiums.

Variable expenses, those from which we shall realize our cash savings, are a little harder to determine. These costs include areas where our income expenditures is discretionary in nature. That discretion is the cause of most financial heartburn. Costs in this category include clothes, food recreation, dining out, and entertainment. Do not forget the coffee mess at work and its associated tray of "donuts and other gedunk!"

Add up your expenses and subtract them from your income. The remaining money is the source from which you will realize the cash necessary for savings and investments. If you are like many Americans, you are probably a little surprised at how much is available. [Ref. 10:p. 65]

You have just completed the hardest part of setting up a budget, analyzing spending habits. I will mention the "B" word now, since 90 percent of the work is completed. The other ten percent is setting monthly and hence annual targets in the different expense categories.

Your budget is your guide as you travel down the road to financial independence. As usual you must be honest in its development for you are not cheating anyone but yourself and family. Do not make the mistake of looking upon your budget as a means to an end. Realize your figures are targets which you will exceed in some months and outperform in others.

Now that you have a plan do not forget to put it into action. In the next chapter we will look at some common wealth building methods.

V. INVESTING FOR WEALTH

A. BACKGROUND

Once the basic foundation of your financial plan is set, insurance, a will, debt reduction, and an emergency fund, it is time to consider investments that will help you increase your net worth. There are many investment vehicles available to help you achieve this goal, but each bears its own level of risk as discussed in Chapter IV. Matching your financial objectives with investment vehicles commensurate with the level of risk you are willing to take is the difficult part of investing.

Another major consideration for the Naval Officer is the task of managing your investment portfolio. Typically, the lack of time and investment knowledge preclude giving the proper attention to a complex portfolio. In the investment world, what you do not know can hurt you financially.

B. ACTIONS TO TAKE

Because the investment arena is so large and complex this chapter will only examine the more commonly held investments. Emphasis will be on reducing risk and ease of management. In particular, an overview of bonds, common stock, mutual funds, and real estate will be presented.

1. Bonds

As an initial buyer, an investor is actually making a loan when he/she purchases a bond. This loan could be to the Federal Government in the form of a U.S. savings bond, a business in terms of a corporate bond or to a state or local government in the form of a municipal bond. The bond issuer promises to pay in return the face value[16] of the bond at maturity and the specified interest of the bond.

Interest payments (income to the holder) is usually paid semi-annually. This payment will equal the face value of the bond multiplied by its interest rate. These two factors will not change over the life of the bond, hence the term fixed-price investment.

The effective interest rate of a bond fluctuates and is based on its purchase price, for which there are a host of influences. Items that tend to impact on the price of a bond are fear of inflation, money supply which influences ease and cost of borrowing, rate of return on other investments, debt rating of the borrower, and risk of capital loss. Therefore, since a bond's interest is fixed, in order to remain competitive in the capital markets, the bond's price must fluctuate to adjust to market demands.

If these influences are negative or perceived to be negative, the selling price of bonds will tend to decrease below their face value. This has the effect of raising the

[16]The face value of most bonds is $1,000 dollars.

effective interest rate paid to the bond holder. If the effects of these influences are perceived as positive, the selling price will tend to appreciate above the face value of the bond. This reduces the effective rate of interest to a new buyer, but could provide capital gains for the present owner. In concert with these influences that affect the price, is the time period until a bond matures.[17] This period could range from 30 days to 30 years. Depending on these variables, yields can be found that range from around 6 percent for government backed bonds upwards to 20 percent for some "speculative issues". Highly speculative bonds are commonly referred to as "junk" bonds.

The fear of inflation typically has the strongest influence on the price of bonds. This phenomenon was discussed in Chapter IV.

There are several types of bonds with those directly backed by the Federal Government having the least risk. Bonds issued by municipalities and state governments also carry little risk, although several cities, New York in particular, needed an infusion of Federal funds to stave off bankruptcy. Corporate and other bond issues cover the investment spectrum exhibiting government level risk to highly speculative.

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[17]At maturity the bond issuer promises to pay the bond holder the face value of the bond.

Most corporate and municipal bonds are rated in accordance with these variables. This rating service is designed to give investors a feel for the "quality" of a bond. The two major companies providing this service are Standard & Poor's and Moody's. Table X shows the ratings used by these two services.

Of special note to the Naval Officer are zero-coupon bonds and municipal bonds. Zero-coupon bonds can be purchased from municipalities and states at a deep discount. Bonds with maturities of thirty years and face values of $1,000 dollars can be purchased for about $75 dollars. No income is received from the bond issuer, instead the interest is compounded in the increasing value of the bond until it reaches its face value at maturity. For approximately $275 dollars an officer could purchase a zero-coupon bond that matures in 15 years, possibly to coincide with the need to pay college costs. [Ref. 10:p. 71]

Some municipal bonds offer tax-free interest payments to the holder. Although, recent legislation has narrowed the scope of bonds qualifying for this benefit, tax-free municipal with good interest rates can still be found. Some of these bonds have interest rates upwards of 6.5 percent. Since this income is tax-free, their effective rate of return could be as high as 8-9 percent, depending on your tax bracket.

TABLE X

BOND RATINGS

RATINGS	INVESTMENT SERVICE	
	MOODY'S	STANDARD & POOR
High Grade		
Best Quality	Aaa	AAA
High Quality	Aa	AA
Medium Grade		
Best	A	A
Least	Baa	BBB
Speculative[18]		
Slightly	Ba	BB
Moderately	B	B
Very	Caa	CCC
Extremely	C	C

Source: Imparato and Hyde

2. <u>Common Stocks</u>

Common stocks provide a means for the average American to invest in a business. The one thing to remember about stocks is that they operate in a very dynamic market. As an investment group they have historically provided the highest rate of return with an average yield of 9.1 percent above inflation. [Ref. 10:p. 71] But, as described in Chapter IV, higher risk investments should bring higher returns. To gauge how risky stocks can be, witness "Black Monday" in October 1987 where during a "market meltdown" an

[18] Junk bond ratings fall into this category, often receiving ratings in the very to extremely speculative range.

estimated one trillion dollars vanished from investors' pockets in one day. This massive downward spiral rattled the teeth of the most astute investor.

Mutual funds, insurance companies, retirement funds, basically large capitalized accounts more commonly referred to as institutional investors, have a gargantuan advantage over the individual investor. Their instantaneous access to information affecting market conditions, contacts, the ability to trade millions of shares instantaneously, the use of computer trading programs and their huge amounts of capital, have contributed to increased market volatility which negatively affects most individual investors.

Although most people, institutions and individuals, were hurt on "Black Monday", the individual investor was literally trampled. Typically, they did not have access to the resources necessary to maneuver through this crisis.

The risk of stock ownership are high, but the rewards can be great. However, unless you have the time, knowledge and capital, this investment game is best left to others. I am not saying to abandon this type of investment altogether, because there is a way you can participate, but leave the individual stock game to others.

3. Mutual Funds

Instead of owning separate stocks and dealing with their inherent risks, mutual funds provide a means for the Naval Officer to participate in the rewards of stock ownership. They allow for diversification[19], require small sums of capital to get started, and provide professional managers to overlook the fund. Mutual funds help the Naval Officer neutralize those problems mentioned earlier and effectively handles the problems of the three T's and M. These specific problems are, training, temperament, time and money. [Ref. 2:p. 102] Additionally for the Naval Officer, the inability to execute market orders in a timely fashion while at sea or in some remote part of the world bode well for mutual funds.

A mutual fund is a managed investment vehicle that pools monies from many investors and invests these funds in a variety of investment instruments. [Ref. 4:p. 109] There are funds available for almost any type of investment an officer may deem necessary to meet his/her financial objectives. Also there are funds designed for the conservative to extremely speculative temperament.

The following questions should help to illustrate why mutual funds are a good investment for those in the military, especially fitting the unique environment of the Naval Officer. Are you mentally prepared to handle the complexities of investing on your own? Can you respond

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[19] Diversification is basically a hedge against ignorance! Because you do not possess all the information required that may affect your investment, having several investments reduces the risk of being financially wiped out or seriously setback because of problems in one of your investments. In other words diversification is the first rule of investing; "don't put all your eggs in one basket".

promptly and properly to changing market conditions? Do you understand market dynamics and can you translate that knowledge into an appropriate action? Do you possess enough capital to diversify your portfolio? If you answered yes to these questions then maybe you should invest for yourself. If you were less than positive though, mutual funds might be best for you. [Ref. 4:p. 108]

In view of our main objective of providing for future financial security through asset accumulation, growth funds provide an excellent investment vehicle to build on. Growth funds are primarily concerned with capital appreciation and are designed for the long term investor. They primarily invest in stocks exhibiting potential for capital appreciation greater than major market indices, such as the Dow Jones Industrial Average. [Ref. 4:p. 114] There are different types of growth funds with investment characteristics ranging from levels of extreme risk to moderate risk.

The difficult decision facing an officer is choosing a fund to invest in. Here are a few thoughts that when coupled with Table XI may help you make this decision:

(1) Examine the funds investment objectives and policies to determine whether they fit with your own.

(2) Consider the funds past performance in meeting its objectives. Be cautious here, because past performance does not necessarily foretell future performance.

(3) Determine the experience level and qualifications of the fund's managers.

(4) Consider all the charges you will be assessed by the fund. If they are too excessive in your view, look elsewhere. You should also investigate whether the fund is a load or no-load type. Load funds charge high up front fees, whereas no-load funds' fees are much less.

(5) Consider the availability of other services that you may desire, such as ease of switching among different funds, phone withdrawals, etc. [Ref. 4:p. 116]

These ideas and Table XI, coupled with your financial objectives should assist you in selecting the type of fund to meet your needs. This convenient and easy to manage investment should be given serious thought by Naval Officers when considering wealth building strategies.

Table XI

FUND CHARACTERISTICS

Financial Objective	Type of Fund	Investment Policy	Capital Growth	Safety of	
				Income	Principal
Income plus principal Protection	Money Mkt	Money Mkt Instruments	None	Low	Very High
Current Income	Bond Fund	Bonds; Preferred stock	Mod	Stable	Low to Mod
Income & Capital Protection	Balanced Fund	Stocks & Bonds	Mod	Mod	Mod
Capital Appreciation	Growth	Stocks	High	Mod	Low
Capital Appreciation & Income	Growth and Income	Stocks	High	Mod	Low to Mod
Aggressive Growth	Aggressive Growth	Stocks	Very High	Low	Very Low

Source: Parrish

4. <u>Rent or Own?</u>

One question the Naval Officer will face often throughout his/her career is whether to rent or own their place of residence. Aside from the intangibles of home ownership, there are many items that must be considered in order to reach an economically viable answer to this question. Consideration must be given to your tax bracket, cost and availability of financing, temperament towards ownership, and alternative investments that could be made with your money.

When an individual completes the deal on a home purchase he/she will discover their are many costs besides the price of the house. These one time costs account for 10-15 percent of the initial cash outlays in buying a home. The following is a list of typical up front fees paid in order to close a deal on a home:

(1) Points-lender's fees for making the loan

(2) Realtor's fees-Typically 6% of the price of the home

(3) Title search and insurance

(4) Loan origination fee-1% for Veterans Administration loans

(5) Appraisal Costs

(6) Survey costs and

(7) Various state and local fees for title recording.

Another area of concern is taxes. When tax considerations are taken into account, the cost differential between renting and owning is reduced significantly. This cost difference is one area that must be analyzed in determining to rent or buy. This is done by comparing how much you could earn by investing this difference. If the increase in your net worth could be made greater through investing the cost difference than what would be experienced through the capital appreciation in your home, give a plus to renting.

The tax advantages of home ownership are well known. Deductions for property taxes and mortgage interest are the two main economical reasons to own. The effects of these deductions on your taxes have been reduced in recent years due to the lower tax brackets imposed by the 1986 Tax Simplification Act.

Another tax benefit to home owners is the ability to roll any capital gains realized on the sale of a residence into another home without being taxed. Military members have four years to take advantage of this benefit, eight years in the case an overseas assignment[20]. Also at age 55 you can stop rolling your capital gains and shelter, on a one time basis, $125,000 dollars from Federal income taxes.

The premium paid, in terms of closing cost, points, and mortgage interest, for home ownership may not be recovered if you sell to soon. This leads to the problem of mobility, of particular concern to those in the military,

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[20]This tax benefit of rolling over capital gains is two years for those not in the military.

since, unlike his counterparts in the civilian and Civil Service fields, there is no compensation for expenses related to the buying and selling of a home.

When an individual expects to be in an area for three years or less, an analysis of the net cost of renting versus home ownership should be undertaken. Economically, the results will give a good indication of whether an individual should buy or rent.

Although renters do not enjoy these favorable tax benefits, there are situations where renting is economical. Because renters' typically pay less for the roof over their head, they may have more funds to use for other investments. The amount of these additional funds could be significant adding a major boost to your investment portfolio.

Renting provides a way for military members to economically set down roots in a community for short periods of time. Further, renting places less demands on you as repairs, maintenance, and gardening may be handled by the landlord. This affords the military member some relief in an already time sensitive profession.

The location of your next assignment is another extremely important consideration. If you are moving to a financially depressed area, you may be able to dictate a price to the seller. However, in a few years the situation may reverse itself. There are certain areas of the country where housing markets are traditionally stable or rising, one such area is Washington, D.C. Generally, a home purchase here will be rewarded when the inevitable time to move arrives.

There are also some personal tangibles we can put our hands on that should be examined. Here is a list of some questions that could help you sort out your feelings on this issue:

(1) Are you willing to perform maintenance and the necessary repair work inherent to home ownership? There is no landlord to call when you own the property!

(2) What is your expected length of stay in the residence? Are you willing to take a chance that you may be forced to sell at a loss?

(3) Have you thought of using your home as a forced savings program? If you have trouble saving, this could be an excellent investment for your cash; beware though there is not always a financial upside to home ownership. Witness the oil bust of the 1980s' and the subsequent results on real estate values in the Texas and Oklahoma areas. [Ref. 4:p. 49-50]

In the long run, because of the tax benefits and savings aspects, home ownership is usually the most beneficial decision for Naval Officers. If you take a person who has rented or lived in government quarters all his/her career and compare their net wcrth to someone who owns, typically the owner fares much better financially.

5. <u>Financial Planner</u>

If all this "bafflegab" concerning finances has you confused, there are individuals called financial planners available to assist you. These professionals are basically self styled financial physicians" who examine your earnings, assets, and expenses and prescribes strategies to manage them." [Ref. 14:p. 140]

The services of a financial planner are offered by many businesses as a benefit to their employees. Although potentially an expensive proposition for the military to offer this benefit, savings could be realized due to receiving group rates. This extra benefit would probably be no more expensive than the Navy's dental plan for which members are assessed a monthly fee.

The Navy understands the importance of financial planning, but chooses to take the approach which mimics the attitude of our educational system-hands off! At least the Secretary of the Navy has issued an instruction which designates the Navy Mutual Aid Association as the authorized financial counselor to its members.

Unfortunately, Navy Mutual Aid Association and its major competitor servicing the military in this area, United Services Planning Association, Inc., and Independent Research Agency for Life Insurance, Inc. (USPA & IRA--one company), operates on a commission basis. Since profits are derived from whatever the company suggests you buy, in some respects you might as well call your local insurance salesperson for help. Navy Mutual Aid mainly covers insurance needs, therefore you can expect that their biggest sales pitch will be for whole life insurance, since it provides the largest margin of profit for the company.

USPA & IRA pushes insurance, naturally the whole life variety, and also covers other types of investments. Unfortunately, in search of commissions, these services are prone to pushing financial products that generate the biggest returns to the company vice what may be best to help you achieve your goals.

One can not really blame these organizations for their various approaches since commissions are their only source of income, but one should be aware of this fact to make a more informed decision concerning what products to purchase.

Should you strike out on your own to find a financial planner? For the typical officer, probably not. It is not that their services are of no value to you, but at hourly fees upward of $200 dollars and typical fees of $1,000 dollars for a customized financial plan, economically this service is too expensive for the typical officer to utilize. However, on a group basis with part of the fees being defrayed as compensation, this helpful service could be made available to any officer who desires such assistance.

VI. CONCLUSIONS

The goal of this study is to provide those Naval Officers considering their financial future a means of developing, monitoring and executing a financial plan. As long as the reader is not expecting immediate riches, this study provides beneficial information concerning personal financial planning.

There are no magic formulas or hidden secrets to achieving financial independence, just will power and determination. By following the steps outlined herein, an officer can begin getting his/her financial house in order.

This study also attempted to uncloak some of the psychological barriers that keep many from achieving financial independence. By understanding these barriers it is hoped that an officer will develop the mental toughness and discipline to overcome them. Personal barriers present the biggest challenge for they generally require a change of attitudes and perceptions about monetary values. They are, however, the easiest to discern and predict. In particular, one must weigh the relative merits of saving for tomorrow or spending for today.

Other barriers unique to the Naval profession were also explored. These barriers are less controllable since they evolve from circumstances beyond an officers' control. With a solid financial plan in effect, their consequences can be minimized.

A healthy attitude towards savings provide a springboard for implementing a successful financial plan. As illustrated by the effects of compound interest, your efforts can be greatly intensified by starting early in life. With time, your chances of success increase dramatically. Hence when the "golden years" arrive, financially they will be "golden".

This study is not all inclusive, nor was it designed as such. It is directed at those officers who desire to reach financial security by planning now. Because finances are so dynamic and the financial race so long, the serious officer will quickly discover there is no one publication to serve all of his/her needs. By implementing the steps outlined, an officer will have taken his first major steps into the world of personal finance.

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