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Client Information Summary

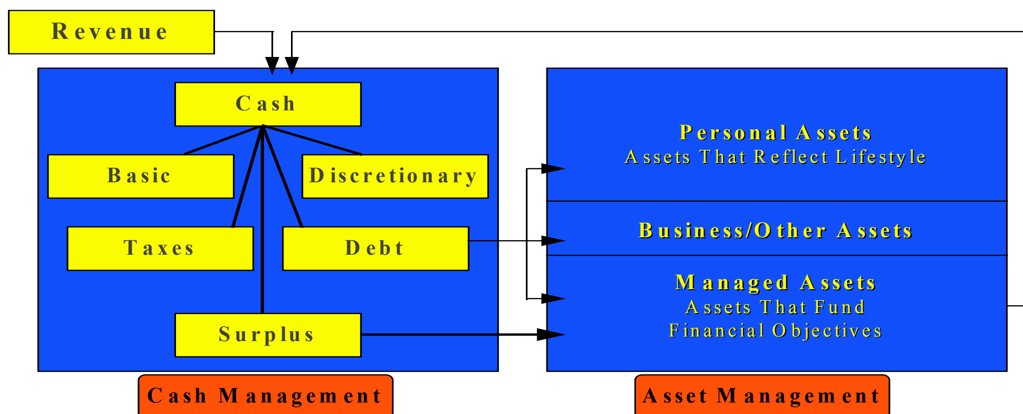
Five Principles of Cash Management

There are five simple principles which have the power to transform your financial circumstances. Together, these principles constitute the bricks and mortar of cash management, a simple concept but one not well understood by many. What exactly does cash management mean and why is it important to you? The answers to these two questions could help you begin to build a better financial future.

So what exactly is cash management? In simple terms: We all have an income stream of some sort; we all have expenses and many of us carry debts; and, with few exceptions, we must all pay taxes. Cash management is the process of managing your cash flow by controlling your expenses, minimizing taxes, and reducing the cost of debt, to ultimately create more bottom line savings.

The following diagram may help you understand this concept better in the context of your own personal financial world.

The left side of the diagram reflects what is referred to as your *cash flow.* The right side depicts your *net worth*.



Looking at your cash flow (left side), your primary source of *revenue* during your working years is your employment or business income. When you stop working, your source of *revenue* changes to pension and/or government benefits. At most times during your working years, the *cash* coming in from employment should exceed what has to go out to cover *basic living expenses* (food, clothing, shelter, transportation); *discretionary expenses* (holidays and entertainment); *debt repayment*, and *taxes*, leaving something at the bottom for *savings*.

This is particularly important because, unless you either are born into or marry into a wealthy family, or win a lottery, *new wealth is only created by saving.* The sooner we learn the truth of this statement, the easier it is for us to achieve our financial objectives.

Once you have acknowledged that cash management is indeed critical, learning *how* to manage your cash flow effectively is the next imperative. In other words, how do you control living and discretionary expenses without severely cramping your lifestyle? How do you reduce the cost of debt? And, how do you minimize taxes. The following discussion of the Principles of Cash Management should help you answer these important questions.

PRINCIPLE #1: *PAY YOURSELF FIRST*

This principle is quite literal, but its implementation often requires an attitudinal shift. This is because most people save what only is left after everything else is paid. The problem with this approach is that there are always too many things on which our money can be spent, leaving nothing to be saved. Interestingly, our years of experience have shown this to be true, regardless of whether you earn $50,000 a year or $500,000 a year. In fact, those who earn $500,000 a year have as much if not more difficulty saving as those who earn $50,000.

For most people, however, a budget is not the solution. Budgets are like diets. They seldom work on a long-term basis. A more sensible solution is to arrange your affairs so that a specified amount gets saved, *before it gets spent*. If you think this is not possible, simply imagine getting a 10% cut in your income as a result of a new tax. We would all grumble, but we would soon find a way to manage, probably without major adjustments to our lifestyle.

But how do you actually save before spending? For most people, the best way to implement this is to set up an automatic pre-authorized savings plan, which assures that you do indeed "pay yourself first."

What amount should you pay yourself? Ten percent (10%) is the rule of thumb touted by many financial advisors. A more appropriate figure, however, is whatever it takes to allow you to reach your objectives. That is why having a specific personalized savings strategy is important. For some people 10% will do it, for others it may take 25%. It depends on how far you have to go to arrive at your financial destination, and how much time you have to get there. But, whatever the amount, *pay yourself first*.

This is a must for all except those who have already retired or who have been fortunate enough to achieve financial independence. If you are in either of these categories, then saving is an activity in which you engaged in the past and, technically, you no longer need to save. In this case, you can probably skip straight to the last principle and begin exploring ways to *maximize your net after tax income.*

PRINCIPLE #2: *DO NOT PRESUME UPON TOMORROW*

This is the most difficult principle to articulate, as it has several meanings. First and foremost it means to insure, to the maximum extent possible, that your family income will not be interrupted by pre-mature death or disability. Once again, for someone who is already financially independent, this is not an issue.

This principle is crucial, however, for anyone who counts on continuing employment income to maintain their family's chosen lifestyle. *Not presuming upon tomorrow* requires that you devote a small portion of your existing employment income to buying the appropriate insurance which will insure that your income will not be extinguished by death or disability.

It also means maintaining an adequate cash reserve for emergency purposes. A three to five month income reserve is a good guideline, but the amount could vary considerably depending on the volatility of your employment income. Normally, the "reserve" should constitute the cash component of your non-registered investment portfolio.

On a more subtle level, *do not presume upon tomorrow* means making sure that you do not live beyond your means. This is seldom an easy principle for any of us to follow. In fact, in some cases you may not even be aware that you are "presuming

upon tomorrow." However, turning a blind eye to this principle can be a recipe for disaster, as the following examples demonstrate:

SCENARIO "A": Todd and Heather plan to retire when Todd reaches age 55, on an income of $75,000 per annum (stated in today's net after tax dollars). The cost of their current lifestyle has been about $90,000. After performing a retirement planning analysis, their financial advisor told them that they needed to save $15,000 per annum (indexed to inflation) until Todd turns 55, in order to achieve their goal. This seemed to pose no problem. They easily saved that amount for several years. However, over the same period of time, Heather started earning quite a bit of extra income, and Todd was getting some bonuses. The problem is that the cost of their current lifestyle grew quickly to a lot more than $90,000, without them realizing it. They were saving a fixed amount and grew accustomed to spending the rest. When Todd's bonuses stopped, they had to axe their savings program "just to make ends meet." They had unknowingly started presuming on tomorrow, thinking their "extra income" would continue forever.

SCENARIO "B": A contrasting example is found in the story of James and Helen. James had a small business which was wiped out during the recent recession, requiring him to start over at age 45. Their financial advisor worked out a strategy for them that relied on an ever increasing percentage of savings each year until James reached age 65. The graduated approach to saving was to allow them the "luxury" of devoting a higher percentage of James' current income to re-building their current lifestyle. During his final working years, he had to save 30% of his income to achieve financial independence. This is not a problem…unless James is not able to work to 65 as a result of a disability or job loss. Presuming too much on tomorrow could leave them vulnerable late in life.

The solution for most people in this situation is to achieve a delicate balance between spending for today and saving for tomorrow. In fact, this is important for all of us.

Adherence to this principle is more easily assured by working with a knowledgeable objective advisor, and by doing regular updates of your personalized savings and investment strategy, so that adjustments can be made as they are required.

PRINCIPLE #3 *MINIMIZE THE COST OF YOUR CHOSEN LIFESTYLE*

To some degree, adherence to the first two principles helps to assure that you are following the third. Still, there are a myriad of ways in which you can reduce your basic living and discretionary expenses, without reducing your lifestyle. A full treatise on the numerous tactics is beyond the scope of this information summary. What we want to stress here is the need to cultivate a prudent business-like attitude toward the management of basic and discretionary expenses.

It was once "in vogue" to have the very best products and services available, regardless of the cost! For most of us, that credo has been replaced with a new one which states that you should attempt to acquire the benefits of having the best products and services, but at the lowest possible price.

For example, rather than acquiring a new $50,000 vehicle, one may opt to acquire a nearly new two year old similar vehicle at a cost of $35,000. If the vehicle was disposed of after two years for $25,000, the cash flow improvement should average at least $5,000 per annum, as opposed to the cost of driving the brand new car. This could translate to a portfolio enhancement of almost $70,000 over a 10 years period, if that $5,000 per year was invested in a fully taxable environment averaging 12% interest (assuming a 50% MTR). Turning this modest lifestyle adjustment into a habit would translate into nearly $200,000 more in your portfolio, after 20 years.

Another prudent habit to cultivate is that of tagging your personal holiday on to the end of a business trip. Doing so would save you $500 - $1,000 in airfare and allow you to take advantage of a preferred corporate rate for an extended stay, which could easily boost your savings by another $500 - $1,000. No sacrifices in lifestyle are required, just good timing. Turned into a habit, this would mean an extra $28,000 in invested capital after 10 years, or $78,000 after 20 years.

There are numerous other such strategies, but the point is simple. It is not difficult to minimize the cost of your chosen lifestyle. Should you or other members of the family see the wisdom of such an approach but lack the necessary discipline to proactively minimize the cost of your chosen lifestyle, adhering closely to the first and second principles provides an excellent start in the right direction.

PRINCIPLE #4: *AVOID NON-DEDUCTIBLE DEBT*

Non deductible debt should be avoided like the plague. The interest you pay on debt which was not acquired in order to earn income is not deductible. Worse yet, most borrowing is done to acquire personal assets which depreciate in value, with the possible exception of a home or cottage, though for some periods of time even the home and cottage have not been exceptions.

When borrowing to obtain personal assets is unavoidable, it is imperative that you never allow your debt-to-asset ratio to exceed 75%. Even within these guidelines, non-deductible debt should be eliminated as quickly as possible, but not to the total exclusion of savings (Principle #1) or risk management premiums (Principle #2).

PRINCIPLE #5 *PLAN TO MAXIMIZE AFTER TAX DISPOSABLE INCOME*

Maximizing your after-tax disposable income is a principle that seems simple. Sometimes, however, people get wrapped up in the need to minimize tax at any cost, and lose sign of the aim of this principle. An example that perfectly illustrates this point is the true story of an elderly couple who kept their money in a chequing account to avoid paying tax on the interest income. Someone had planted the idea in their minds that they were ahead of the game by paying no tax. They were shocked to learn that they would actually get to keep about 50% of the income that their $200,000 earned each year. At only 6%, that still amounted to $6,000 per annum. Yes, they had been minimizing their tax, but their wealth was not enhanced in any way, by doing so! A better financial education, strategy or advisor would have earned them more money.
There are four primary ways for you to maximize your after-tax disposable income: Deductions and Credits, Deferrals, Diminish and Divide. (Refer: 191T Principles of Tax Management for a detailed discussion regarding increasing your cash flow through effective tax planning).

THE BOTTOM LINE

The bottom line is that it is possible to start from wherever you are and radically transform your financial situation. These five very basic principles provide a road map that can assist you in doing so. However, you must be motivated to put these principles into practice for yourself, and, above all, you must have a financial strategy which can keep you on course toward your ultimate financial goals.

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CIS #175-C 20030202

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