Cytonn INVESTMENTS

Personal Financial Planning, & Cytonn Weekly #08/2020

Focus of the Week

More often than not, we face various financial obligations in different stages of life ranging from medical expenses, education expenses, and other miscellaneous expenses. In our Cytonn Weekly #07/2020, we focused on Education Investment Plans in Kenya and elaborated on why one should invest in an education plan. This week, we revisit the Personal Financial Planning topic where we discuss the importance of financial planning, the various considerations to make based on one's own characteristics, needs and preferences and some of the investment avenues available.

Therefore, we shall be discussing the following:

I. What is Personal Financial Planning and Why is it Important?
II. The Financial Planning Process,
III. The Key Considerations to Make When Coming Up With a Financial Planning Strategy,
IV. Investment Avenues Available and the Steps or Process of Selecting the Most Suitable Avenue, and,
V. Conclusion.

Section 1: What Is Personal Financial Planning and Why is it Important?

Personal Financial Planning refers to a systematic approach towards managing one's finances by allocating resources optimally in an effort to maximize the use of these resources in order to achieve one's financial goals and objectives. Having a sound personal financial plan is important because it helps reduce and possibly eliminate financial distress arising from various responsibilities and unexpected situations. It is key to note that financial planning largely depends on one's age, income level, risk tolerance, the responsibilities at hand, and future objectives. These factors have led to the broad classification of investors into three phases:

- **Accumulation Phase**: It constitutes the young population of ages 18- 30. Their net worth is low and restricts them to low-priced investments. Nevertheless, they have a high-risk tolerance because of their long-term investment lifespan since a loss incurred during this phase can be recovered in the next investment cycle,
- **Consolidation Phase**: It encompasses the middle age income earners of ages 30-55. At this stage, the net worth of individuals is relatively high since payment of school loans does not burden them like those in the previous stage. They can afford a range of investment commodities. However, their risk tolerance is lower than that of individuals in the accumulation phase. They seek out ventures that would not imbalance their accumulated capital while still investing to offset inflationary rates, and,
- **Spending/ Gifting Phase**: Most people at this stage are retired and are of ages 55 and beyond. Their source of income is majorly from the investments held. They have a low-risk tolerance and prefer little to no risk investments.

It is critical to evaluate these three phases before launching a financial map. Once an individual identifies the appropriate classification, one should be able to determine the personal optimal plan. After this evaluation, we describe the process of creating a financial plan.

Section 2: The Financial Planning Process

Personal financial planning is a continuous process founded on four pillars namely; budgeting, saving, investing and debt management. The planning process takes into account every aspect of your financial situation and how they affect your ability to achieve your goals and objectives. Achieving financial freedom can be through the following steps:

A. **Assessment:** This step involves identifying factors that are likely to affect one's financial plan by evaluating his/her income, spending habits, lifestyle and see how each of them will affect their financial plan,
B. **Goal Setting:** In this step, one should outline their financial end goal before developing financial action plans. An individual could have multiple goals, some long-term and others short-term. Usually, financial goals and priorities attached to them differ by person and change over time and therefore it influences the path one takes towards the achievement of their financial objective. Your financial planning goals should be measurable and achievable by one or a combination of the following four practices:

- **Saving -** Saving basically means deferred consumption and entails consuming less out of a given amount of resources in the present in order to consume more in the future by setting aside part of your income in some form of asset. Efficient saving requires discipline. While saving, it is important to treat savings as a necessary expense and have a plan. Here are a few tips to guide you. Firstly, save with a goal. Secondly, save first, and then spend what you have left. Thirdly, don't just save, invest,
- **Investing** - Saving is often confused with investing, but they are not the same. Saving allows you to earn a lower return but with no risk involved, while investing gives a higher return but at the risk of loss. Investing involves the purchase of an asset with the hope of generating some income in future or the asset appreciating hence being able to sell it at a profit. There are different asset classes that one can consider and an investor will choose the different vehicles based on their risk appetite, the returns expected and the liquidity requirement. As you invest, it is important to diversify one's portfolio through investing in different instruments in a bid to mitigate risk,
- **Debt and Debt Management** – Is debt good or not? Debt is only good if used towards an investment or for future financial gain such as business, education, or property. However, it is advisable to take up debt for investment only if the economic rate of return, which is simply how an investment's economic benefits compare to its costs, are able to finance the debt repayment. Here are a few do's and don'ts for debt management;

  1. Plan before you borrow,
  2. You should never use more than 1/3 of your net income in loan repayment,
  3. Never borrow for things you desire but don't need,
  4. Avoid borrowing on consumption items, and,
  5. Live within your means.

- **Budgeting –** Budgeting is simply creating a plan on how to spend your money. It is important that you have the discipline to create a budget around the resources you have and stick to it. When budgeting, prioritize your needs and necessary expenses and try as much as possible to cut down on unnecessary expenses to save money,

C. **Plan Creation and Execution:** The financial plan is a well-detailed process of how one intends to accomplish the goals in the step above, how long it would take to achieve said goals and the best

strategy for achieving those goals. Execution refers to how best to put the created plan to action. A well laid out plan should highlight the following items:

1. **Suitable channels and investment instruments to achieve your goals-** This involves selecting the best strategies to achieve your financial targets. This may be through saving, proper budgeting, cutting on expenses, and through investing, and,
2. **Timelines-** Depending on whether your goals are long term or short term, your plan should indicate how long you are willing to invest in a given investment instrument. Long-term investments, such as bonds and real estate, may be most suitable for long-term goals and short-term investments, such as money markets, are suitable for short term investments, and,

D. **Monitoring and Reassessment:** Financial planning is a continuous process because goals and priorities change over time and therefore monitoring a financial plan for possible adjustments or reassessments is necessary. A review allows you to analyze individual investments and determine if they are helping in the achievement of your goals. The following factors should prompt one to make changes on their financial plan during a review:

- **Status of Set Goals-** Achievement of pre-determined goals should prompt you to change your financial plan. If the goals are yet to be achieved it is necessary to determine if they can still be achieved, given the present circumstances,
- **Change in Income-** A change in income levels directly impacts your financial plan because it may require a change in priorities and may also lead to early maturity or a delay of set goals and therefore affect the set timelines,
- **Number of Dependents-** An increase/ decrease in the number of dependents may mean that one has less or more disposable income to put into investments, and,
- **Change in Risk Appetite and Risk Tolerance-** Factors such as age, number of dependents and income levels of an individual affect the risk appetite and tolerance of individuals, therefore their financial plan should adjust to suit their new risk appetite and tolerance.

Section 3: The Key Considerations to Make When Coming Up With a Financial Planning Strategy

The investment considerations made will largely depend on one's individual risk tolerance and appetite, which largely depends on age and the level of income. Some of the factors likely to inform one's financial plan include:

- **Age**- Younger people have a longer time horizon and can, therefore, make riskier investment decisions as they have time to recover if they end up making losses. Their investments are mostly in real estate and equities, which allow the investor time to grow value in their investment. For older people, the time horizon is shorter and therefore they are averse to high-risk investments. Safer investment options are preferred because they offer steady and predictable income, with their investments skewed towards government-backed assets such as bills and bonds, which offer an almost guaranteed return after a given period. They may also invest in various collective investment schemes such as fixed income or money market funds, which are professionally managed, offer liquidity, periodic income, and principal protection,
- **Risk Profile**- Risk is the potential threat that may affect the outcome of your investments and individuals either tolerate or avoid risk. Risk-averse individuals generally avoid riskier investment decisions. Their financial planning decisions are geared towards safer investment plans and their portfolio will most likely include investment instruments such as treasury bonds, bills, and bank deposits. They can also invest in these securities through money market funds or fixed income funds. Risk-takers, on the other hand, will channel their planning towards high-risk investments such as real estate and equities, with the aim of generating higher returns,
- **Income**- A change in an individual's income affects their disposable income and the amount of money they have left to invest. The investment vehicles one uses in achieving their financial goals is dependent on their level of income. Low-income earners can gain access to various securities

such as bank deposits, treasury bills, bonds and equities through the various types of collective investment schemes and structured products given the relatively lower initial investment requirement,

- **Investment Goals**- What an individual hopes to achieve will determine the type of investment they venture into long term or short-term investments. Investment goals address two major themes regarding money and money management. First, they generate accountability, forcing individuals to review progress from time to time and second, they help in generating motivation, and,
- **Marital Status and Number of Dependents**- People with few dependents have the freedom to make riskier investment decisions as compared to those with many people depending on their income. Married individuals often prioritize their families and would always look for less risky portfolios due to their responsibilities in the family.

The table below summarizes the investment allocation depending on the highlighted factors.

Investors Age	Expected Risk Profile	Income Level	Skew investments towards	Reasoning
Below 25	High	Low to Medium	Collective Investment Schemes, Pensions, and Equities	Has a long investment horizon to withstand volatility and get enhanced returns
25- 35	High	Medium to high	Collective Investment Schemes, Pensions, Real Estate and Equities	Few cash flow requirements. Still has time to withstand volatility
35-45	Medium	Medium to high	Pensions, Collective Investment Schemes, Real Estate, Equities, and Fixed Income	There are constant cash flow obligations. Still has time to withstand medium volatility
45-55	Medium	Medium to high (Generating income from prior investments)	Real Estate, Equities, and Fixed Income	There are constant cash flow obligations. Still has time to withstand medium volatility
Above 60	Low	Low or non-existent	REITs and Fixed Income	Stability of income is key

Section 4: Investment Avenues Available and the Steps or Process of Selecting the Most Suitable Avenue

The achievement of long-term financial safety involves undertaking various investment projects that would not only build wealth but also secure it. As highlighted in our previous report on investment options in the Kenyan Market, numerous investment options available appeal to different classes of investors. Investors decide on different channels based on their risk appetite, the returns expected and the liquidity requirement. Investment products available are broadly categorized into two categories:

i. Traditional Investments
ii. Alternative Investments

Traditional investments involve putting capital into well-known assets that are sometimes referred to as public-market investments. The main categories of traditional investment products under this category include:

- **Equities**- Equities, otherwise known as stocks, represent an ownership interest in a company. They are traditional investments that are relatively liquid, highly volatile and hence considered risky. They are suitable investment options for long-term investors and offer returns in form of dividends and capital appreciation. To invest in the equities market in Kenya, one would need to open a Central Depository and Settlement (CDS) account, which is an electronic account that holds your shares and bonds, and allows for the process of transferring of shares at the Securities Exchange, through a licensed stockbroker,
- **Fixed Income**- These securities offer fixed returns to investors in the form of fixed periodic

interest payments and the repayment of the principal upon maturity. They are also that are moderately liquid, have low volatility and hence considered less risky. They are suitable for medium-term to long-term investors and offer returns in form of interest income and capital appreciation. They include fixed deposits, Treasury bills and bonds, and commercial papers,

- **Mutual Funds / Unit Trust Funds**- This is a Collective Investment Scheme that presents investors with an opportunity to participate in the various asset classes with no professional expertise and low capital by pooling money together from many investors. The funds are managed by a professional fund manager who invests the pooled funds in a portfolio of securities to achieve objectives of the trust. The funds in the mutual fund earn income in the form of dividends, interest income and/or capital gains depending on the asset class the funds are invested in. The following are the main types of funds:

a. **Money Market Fund**- This fund mainly invests in short-term debt securities with high credit quality such as bank deposits, treasury bills, and commercial paper. The fund is best suited for investors who require a low-risk investment that offers capital stability, liquidity and a high-income yield. The fund is a good safe haven for investors who wish to switch from a higher risk portfolio to a low risk, high-interest portfolio, especially during times of high stock market volatility,
b. **Equity Fund**- This type of fund aims to offer superior returns over the medium to longer-term by maximizing capital gains through investing in listed securities. This fund is suited for investors seeking medium to long-term capital growth in their portfolios and want to gain exposure to equity investments. The fund has a medium to high-risk profile. Due to the volatile nature of the stock markets, risk is usually reduced through holding a diversified portfolio of shares across different sectors,
c. **Fixed Income Fund** – This fund invests in interest-bearing securities, which include treasury bills, treasury bonds, preference shares, corporate bonds, loan stock, approved securities, notes and liquid assets consistent with the portfolio’s investment objective. The fund is suitable for investors who are seeking a regular income from their investment, including those who intend to secure a safe haven for their investments in times of stock market instability,
d. **Balanced Fund** – This fund invests in a diversified spread of equities and fixed income securities with the objective to offer investors a reasonable level of current income and long-term capital growth. The fund is suited to investors who seek to invest in a balanced portfolio offering exposure to all sectors of the market. It is also suitable for pension schemes, treasury portfolios of institutional clients, co-operatives and high net worth individuals amongst others. The fund is a medium risk fund and has a medium risk profile. For more information on Unit Trust Funds, see our topical on Investing in Unit Trust Funds, and,
e. **High Yield Fund** – This type of fund invests in securities that generally pay above average interests and dividends, with the fund’s objective being delivery of high returns to investors. The fund has a high-risk profile and is suited for long-term investors who are looking for growth of their portfolios over-time.

Alternative investments are those that fall outside the conventional investment types such as publicly-traded stocks, bonds, and cash. The most common alternative investments today are:

- **Real Estate** - This involves investment in property and land. Real Estate is considered an alternative investment that is illiquid, relatively stable and uncorrelated to traditional investments. They are suitable for long-term investment plans, which makes them a risky investment. Real Estate can yield high returns, and is useful for diversification and as a hedge against inflation since its value increases over time. Real Estate offers returns in the form of rental yield and price appreciation, and,
- **Private Equity -** It generally involves buying shares in companies that are not listed on a public exchange or buying shares of public companies with the intent to make them private. Private equity can involve many strategies that may help provide money to companies at different stages

of their development. The most widely used strategies are venture capital, buyouts and distressed investing.

The myriad of possibilities can leave an individual confused about the ideal product. In determining the appropriate investment option, one should consider:

- **The rate of return**- A rational investor seeks out a venture that would provide maximum return for a given level of risk,
- **The cost of the investment**- One should harbor the same sentiments in purchasing an investment as they do in buying groceries. The price of the investment is a key element. Over time, the returns received should exceed the cost of the investment,
- **Liquidity needs and time horizon for investment-** The liquidity varies from one asset to another. An individual must evaluate the target for the investment chosen and the length of time they for which they require illiquid assets, and,
- **The regulatory and legal constraints placed on the venture**- Awareness of the tax treatments that the selected investment options are subject to assists one in evaluating their longstanding returns.

Section 5: Conclusion

With proper financial planning, financial peace of mind is guaranteed no matter the stage of life one is in. Personal financial planning is important for an individual's present and future financial stability. Financial planning is important for the following reasons:

1. **Income Management** – It is easier to manage your income more effectively through planning. Managing incomes helps you understand your necessary expenses and also helps you to pick out wasteful expenditures and adapt quickly when your financial situation changes,
2. **Improving the standard of living**- The savings and investments created through proper planning act as a cushion during financial times,
3. **Defining Financial Goals** – Clear financial goals enables you to focus on execution, ultimately increasing the chances of realizing your goals and helps in avoid financial distractions, such as unnecessary expenses e.g. impulse purchases, by enhancing accountability,
4. **Act as a guide for Investments** – One is able to choose the right investments to fit their needs since a financial plan considers their personal circumstance, objectives and risk tolerance,
5. **Financial Understanding** – Understanding the effects of financial decisions and reviewing the results of these decisions can be achieved through measurable financial goals. One is able to understand better and take control of their financial lifestyle,
6. **Asset-Liability Management** – Through the creation of a budget where one looks at their income versus their expenses, one is able to distinguish the real value of an asset since some of them come with liabilities attached to it and therefore understand how to settle or cancel such liabilities. For example; buying a car that needs to be serviced every 3-months, needs to fueled and requires an insurance cover in case of accidents,
7. **Precautionary Motive** – One is able to plan for emergencies by setting aside investments of high liquidity such as a money market fund or bank deposit, that act as a safety net,
8. **Comfortable Retirement**- Enjoying retirement is easy with a stable source of income and given that formal employment is no longer an option, it is important to sign up to a registered Retirement Benefits Scheme and make regular contributions in your employed years. Other benefits of saving through a retirement benefits scheme, aside from alleviating poverty include:
   a. Provision of regular income to replace earnings in retirement, and,
   b. Provision of lump-sum benefit income for surviving dependents in the event of your passing.

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The Chancery, Valley Road
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