Topic 2

Different plans for different people

Learning outcomes

After studying this topic, you will be able to:

- explain personal factors that affect financial planning;
- explain the term ‘attitude to risk’ in the personal finance context;
- describe the need to make changes to financial plans where necessary.

Introduction

In Topic 1 we looked at the basics of financial planning and why it is important. Topic 2 will consider how financial planning depends on each individual person’s circumstances; there is no ‘one size fits all’ solution. We will then look at how people can get help with financial planning.

Each individual has a unique set of personal circumstances, with different levels of income and expenditure, and different needs and objectives. We will look first at how circumstances can differ and then move on to consider typical issues for people in each of the life stages that we considered in Unit 1.

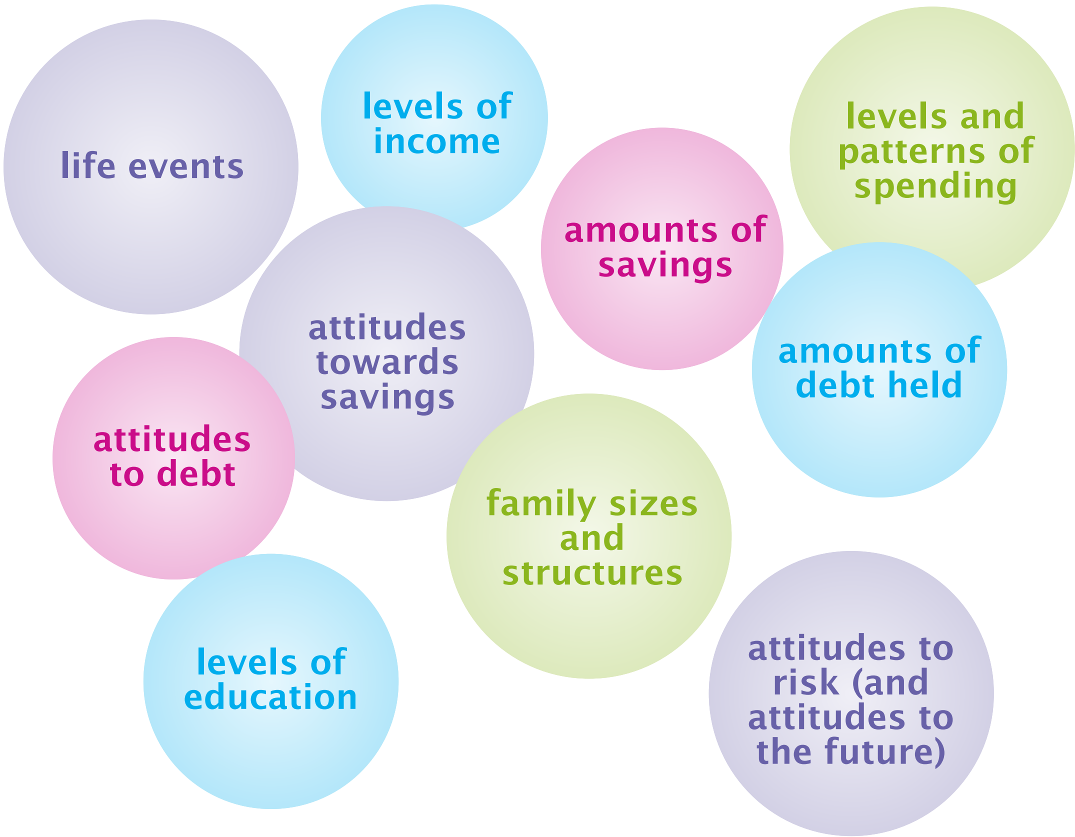
2.1 Financial planning and personal circumstances

There are lots of reasons why one person’s needs and plans will differ from another’s. Each one of the factors below, and more, will have an impact:

- age and life stage;
- family circumstances – single, married, with a partner, children, etc;
- level of income and expenditure;
- financial circumstances – savings and borrowing.

All of the factors mentioned will be affected by where the person is in life – their life stage. When planning current and future finances, we should think about the typical financial and personal circumstances that usually apply to each life stage, and the financial consequences of things that could happen during each stage.

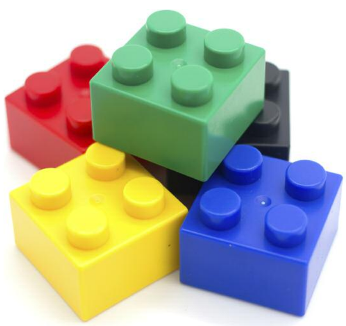
At each life stage, people tend to have different:



2.1.1 The main life stages

You learned about the typical life stages in Unit 1, so we will just recap here before we go on to look at how they impact on an individual's financial situation.

2.1.1.1 Childhood (from birth to around 12 years of age)



During this stage, the person has no financial responsibilities; their parents or guardians provide a home and pay for everything they need. They might receive pocket money, and relatives may save for their future.

2.1.1.2 Teenage (age 13–19)

As any reader will know, a teenager will have many ways to spend money! In most cases, the emphasis will be on spending rather than saving, although it is a very good stage to start learning about the value of money and the importance of money management.

Teenagers are likely to receive an allowance from their parents or guardians, and as they grow older may take part-time jobs to increase their spending power. Although growing in independence generally, a teenager is still largely dependent on their parents or guardians for food, shelter and other routine expenses.

They may start to save for short-term things such as driving lessons, computers and so on. They may have to take more responsibility for their own finances, if they go to college or leave home for work.

2.1.1.3 Young adult (age 18–25)

Young adults are building the foundation for their later life. They may move away from home for a number of reasons, such as:

- a need for independence and their own space;
- studying at college or university;
- moving for work.

Others may stay at home for a number of reasons, perhaps because they:

- are working nearby;
- may not have found a job yet;
- can't afford a place of their own;
- are saving to get a place of their own;
- are simply happy at home.

Those who have a job or an apprenticeship are likely to be on a relatively low income, because they are at the start of their career ladder. Those still in education are likely to have loans to fund some of their studies, and may have part-time jobs to help.

Regardless of their particular situation, it is unlikely that a young adult will have a great deal of spare cash after their living costs have been met, so their main focus will be on paying their bills and possibly short-term saving for a car or a deposit on a flat or house.

2.1.1.4 Mature adult (age 26–40)

People in this age bracket are likely to be earning more as they get older, but their needs and objectives are likely to be different.

They may be married or in a relationship, in which case they are likely to be concerned about:

- **saving** – for a wedding or civil partnership celebration or some other important target;
- **children** – planning to have children, supporting children they already have and making plans for those children;
- **buying a home** – saving for a deposit and arranging a mortgage, or paying for an existing mortgage;
- **future needs** – planning their financial future;
- **insurances** – making sure they don't lose what they have, by protecting the family against the financial problems caused by either of them dying or losing their income through illness or injury.

Those who are single will have needs and concerns such as:

- buying a home;
- saving for specific targets or wishes, such as holidays or a new car;
- insurances – making sure they don't lose what they have, by protecting their standard of living if they fall ill or are injured.

2.1.1.5 Middle age (age 41–54) to late middle age (age 55–65)

In most cases, those in middle age will be well settled in their working life and earning more than they have done before, perhaps even getting promoted at work. As their children become more independent, the parents will have more money to spend on themselves and more time to spend it. They may be close to paying off their mortgage or other debts.

Saving for retirement becomes more important as retirement gets closer. However, there is also the possibility of redundancy or the need to retrain for another job – both of these become harder to face as we get older. Ill health may also be a problem, which could force the individual to retire early or reduce their workload; either way, they would see a drop in income.

In most cases, people at this life stage will probably have savings and insurance products, but they should always review what they have, to make sure that it's still right for them.

2.1.1.6 Old age (age 65 onwards)

In old age, the emphasis moves from building up savings to converting savings into income to spend in retirement. In the not-too-distant past, people had retired by the age of 65, often on a small pension that didn't allow them to do much. This may not have been a problem for many people, because their expectations of retirement were quite low.

However, people today have much more ambitious plans and needs in retirement. They want to travel, take holidays and make the most of their leisure time. This all takes money, and in many cases they need almost as much net disposable income in retirement as they had when they were working. Most people aged 65 or older will have paid off their mortgage and debts, which means that their essential expenditure is lower than when they were working.

Many people in this age group have enough income to do what they want, because they have saved and planned for retirement. But some haven't, and will be looking for ways to increase their income, perhaps through part-time work or by releasing some of the money tied up in the value of their property using special schemes.

People in this age group might also be concerned about paying for care, if they can't look after themselves and have to go into a care home. They may also be concerned about inheritance tax (IHT). When people die, all their money, property and possessions form their 'estate'. If the estate is above £325,000, the government will charge IHT at 40% on the amount above £325,000 that is left to anyone other than their spouse or civil partner. Since April 2017, IHT is not charged on part of the value of the deceased person's home, which will reduce the tax bill for many people. There are many things that can be done during someone's life to reduce IHT, and IHT planning is big business for financial advisers and solicitors.

Discuss

Many people feel that having to pay IHT is unfair, and look at legitimate ways to reduce their taxable estate to make sure that as much of their wealth as possible goes to their family.

Why do you think they see it as unfair, and do you agree?

Why might the threshold be £325,000?

2.2 Attitude to risk

Another major factor that can impact on an adult's approach to financial planning, regardless of their stage in life, is their attitude to risk. This is particularly important when talking about savings and investments.

In investing, there is a principle known as 'risk versus reward'. The theory is quite simple – if you want to make good returns on an investment, you have to take some risk with the money. The risks are that the value could go up or down (known as 'volatility'), and there is even a risk that you could lose some or all of the money. The reward is that, over the longer term, you could make far more money than by taking little or no risk.

The opposite is to take no risk, which means that although the money is quite safe, it will not grow much. Experts consider that higher-risk investments may be suitable for someone who has a long time until they need the money, because the investment will be able to recover any losses and will benefit from potential growth.

Someone who needs the money fairly soon shouldn't take any risk with the money, and should put it into a savings account that allows them instant access to their money.

2.2.1 Risk vs reward

Figure 2.1 provides an idea of how the main types of investment fit into the risk vs reward spectrum.

Figure 2.1 The risk vs reward spectrum

Each type of investment is explained briefly below. So, for example, deposits are safe in terms of risk, but deliver quite low rewards. Overseas shares, on the other hand, are high on the risk scale but, if everything goes well, they are likely to deliver much higher rewards.

2.2.1.1 Deposits

Investing in bank and building society deposit accounts is considered to be safe, because the original money will not reduce in value, and interest is added on a regular basis. There are rules in place to ensure that the money is protected, if the bank or building society goes out of business or 'goes bust'.

2.2.1.2 Gilts and corporate bonds

Gilts are investments where the investor lends money to the government for a set term, usually between 5 and 30 years, in return for a fixed rate of interest paid each year and a return of the investment at the end.

Corporate bonds work in the same way as gilts, but are loans to large companies.

Both gilts and bonds can be sold to another investor during the term, and the sale price could be more or less than the original price paid, depending on a number of factors that would make the investment more or less attractive.

There is a risk that the borrowing organisation may be unable to pay the interest or repay the loan at the end, but experts consider the risk of the government failing to make payments to be almost nil, and it is also unlikely that large UK companies would fail to make payments. For these reasons, gilts and bonds issued by major UK companies are seen as low risk and, although the interest paid is usually higher than on deposit accounts, the potential rewards are not as high as other investments.

2.2.1.3 Property

When we talk about property as an investment, we are really referring to commercial property, such as factories, shops, offices, hotels and so on.

Most experts consider property to be somewhere between bonds and shares in terms of risk and reward.

Most people are unable to invest directly in property because of the cost of purchase, so the most popular investment is through collective property funds, whereby many people's invested funds are pooled together.

2.2.1.4 UK shares

Companies offer shares (sometimes called 'equities') to investors to raise money to invest in the business. The name 'shares' is used because the investor actually buys a share (portion) of the company.

In return for buying shares, an investor may be rewarded in two ways.

1. Once purchased, shares can be sold to other investors. If the company does well, the value of the shares will rise and the owner could make a profit by selling. However, if the company doesn't do well, the value of the shares may fall, which could leave the investor with a loss if they sell. Another important point is that shareholders are last in the queue to get their money back if the company stops trading. They will share what's left after borrowing, expenses and other commitments have been settled. This could leave them with less than they paid – or even nothing.
2. If the company makes a profit, it will usually pass some of the profit to shareholders through dividends, which are payments made once or twice a year. The company doesn't have to pay dividends, so they are not guaranteed.

When the company first issues the shares to investors, it will receive all the money raised (minus expenses), to spend on running the company. Once the shares are in the hands of investors, the company will not own the shares and will not benefit directly if they go up in value. Shareholders have a big say in how the company is run, because they own it, which means that companies try hard to keep shareholders happy.

Shares are traded in the stock market, which is a system that regulates the way shares are issued, valued and sold. Stock markets in the UK, the USA and most of Europe have been operating for many years and are seen as reliable and well controlled. Stock markets in some other countries are relatively new and are not as well controlled.

The risk factor for shares will vary, depending on a number of factors.

- **The size and success of the company** – shares of large companies with a good track record of profits and good management (such as BT, GlaxoSmithKline and HSBC) are seen as relatively low risk. Shares in small companies, new companies or companies that are recovering from major problems are seen as relatively high risk.
- **The country the company operates from** – shares in overseas companies are seen as more risky than UK shares, because the UK has no control over how they operate, they use a different currency and their laws may be different.

2.2.1.5 Overseas shares

Major economies with an established stock market, such as the USA and Germany, are seen in the UK as slightly higher risk than UK shares, because the UK has no control over how their markets operate and they use a different currency.

Shares in some major countries, such as China, India and Russia, are seen as higher risk for a number of potential reasons, which could include:

- the lack of UK influence over how they operate;
- the risk of political interference;
- inefficient stock markets;
- the country's economic history;
- the risk of corruption in companies and other organisations.

Not all of the factors apply to each country.

Investment in small countries and those recovering from severe financial problems is seen as very high risk.

2.2.1.6 Specialist investments

Specialist investments, such as futures and options, are very complicated, because they involve gambling on the future price of shares or commodities such as oil, gold and other natural resources, and carry a high level of risk.

If all goes well, they could produce spectacular results, but if all goes badly, then the investor could lose all their money. Many experts see certain specialist investments as little more than gambling.

2.2.1.7 Diversification of shares

Buying shares in one company, or a couple of companies, is risky because of the effect that any losses from one share would have on the investment. Investing in 20 to 30 companies would spread the risk and reduce the impact that one share could have on the investment. This is known as 'diversifying the investment' (or 'diversification').

One simple way to reduce the risk of share investment is to invest in collective funds, such as unit trusts and open-ended investment companies. In these funds, experts make all the investment decisions and spread investors' money across lots of companies to reduce risk, while at the same time hoping that their expertise will bring good returns. Consider the following examples.

Ryan

I bought £10,000 worth of shares in one company – Acme Holdings. After six months, Acme shares have fallen in value by 15%, so my investment is now worth £8,500.

Clare

I also invested £10,000, but bought £1,000 worth of shares in each of 10 companies, including Acme Holdings. This means that Acme represents just 1.5% of my total investment. After six months Acme shares have lost 15%, but this is only £150 of the total £10,000 investment. Whatever Acme shares do will only affect 10% of my total investment. Let's hope the other shares in my portfolio have performed better!

Experts advise that investment in shares should be considered a long-term investment, with a minimum five-year timescale.

2.2.2 What makes up 'attitude to risk'?

There are two parts to attitude to risk.

1. **Risk tolerance** – how does the individual feel about the possibility that the value of their savings could fluctuate over time, and that they could even lose some of their funds? This is not based on hard facts, but on the person's feelings.
2. **Capacity for loss** – this is based more on hard facts. It describes the amount of money the person could afford to lose (or needs to risk) when trying to achieve their objectives. For example, if we have £10,000 in the bank today and really want to buy a car next year for £10,000, we will not need to take any risk. The money is already there and we can't afford to (and need not) take any risk; our capacity for risk would be nil. However, if we have £10,000 available to invest today and want to buy a holiday home in 20 years' time for £50,000, we will need to take some risk, because putting it in a bank deposit account will not meet the target.

If we aren't happy to take the risk, then the target cannot be achieved and we will need to change plans. In reality, a 20-year timescale means that we could afford to take some risk and be reasonably confident that it would work out.

We've looked so far at the different life stages, the likely needs that occur during each stage and how attitude to risk is an important part of financial planning. Now let's consider some typical people and their different financial considerations, concerns or needs.

Case studies

Angela and John

John

I am 67 and married to Angela, who is 63. We're both retired and have paid off our mortgage, so we own our home.

Angela

We both have reasonable pensions, but we're going to need more money to do all the things we'd like to do in retirement.

Dave and Sheila

Sheila

Dave and I are both in our late 40s and have been married for 28 years. We have two adult children: Jenny, who lives with her boyfriend Kyle; and Andrew, 22, who is in his final year at university in the USA. I work part-time in a local nursery.

Dave

I'm a manager for a large retail organisation, and I'm excited because I've recently been told I'm being considered for a manager's role at a much larger local store.

Jenny and Kyle

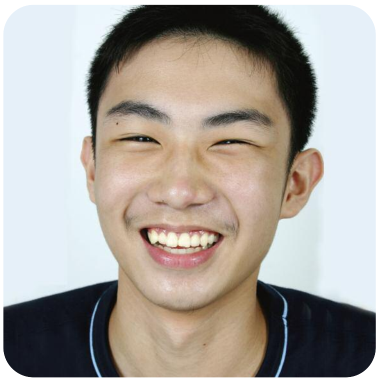
Kyle

Jenny and I are both 25, have been together for three years and live in a small rented flat. I'm a self-employed hairdresser.

Jenny

I'm in a junior position at the moment, but in a job where I can work my way up the career ladder in a good company. I also have an evening job to supplement my income.

Kristian



Kristian

I'm 16 and live with my mum and dad. I've just passed 11 GCSEs with good grades and am starting my A levels. If all goes according to plan, I want to go to university to study law.

Discuss

Here's a list of 12 typical considerations, concerns or needs of people at certain life stages:

- thinking about starting a family;
- saving for a house;
- being close to paying off the mortgage;
- earning more than at any other time;
- raising money from their home;
- concerned about providing for retirement;
- converting savings into income;
- receiving a weekly allowance;
- making sure their money goes to the family when they die;
- saving for a wedding;
- having a part-time job at weekends;
- being mainly dependent on others.

Now copy out Table 2.1 (on the next page). Identify in the right-hand column which three factors would be most likely to apply to each of the people in the left-hand column. So, for example, which three factors are most likely to concern Dave and Sheila?

When you have matched all the items on the list to the relevant people, consider any that could also apply to other people in the list. Discuss why.

Table 2.1 Considerations, concerns or needs of people at different life stages

Name	Considerations, concerns and needs
Angela and John	
Dave and Sheila	
Jenny and Kyle	
Kristian	

Suggested answers are given at the end of the topic.

Summary

Finally, we can recap what we have learned in this topic.

We have learned:

- the differing financial needs of typical people at different stages of the life-cycle;
- the meaning of the term ‘risk vs reward’;
- how attitude to risk is an important part of financial planning.

Key terms

Capacity for loss – the amount of money that a person could afford to lose (or needs to risk) when trying to achieve their objectives.

Corporate bonds – are similar to gilts (see below) in the way that they work, but the borrower would be a large company, rather than the government.

Gilts – the full name for these is 'gilt-edged securities', which derives from the fact that the certificates used to be edged in gilt (ie covered thinly with gold leaf or gold paint). The government issues gilts when it needs to borrow money, and promises to pay a guaranteed rate of interest each year and repay the money at the end of the term. Gilts usually have a fixed term of between 5 and 30 years and are usually bought by large organisations and investment companies.

Life stages – people go through a number of stages in their life. Each stage is based on their age. Each of the stages has its own typical opportunities, challenges and needs.

Risk tolerance – how the individual feels about the possibility that the value of their savings could fluctuate over time and that they could even lose some of their funds.

Shares – the name derives from the fact that the shareholder actually owns a share in the company. Shares will go up or down in value, according to how investors and large financial organisations think the company is doing.

Stock market – a system that regulates the way shares are issued, valued and sold, and through which shares are traded.

Volatility – a measure of the extent to which a value goes up or down over a period of time. High volatility means higher risk.

Suggested answers for Table 2.1

Name	Considerations, concerns and needs
Angela and John	Converting savings into income.
	Making sure their money goes to the family when they die.
	Raising money from their home.
Dave and Sheila	Earning more than at any other time.
	Being close to paying off the mortgage.
	Concerned about providing for retirement.
Jenny and Kyle	Saving for a house.
	Saving for a wedding.
	Thinking about starting a family.
Kristian	Receiving a weekly allowance.
	Having a part-time job at weekends.
	Being mainly dependent on others.

Bibliography and further reading

Barclays (no date) *Risk and return* – available at:
www.barclays.co.uk/BarclaysInvestorZone/Understandingyourattitudetorisk/P1242582567863